



Delivering equitable growth

Strategies for the next Administration



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Delivering equitable growth: Strategies for the next Administration

This series of essays serves as a guide to the two presidential transition teams, highlighting academic experts and their ideas on a wide range of economic policy issues core to our country's future.

Ideas about what does—and what does not—make the economy grow are at the core of our national economic debate. The U.S. economy underwent dramatic structural changes over the past three decades, with one of the most profound being the rise in economic inequality. Data from University of California-Berkeley economist Emmanuel Saez shows that share of income accruing to the top one percent grew dramatically, from 34.2 percent in 1979 to 50.5 percent in 2015. Analysis from the non-partisan Congressional Budget Office finds that while incomes for the top one

percent grew by 187 percent between 1979 and 2013, incomes for the middle 60 percent of American households grew by just 32 percent over that same period. This period of rising inequality has been matched by a three-decade long deceleration in the rate of U.S. economic growth.

The Washington Center for Equitable Growth is proud to be a hub for economists and other scholars who are actively working to come to terms with what these changes mean—and what the research implies for policymaking. Making evidence-informed policy requires knowing the research, and, perhaps even more importantly, knowing who to rely on for smart ideas. As the next Administration gears up to govern, building out this network of ideas and scholars is critical. To that end, we introduce “Delivering equitable growth: strategies for the next Administration.” This series of essays highlights academic experts and their ideas on a wide range of economic policy issues core to our country’s future.

These essays are neither a platform nor a position statement. Rather, they represent a diverse range of academic experts writing in their own words about an economic problems facing our society, summarizing the research that defines those problems, and proposing solutions informed by that research. Scholars tackled topics ranging from policies affecting families, businesses, capital and markets, and communities. Equitable Growth provided copy editing and layout assistance for the essays.

These essays are meant to be a starting place for the next Administration’s engagement with Equitable Growth’s rapidly growing network of academics who are part of the evidence-driven conversation about the future of U.S. economic policy. We hope that our efforts provide a launch-point for elevating new voices and new ideas into the conversation, as well as highlighting the evidence behind ideas that have been part of the conversation for quite some time.

Don’t hesitate to reach out if you are interested in speaking with one of the authors or in learning more about the Washington Center for Equitable Growth.

Elisabeth Jacobs

Senior Director, Policy

Washington Center for Equitable Growth

Policy Issue: The tipped minimum wage

Two and a Half Decades: Still Waiting for Change

By **Sylvia A. Allegretto, University of California-Berkeley**

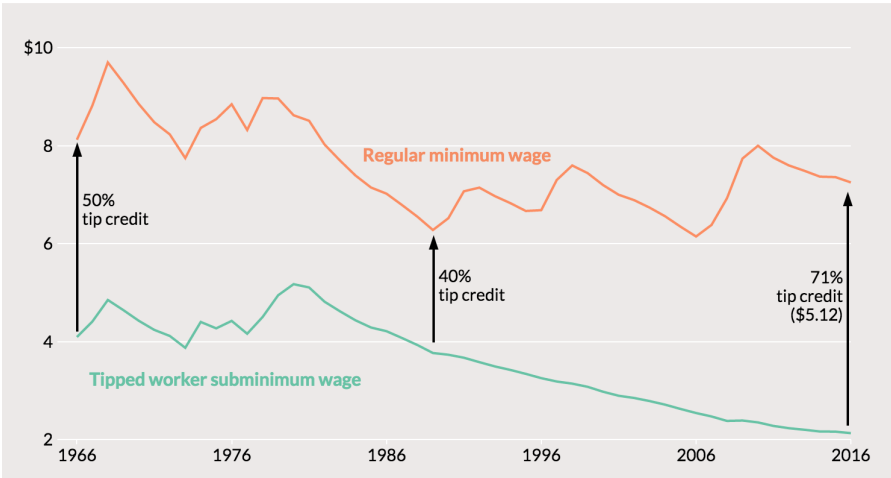
Over the past few years, minimum wage policy has been propelled to the forefront of the economic debate boosted by “Occupy Wall Street,” the “Fight for \$15,” and other pro-worker campaigns. One result has been the adoption of numerous minimum wage policies at state and local levels that increased wages for many of our lowest-paid workers. Much action on the minimum wage front is owed to the discussion on inequality as it relates to decades of stagnating or falling wages at the bottom end of the pay scale coupled with the long erosion of the federal minimum wage. Often overlooked in wage policy is the recognition that the federal subminimum wage received by tipped workers has been frozen at \$2.13 since 1991.¹ There is often confusion and misinformation around the sub-wage floor, the workers who earn it, and the two-tiered system that makes it possible. Future debate and policy consideration on wage floors must include the often forgotten subminimum wage workforce.

This essay shows that tipped workers are overwhelmingly female who typically earn low wages. They also have few workplace benefits, live disproportionately in poverty, and experience high rates of sexual harassment—especially in states that set their sub-wage floor at \$2.13. These workers also face workplace challenges unique to tipped workers such as unreliable shifts that result in extreme fluctuations in pay. Importantly, the full-service restaurant industry that employs most of the tipped workforce is rapidly growing and is becoming a larger share of the overall workforce—this is the case even in the states that do not allow for a subminimum wage.²

A bit of history will lend some perspective. In 1938 the Fair Labor Standards Act, a New Deal initiative, was signed into law. The new law banned oppressive child labor, set the maximum workweek at 44 hours, and established the first minimum wage at 25¢ an hour. But the law applied to few industries whose combined employment represented about one-fifth of the labor force. The 1966 amendment extended protections to hotel, restaurant, and other service workers who had previously been excluded. At the same time it punctured a permanent hole in the law’s umbrella via the introduction of a “subminimum wage” to be paid to workers who “customarily and regularly receive tips” —otherwise, most of the newly covered workforce.³

The two-tiered system is dependent upon the tip-credit provision—in other words, the amount of the wage bill an employer can pass on to customers in the form of tips. Thus tips are, at least in part, a wage subsidy provided by customers to employers and the subsidy has grown considerably over time. Both wage floors, after adjusting for inflation, are trending downward over time—the difference between them is the allowable federal tip credit. Customers now pay the lion’s share (71 percent) of a tipped worker’s wage bill—while employers pay a base wage that is just 29 percent of the regular minimum wage. (See Figure 1.)

FIGURE 1
Real value of the federal minimum and subminimum wage, 1966-2016
 2016 dollars, adjusted using the CPI-RS. Tip credit shows the difference between the regular minimum wage and the subminimum wage



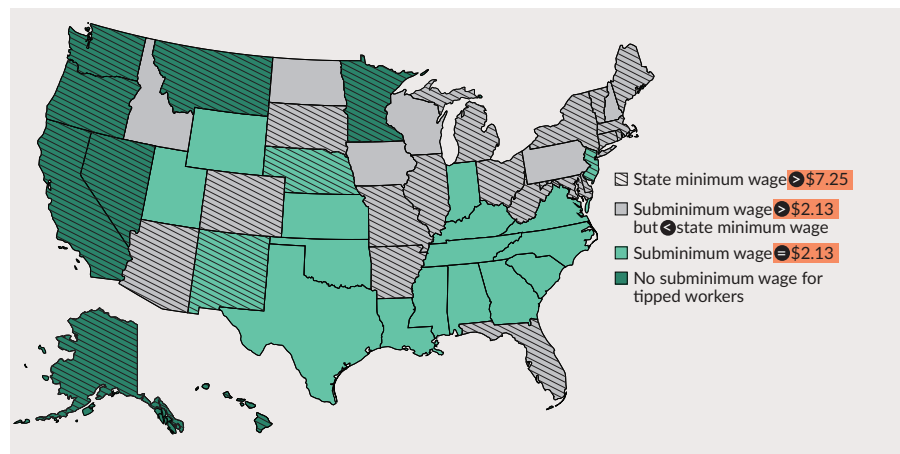
Note: Assuming 1.5% inflation for 2016. Minimum or tipped wage changes that occurred mid-year are averaged.



There is a sort of quasi-natural experiment being conducted across the country as there are three general state policy scenarios regarding tipped wages. Additionally,

each state’s regular minimum wage is set at the federal policy of \$7.25 or above.⁴ There are 18 states that follow the federal policy of \$2.13 (that is, they take advantage of the full tip credit provision) and most also have a \$7.25 minimum wage. On the other end of the spectrum there are seven states that do not allow for a subminimum wage (states without a tip credit provision)—all seven also have regular minimums above the \$7.25 federal level including \$10.00, \$9.75, and \$9.50 in California, Oregon and Minnesota, respectively. In between there are 25 states and the District of Columbia that pay tipped wages above \$2.13 but below their state regular minimums, which take advantage of a large range of partial tip credit provisions. (See Figure 2.)

FIGURE 2
State minimum wage and subminimum wage policy, 2016



Note: Data current as of September 2016



The majority of these states also have minimums above the federal rate. The largest tip credit is \$8.73 in Washington DC, where the minimum wage is \$11.50 and the tipped wage is \$2.77, meaning customers pay 76 percent of the wage bill for tipped staff.

Subminimum wage workers

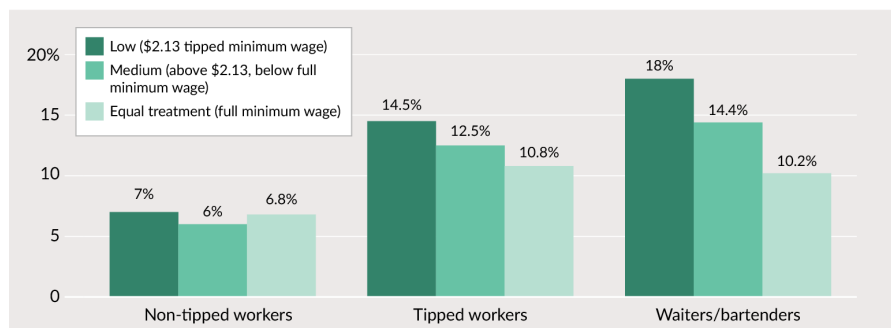
A common misconception is that wait staff and other tipped workers make “a lot” of money; thus there is no need for concern. Sure, there are some workers in fine dining restaurants where large bills may result in generous tips and decent annual earnings, but this is the exception. Tipped workers are most commonly working at modest establishments—think of those working at a Denny’s in Alabama, a diner in rural Pennsylvania, or at a 24-hour truck stop in Texas.

Here I draw from an issue brief on tipped workers and the tip credit as well as a published peer-reviewed academic paper on the wage-and-employment effects of subminimum wages in the United States to bring some salient facts to light.⁵ Tipped workers, like minimum wage workers, are often thought of as young workers just getting a foot in the door of employment. The reality is that 63 percent of tipped workers are at least 25 years old, the vast majority (67 percent) are women, and among female workers, one in three have children. The typical hourly wage of tipped workers in the United States is \$10.55 including tips. For wait staff and bartenders, who represent the largest share of the tipped workforce, it is \$10.44. Importantly, average hourly earnings of tipped workers is about 21 percent higher in states that do not have a sub-wage floor compared to states that follow the federal \$2.13 policy.

The norm is that workers in tipped occupations are overwhelmingly low-wage earners.⁶ Even as the tipped workforce in states without a sub-wage floor has relatively higher earnings, those working full-time, full-year, are typically earning just around \$24,000 annually. Low wages translate into low family incomes for many tipped workers. About 30.5 percent of all U.S. workers are in families that earn less than \$40,000. That share jumps to 47.2 percent for all tipped workers and 49.9 percent for waiters and bartenders (52 percent for female waiters and bartenders).⁷

Tipped workers and their families experience elevated rates of poverty. The U.S. poverty rate of non-tipped workers is 6.5 percent, while it is 12.8 percent for the tipped workforce, and 14.9 percent for waiters and bartenders.⁸ Importantly, poverty rates for non-tipped workers do not vary much by state tipped-wage policies. (See Figure 3.)

FIGURE 3
Poverty rates of three types of workers by state tip wage
 Percent of workers below the poverty line



Source: Authors' analysis of Current Population Survey Annual Social and Economic Supplement microdata, 2010-2012



Yet for tipped workers, and particularly for waiters and bartenders, the negative correlation between low-tipped wages and high poverty rates is dramatic. Among wait staff and bartenders, for example, 18.0 percent are in poverty in states that follow the \$2.13 subminimum wage, compared with 14.4 percent in medium-tipped-wage states, and 10.2 percent in states without a sub-wage floor. This pattern strongly suggests that higher tipped wages mitigate poverty to some extent, yet it is still the case that poverty among tipped workers is far too high even in states that do not allow for a subminimum wage.

Unique challenges facing tipped workers

For any job, overall job quality is important and goes beyond wages to include benefits such as paid sick leave, paid vacation, health insurance, and retirement. Job quality also includes other important issues such as workplace conditions, worker voice, and scheduling practices. In previous work I documented that tipped workers are far less likely to receive even the basic benefits such as paid sick leave let alone benefits such as retirement or disability.⁹ For instance, the problem of sick restaurant workers handling food is real—just 23 percent of all workers in the Accommodation and Food Services industry are offered paid sick leave compared to 61 percent of the private sector workforce. This low figure includes managers and supervisors and is undoubtedly much lower for tipped staff.¹⁰ Many workers simply cannot afford to take leave when they are sick.

Many tipped workers, especially in states with the \$2.13 sub-minimum wage, effectively go home after each shift with the tips they are left with *after* they “tip-out” other staff such as hostesses, bartenders, bar backs, and bus persons. These workers also owe taxes on tips and their hourly base pay—which means they are often without a regular pay check. Thus pay is often based solely on tips that vary tremendously by the day of the week and the time of a scheduled shift. Schedules can vary down to an hourly basis at the whim of an owner or manager, as restaurants and bars are intense users of “just-in-time” employment practices. This means that many workers cannot even rely on the hours of a pre-scheduled shift, as restaurants and bars often utilize a “first one in, first one out” practice determined solely by customer demand. Constantly changing shifts make it difficult to have a second job or to plan for childcare.

As mentioned earlier, in states that allow for a subminimum wage, a worker’s tips plus their tip wage must equate to at least the regular state minimum wage. If not,

the employer must make up the difference. This poses several problems. First, if the law is even known, it often puts the onus of enforcement on tipped workers who may not feel comfortable confronting management about whether they were shorted on wages, to remedy the situation. Additionally, this regulation is difficult to implement in practice. First, it is logistically difficult as many tipped workers work irregular schedules. Second, a portion of tips are often given to secondarily tipped workers. Third, management would need an accounting system to keep track of pay, hours, and actual tips. And finally, at what point does an employer stop the clock to tally up hours, tips, and base wages?

Time and again, where there is adequate monitoring by regulators, they find that non-compliance is an issue especially in the full-service restaurant industry. A 2010–2012 compliance sweep of nearly 9,000 full-service restaurants by the U.S. Department of Labor’s Wage and Hour Division found that 83.8 percent of investigated restaurants had some type of violation. In total, the federal government recovered \$56.8 million in back wages for nearly 82,000 workers, assessing \$2.5 million in civil money penalties. Violations included 1,170 tip-credit infractions that resulted in nearly \$5.5 million in back wages.¹¹ Most states do not have adequate investigators to monitor sufficiently the tipped wage workforce and the two-tiered system.

Research shows that the practice of tipping is often discriminatory and harmful to workers. For instance, white service workers receive larger tips than black service workers for the same quality of service.¹² Michael Lynn, an expert on tipping and the Burton M. Sack Professor in Food & Beverage Management at the Cornell University’s School of Hotel Administration, reports on a range of aspects regarding tipping, such as how tips vary by race, physical appearance, and religious affiliation.¹³ The worker advocacy group Restaurant Opportunities Centers United has published numerous testimonies that echo what I have found in much of my work. Their reports, based on worker surveys, document an array of problems from low earnings and low-to-no benefits, to overtime violations, working off the clock, and issues of safety.¹⁴

Of particular importance, given the overwhelmingly female-dominated tipped employee workforce, is the incidence of sexual improprieties. Restaurant Opportunities Centers United reports that in the states with the \$2.13 subminimum wage tipped female workers are twice as likely to experience sexual harassment compared to those working in states that pay the full minimum wage to all workers.¹⁵ In fact, all workers in these \$2.13 states, including men, reported higher

rates of sexual harassment, indicating that the sub-wage floor may perpetuate incidences of sexual harassment.

The protections of union representation could help many workers with issues of pay, benefits, scheduling, and unfair and dangerous working conditions. Yet just 1.9 percent of workers in food services and drinking places are represented by a union.¹⁶ This is one reason why worker organizations, such as Restaurant Opportunities Centers United, exist—to help to give workers justice and a fair voice in the workplace.

Policy action

The most basic question concerning the tipped wage is who should pay the workers—employers who hire them or by means of customer tips? The quasi-natural wage floor experiment going on across the county is proof at the very least that the \$2.13 federal subminimum wage can easily and without undue economic harm be increased.¹⁷ The restaurant industry is booming in states that do not allow for subminimum wages—and those no-tip-credit states also have regular minimums significantly above \$7.25. Lending credence to the immediacy of policy action are the low wages, low-to-no benefits, and high poverty rates of tipped workers, especially acute for women in states that follow the federal \$2.13 sub-wage floor.

Furthermore, 46 percent of tipped workers and their families rely on public assistance to make ends meet—compared to 35.5 percent of the non-tipped workforce.¹⁸ It is good policy that low-wage workers can turn to public assistance for help, but these programs were not designed to serve as a permanent wage subsidy or part of the business strategy for low-wage employers.

Relevant to all low-wage workers, and even to middle-tier workers, is an imperative to increase wage growth, enforce and strengthen labor protections, and provide a seamless path to unionize. We also need to upgrade workplace benefits and scheduling practices. How can it be that of all advanced economies in the world, it is the U.S. worker who, regardless of anything, gets no mandated paid time off? After a quarter of a century, the time is past due to raise the federal subminimum wage (along with the minimum wage) and have a discussion about the merits of complete abolishment of this sub-wage floor. A stronger wage policy would be a start to address two of the biggest problems in our economy—growing inequality and poverty among the working poor.

—*Sylvia A. Allegretto, Ph.D. is an economist and Co-chair of the Center on Wage and Employment Dynamics at the Institute for Research on Labor and Employment, University of California-Berkeley*

Endnotes

- 1 The Minimum Wage Increase Act of 1996 froze, in perpetuity, the \$2.13 subminimum wage—thereby eliminating the original Federal Labor Standards Act statute that required the tipped minimum wage to be a certain percentage of the full minimum wage.
- 2 Since 1990, employment growth is up 98 percent up in full-service restaurants compared to private-sector job growth of just 30 percent over the same time frame. (Data from U.S. Department of Labor, Bureau of Labor Statistics. Quarterly Census of Employment and Wages. Analysis of annual data 1990-2015 for private sector employment and the full-service restaurant industry.)
- 3 The institution of tipping is based in racialized ideology and tied to slavery. For more see: Saru Jayaraman, *Forked: A New Standard for American Dining*, (New York, NY: Oxford University Press, 2016).
- 4 Wage-floor policies change frequently and up to date information can be found at the Economic Policy Institute's Minimum and Subminimum Wage Tracker: http://www.epi.org/minimum-wage-tracker/#/min_wage/Washington
- 5 Sylvia A. Allegretto and David Cooper, "Twenty-Three Years and Still Waiting for Change: Why It's Time to Give Tipped Workers the Regular Minimum Wage," (Economic Policy Institute, Washington DC, 2014) and Center on Wage and Employment Dynamics, University of California-Berkeley, briefing paper at <http://www.irle.berkeley.edu/cwed/briefs/EPI-CWED-BP379-1.pdf>. See also Sylvia A. Allegretto and Carl Nadler, "Tipped Wage Effects on Earnings and Employment in Full-Service Restaurants," *Industrial Relations: A Journal of Economy and Society* 54, no. 4 (2015): 622–647, (2015) at <http://www.irle.berkeley.edu/cwed/allegretto/pubs/AllegrettoNadler.pdf>
- 6 For other sources on U.S. wage floors see White House Report, "The Impact of Raising the Minimum Wage on Women and the Importance of Ensuring a Robust Tipped Minimum Wage," National Economic Council, the Council of Economic Advisers, the Domestic Policy Council, and the Department of Labor (2014), at https://www.whitehouse.gov/sites/default/files/docs/20140325_minimumwageandwomenreportfinal.pdf. See also Heidi Shierholz, "Low Wages and Few Benefits Mean Many Restaurant Workers Can't Make Ends Meet," (Economic Policy Institute, Briefing Paper No. 383, 2014) at <http://www.epi.org/files/2014/restaurant-workers-final.pdf>
- 7 From Figure D, Allegretto and Cooper (2014, Figure D, p.14), 23 percent of waiters and bartenders have family income of at least \$75,000 annually compared to 40 percent of the overall workforce.
- 8 Poverty statistics are from Allegretto and Cooper (2014, pp. 13-15).
- 9 See Allegretto and Cooper (2014, pp. 17-18).
- 10 The U.S. Bureau of Labor Statistics does not provide figures on occupations at a lower level.
- 11 Email correspondence with U.S. Department of Labor program analysts from the U.S. Department of Labor's Wage and Hour Division.
- 12 Michael Lynn, M. Sturman, C. Ganley, E. Adams, M. Douglas, and J. McNeil, "Consumer Racial Discrimination in Tipping: A Replication and Extension." *Journal of Applied Social Psychology*, vol. 38, (2008): 1045–1060 at <http://onlinelibrary.wiley.com/doi/10.1111/j.1559-1816.2008.00338.x/full>
- 13 For more on Michael Lynn's research on tipping see: <http://www.tippingresearch.com/>
- 14 Saru Jayaraman and Eric Schlosser, *Behind the Kitchen Door*, (Ithaca, NY: ILR Press, 2013).
- 15 Restaurant Opportunities Centers United, "The Glass Floor: Sexual Harassment in the Restaurant Industry," (New York: ROC United, 2016), <http://rocunited.org/pr-the-glass-floor-report/>.
- 16 Union representation refers to both union members and workers who are not union affiliation but whose jobs are covered by a union or an employee association contract. See "News Release: Union Members-2015," (Washington, DC: Bureau of Labor Statistics, 2016), <http://www.bls.gov/news.release/pdf/union2.pdf>.
- 17 In Allegretto and Nadler (2015) we show that tip-wage increases from 1990-2013 did increase earnings for restaurant industry workers but did not result in significant employment effects. Allegretto and Reich (2016) we show that restaurants adjust by and large to wage increases by increasing prices—which is a reasonable response. We estimate a price-pass-through elasticity of 0.058.
- 18 Public assistance programs include: federal housing or energy subsidies, the earned income tax credit, school lunch subsidies, Supplemental Nutrition Assistance Program benefits, and/or Supplemental Nutrition Program for Women, Infants, and Children.



Policy Issue: Income volatility

Addressing income volatility in the United States: flexible policy solutions for changing economic circumstances

By Bradley L. Hardy, American University

Many low-income individuals and families also have highly unstable incomes between weeks, months, and years.¹ This “income volatility” is an economic phenomenon driven largely by earnings, with a tendency to rise during recessions,² and is attributed to short-term economic shocks such as job loss as well as larger, permanent structural changes throughout the economy,³ including the decline of blue-collar manufacturing jobs and the emergence of part-time and contingent work arrangements.⁴

Survey-based data suggest that volatility has been on the rise for most families, and I argue that this warrants concern for three reasons related to imperfections in the economy and social welfare policy:

- The poorest families face the highest volatility
- Low-wage workers and their families have limited credit market access and savings
- Low-income workers with children face a weakened cash-based safety net

This essay examines these three issues and then offers several different policy solutions to the problems.

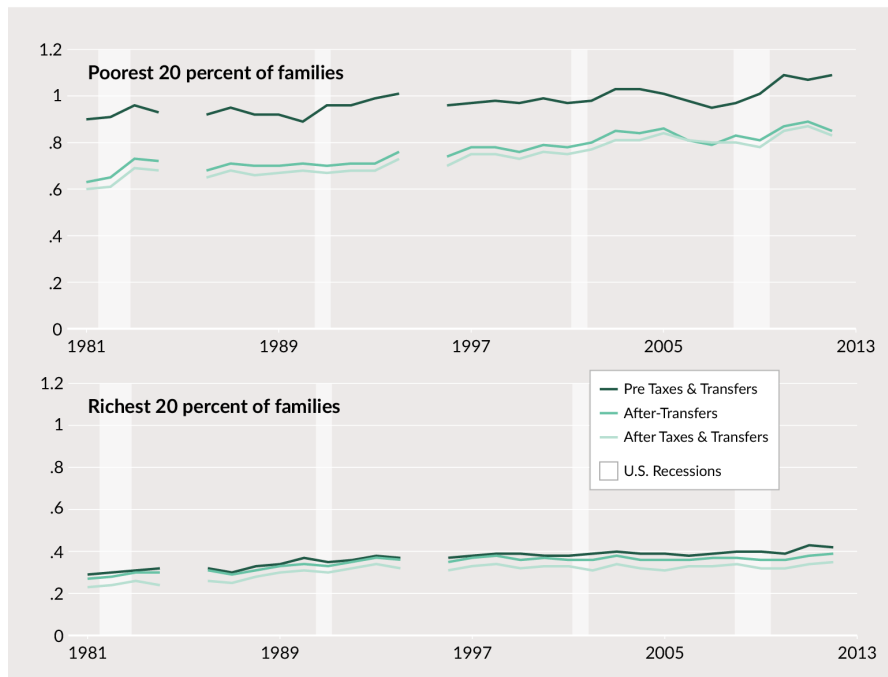
The poorest families face the highest volatility

Over the past 30 years, income volatility⁵ is highest among the nation's poorest families. Tabulations in Figures 1 and 2 using the U.S. Census Bureau's 1980-2013 Current Population Survey show that income volatility is highest for low-income families—those in the bottom 20 percent of the income distribution. Higher income households, in the top 20 percent of the income distribution, in turn have the lowest levels of volatility. Thus, poor families are effectively stuck with the worst possible financial portfolio—one with a low mean and high variability. While transfer policies could perform better, they do benefit low-income families by reducing income volatility, whereas higher income families are buffered from income volatility by the tax system. (See Figure 1.)

FIGURE 1

Poor families have higher income volatility than rich families

Income volatility by year for families in the bottom 20 percent of disposable income



Source: Hardy, B. (2016). "Income Instability and the Response of the Safety Net." Contemporary Economic Policy doi:10.1111/coep.12187



Low-wage workers and their families have limited credit market access and savings

Many low-wage workers and their families lack access to savings and also face imperfect capital markets and limited access to loanable funds.⁶ Such families may

be denied loans or credit cards that allow for consumption smoothing against negative income shocks—perhaps the first solution many households pursue when faced with an unanticipated expense or income shortfall. Whether due to displacement from employment altogether or unpredictable hours, credit and loan denials can lead to far costlier alternatives such as payday lenders. Such financial streams provide financial assistance for low-income families facing liquidity constraints, but they do so at interest rates that can exceed 100 percent and cause longer-term damage to borrowers.⁷

This stands in contrast to the predictions derived from standard economic models which perhaps better characterize the circumstances of higher income families in a position to save more and then draw upon those same savings in the event of an unanticipated negative income shock. Similarly, higher income families possess greater access to credit markets that can serve the same purpose in response to temporarily low income.

Low-income workers with children face a weakened cash-based safety net

Low-income workers with children face higher income volatility on average, and are less likely to have affordable access to credit markets. These families are increasingly underserved by the nation's welfare program—Temporary Assistance for Needy Families, or TANF. This program could be altered to be more responsive for low-income workers with volatile income. Returning to Figure 1, the after-transfer reduction of income volatility from safety net programs is somewhat diminished in the post-1996 years, coincident with the new welfare reform law enacted at the time. This appears to be the case as well for female-headed families, and black families.⁸

This is consistent with the dramatic fall in TANF caseloads since the middle 1990s. The program today provides less in cash assistance per case than in the 1980s and 1990s, and appeared to be unresponsive during the Great Recession of 2007-2009.⁹ The welfare reform law that created TANF occurred amid a large economic expansion, and the program should be adjusted to reflect new realities.

Flexible policy solutions to address income volatility and job displacement

Income volatility is driven by a combination of aggregate macroeconomic shifts alongside individual-level events such as job losses and gains. Especially for low-income and less-educated workers, this volatility is indicative of a riskier labor market. With these conditions in mind, the first set of solutions presented below are the most ambitious and call for reforms to TANF and the Supplemental Nutrition Assistance Program, or SNAP. The reforms would enhance job training in sectors of high local-labor demand, providing both financial and employment support, suspend time limits on TANF assistance, create minimum state requirements for the provision of TANF cash assistance, and increase SNAP generosity.

The remaining solutions presented below would provide families with greater liquidity to buffer against economic risk and uncertainty through an expanded Unemployment Insurance system. These reforms also would reconsider program recertification periods and re-introduce advance Earned Income Tax Credits (as an elective option for tax filers). Below, I summarize each of these policy solutions.

Ambitious policy solutions

Broader education and training as work-related activities within the Temporary Assistance for Needy Families program

As a share of gross domestic product, the United States lags several other developed countries' investments in job training.¹⁰ I recommend expanding allowable work-related activities to include education and job training with cash assistance during the training period, up to 3 years.¹¹

Following the spirit of recent reform proposals by Georgetown University public policy professor Harry J. Holzer related to community colleges,¹² such training programs would include community college career training, and would be coordinated with Workforce Innovation and Opportunity Act providers and, as a result, be deemed by WIOA providers as subject-training areas of high local-labor demand to ensure trainees have strong employment prospects.¹³ States would be encouraged to include non-custodial parents in such training programs, and job-seekers within TANF would be eligible for public-sector employment and infrastructure jobs as they become available.¹⁴ Due to years of under-investment, there

are labor shortages and opportunities to train workers in local sectors with high demand, including healthcare as well as elements of the nation’s aging transportation, water, and electricity infrastructure-related trades.

Conditional TANF time-limit suspensions

Income volatility is a reflection of an increasingly competitive, dynamic, and at times unpredictable employment situation in the United States, particularly among low-income and less-educated workers. The Temporary Assistance for Needy Families program can help buffer against this risk by suspending time limits under qualifying circumstances while maintaining work requirements. Approved education and training would be permitted to occur full time and without work/job search, and would not count against the 5-year federal time limit—stopping the clock. Adults who satisfactorily complete TANF- and WIOA-approved education and training and/or engage in continuous job search efforts would receive assistance, even if they breach the time limit.

Next, states would be required to allow qualifying recipients to remain on welfare for the entire 5-year federal time limit—the current policy sets five years effectively as a maximum with a state option to provide extended benefits, but this would now be a minimum standard. Finally, following the recommendations of Marianne Bitler at the University of California-Davis and Hilary Hoynes at the University of California-Berkeley,¹⁵ time limits would be suspended during periods of high local unemployment or joblessness, much like the allowable suspension for high local unemployment in the Supplemental Nutrition Assistance Program for able-bodied adults.

Importantly, work requirements would remain in place, and TANF participants would still be subject to sanctions and removal via administrative rules and/or rules violations. This modified version of TANF—with its work requirements and rules—retains a design promoting temporary participation relative to the predecessor policy, whereas time limits in their current form in some states potentially undermine the capacity of the program to respond to changing economic circumstances.

Increase TANF cash spending and responsiveness

Welfare reform had unintended consequences, one of which was the dramatic decline in cash benefits. While there is fairly broad consensus that the program

rightly emphasizes employment, many states have done so at the expense of maintaining a cash safety net for vulnerable families with children. In some instances, states are merely responding to financial incentives from the block-grant design of TANF to plug a variety of budgetary holes where available, and spending has moved from cash assistance to non-assistance in the post-welfare reform era.¹⁶

Following the recommendations of Bitler and Hoynes, I recommend that states be required to spend at least 25 percent of their TANF funds on cash assistance.¹⁷ Increasing cash assistance will help to ensure that the nation's most vulnerable families are better protected against negative income shocks.

Food stamp reforms, work requirements, and time costs

Workers with low, volatile income are increasingly reliant on programs such as SNAP and the Earned Income Tax Credit. Recent evidence suggests that caseload declines throughout 2016 are being driven in part by states that are implementing the 3-month SNAP time limit for so-called ABAWDs—able bodied adults without dependents.¹⁸ I and my co-authors in a 2015 working paper show that SNAP participation is increasingly predicted by structural economic variables such low wages and the decline of full-time employment.¹⁹ To account for this, the work requirement for ABAWDs could be lowered to 10 hours per week, from 20 hours. These low-wage workers are also more likely to face long, costly commutes that preclude the most time consuming, cost efficient forms of food preparation. With this in mind, I follow the recommendations of University of Kentucky economist James P. Ziliak for SNAP benefits to be increased to account for higher food preparation costs and transportation costs.²⁰

Buffer policy solutions

Optional year-round Earned Income Tax Credit

The Earned Income Tax Credit is the largest cash transfer for the working poor. While the EITC program has well-documented employment and anti-poverty benefits, it is not constructed to address income volatility in its current form. First, the refund occurs as a lump sum at tax time. While this benefits families as a form of precautionary savings, those that face weekly or monthly income shortfalls do not benefit from support that is backloaded until tax season.

Re-introducing an optional Advance EITC, whereby filers could elect to have the EITC distributed paycheck-to-paycheck over the entire year, would provide families with several thousand dollars of immediate income support.²¹ Hybridized versions similar to the Advance EITC would allow a portion of the full EITC to be made available throughout the year.²² Although participation in the Advance EITC program was low prior to being discontinued in 2011, employers and human resources professionals could more aggressively promote it as a financial tool.

Expanded Unemployment Insurance coverage for part-time and less experienced workers

The Earned Income Tax Credit is of little or no use for low-income individuals who are jobless—by design EITC receipt is predicated on labor market earnings.²³ At the same time, a growing share of workers are part-time and many have work-history gaps leaving them uncovered by the current Unemployment Insurance system.

Rachel West and her co-authors at the Center for American Progress offer a range of suggested reforms to the Unemployment Insurance system that would provide financial incentives for workers who find new employment in a lower paying job—from covering part-time workers to covering workers with less than five quarters of work history.²⁴ These workers, varying state-to-state, generally lack protection via the unemployment insurance system. Many hold more than one part-time job, and do so in the absence of access to stable, full-time employment. Such reforms can provide an important buffer in the event of earnings loss due to unemployment, and would reflect the modern growth in part-time, contingent work arrangements. In the absence of substantial Unemployment Insurance reform, the aforementioned TANF solutions loom especially large—many individuals are currently underserved by both programs.

Longer and clearer program re-certification

In some states, low-income families participating in SNAP, TANF, Medicaid, and low-income housing assistance are required to provide eligibility verification, by program, throughout the year. As a consequence, many such households flow in and out of eligibility for these programs, raising the possibility that families lose out on benefits when they find themselves to be temporarily in need—or when complexity in the renewal process causes qualifying families to cycle off the program. Currently the typical program requires re-certification at a rate of every

six months to one year. I recommend extending recertification periods to once per year while simplifying and aligning recertification across safety net programs.

Conclusion

Income volatility is highest among lower income and less-educated Americans. While the safety net provides some buffer against volatility, changes can be made to better address the reality of low and volatile income. Some firms see this need, and are introducing flexible pay plans that allow workers to withdraw their earned income on a daily basis to meet immediate consumption needs that arise between pay periods.²⁵ Still, such private initiatives are working at the margins of a larger challenge—many workers find themselves unemployed or under-employed in sectors of the economy offering low, unpredictable earnings.

Moreover, many families lack the resources to buffer against negative and unanticipated economic shocks. To address this, the safety net can provide greater cash assistance via TANF and SNAP, including financial assistance to support families while they participate in approved job training as well as during periods of high unemployment. Such assistance would operate in part through a conditional suspension of time limits in TANF. In addition, part-time and less-experienced workers should have greater access to the unemployment insurance system, and the working poor and near poor could benefit from an optional Advance EITC that spreads the credit over the year.

Taken together, the policy recommendations put forth in this essay aim to address income volatility among low-income workers by providing greater liquidity and insurance against negative shocks while providing a wider range of job training opportunities to move workers into higher demand, stable employment opportunities. These policies retain the values of work that are embedded in the current set of programs while providing a pathway for workers to respond to economic risks that characterize today's dynamic, globally competitive economy.

—Bradley L. Hardy is an assistant professor in the Department of Public Administration and Policy at American University

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Policy Issue: Early childhood development

How economic inequality affects children's outcomes

By Ariel Kalil, University of Chicago

What happens in the home is paramount to children's early development. Economically disadvantaged children's limited access to cognitively enriching home environments may help drive growing gaps in cognitive and non-cognitive skills, producing a feedback cycle that leads to low socioeconomic mobility and further grows inequality. Research increasingly suggests that policy should identify new targets for programs aimed at enhancing parent-child interactions in low-income families, such as Early Head Start and Healthy Families America. All parents want to help their children flourish, but low-income parents often lack the resources to achieve their parenting goals. Parents are children's first teachers and, to equalize the playing field, governments need to invest in parents so that they, in turn, can better invest in their children.

Background

Economic growth for much of the 20th century supported America's promise of offering opportunities to both parents and their children. It is well known, however, that income inequality increased dramatically in the United States beginning in the 1970s.¹ Greg Duncan and Richard Murnane illustrate how increasing family income inequality may affect access to high-quality child care, neighborhoods, schools, and other settings that help build children's skills and educational attainments.² Changes in these social contexts may in turn affect children's skill acquisition and educational attainment directly as well as indirectly by influencing how schools operate.

Growing income inequality also increases the gap in the resources high- and low-income families can spend on enrichment goods and services for their children.³

For instance, Sabino Kornrich and Frank Furstenberg show that spending on child-enrichment goods and services jumped for families in the top quintiles but increased much less—in both absolute and relative terms—for families in bottom-income quintiles, as reflected in four large consumer expenditure surveys conducted between the early 1970s and 2005-2006. In 1972-1973, high-income families spent about \$2,700 more per year on child enrichment than did low-income families. By 2005-2006, this gap had nearly tripled, to \$7,500.⁴

As the incomes of affluent and poor American families have diverged over the past three decades, so too has the educational performance of the children in these families. Sean Reardon documents substantial growth in the income-based gap on the test scores of children born since the 1950s. Among children born around 1950, test scores of low-income (10th income percentile) children lagged behind those of their better-off (90th income percentile) peers by a little over half a standard deviation, or about 50 points on an SAT-type test. Fifty years later, this gap was twice as large. Family income is now a better predictor of children's success in school than race.⁵

At age four, children from families in the poorest income quintile score on average at the 32nd percentile of the national distribution on math, the 34th percentile in a test of literacy, and at the 32nd percentile on a measure of school readiness compared with children in the richest quintile, who scored at the 69th percentile on math and literacy and at the 63rd percentile on school readiness.⁶ Gaps in conduct problems and attention/hyperactivity also are apparent albeit less pronounced. On measures of hyperactivity, for instance, children from families in the poorest income quintile score on average at the 55th percentile of the national distribution (in this case, higher scores indicate higher levels of behavior problems) compared with children in the richest quintile, who scored at the 44th percentile.⁷

Using data from the 1979 and 1997 National Longitudinal Surveys of Youth, Martha Bailey and Susan Dynarski show that graduation rates for children born into high-income families jumped 21 percentage points (from 33 percent to 54 percent) between the early 1960s and the early 1980s. The corresponding increase for children born into low-income families was only four percentage points (from 5 percent to 9 percent). A little less than half of the gap between rich and poor in college graduation rates can be explained by differences in college enrollment rates, with the rest explained by differences in students' persistence in completing their degrees.⁸ Phillipe Belley and Lance Lochner show that high family income has become a substantially more important determinant of college attendance and college quality in recent years, particularly for those youth with the lowest skills.⁹

Drivers of the socioeconomic status-based gaps in child outcomes

Rising gaps in children's skills and attainments cannot be attributed to rising income gaps alone, however.¹⁰ In fact, Reardon estimates that only about half of the rising income-based gap in test scores can be attributed to rising income inequality.¹¹ Parents invest more than money in their children's development. Through their time and attention parents can provide a cognitively stimulating and emotionally supportive home environment that promotes children's early learning and behavioral adjustment. Economically advantaged parents differ from their less advantaged peers on many relevant dimensions of parenting.¹²

Mounting evidence suggests that socioeconomic status-based gaps in parenting and children's early developmental outcomes have grown alongside increasing economic inequality in family conditions.¹³ The demography of family structure, for example, has changed in ways that favor the socioeconomically advantaged and their ability to invest parental time and resources in their children's development. Between 1980 and 2010, the share of children living with college-educated mothers who were married remained at about 90 percent. In contrast, the share of children living with mothers who lacked a high school degree and who were married decreased from about 73 percent to about 66 percent.¹⁴ Two-biological-parent households not only enjoy greater economic well-being but also demonstrate higher levels of parental time investment in children than do single-parent households.¹⁵

Trends in maternal age at first birth also have changed in important ways that may favor the parenting environments provided by mothers with high socioeconomic status. Comparing data on U.S. births in 1970, 1989 and 2006 by age of mother and maternal schooling reveals that the maternal age gap between children born to high school dropouts and college graduate mothers grew by nearly 3 years—from 4.3 years to 7.1 years.¹⁶ Positive parenting behaviors increase in maternal age at first birth whereas negative parenting behaviors decrease in maternal age at first birth.¹⁷

Finally, how parents think about parenting has changed dramatically over the past century. In 1900, parenting experts emphasized nutrition, medical care, and fresh air as the key inputs into child development, according to a comprehensive analysis of magazine articles containing parenting advice. By the 1980's, intellectual stimulation and social/emotional development had replaced nutrition and fresh air as key topics of concern along with medical care.¹⁸ Yet economically

advantaged parents, more so than their disadvantaged counterparts, may have responded more quickly to this advice, thus widening the parenting gap.

Why parents matter

Economically advantaged parents display more of the behaviors deemed supportive of children's development across a range of parenting domains. Economically advantaged parents display more authoritative (versus authoritarian) parenting styles,¹⁹ engage in more sensitive and responsive mother-child interactions,²⁰ use greater language stimulation,²¹ and use greater levels of parental management and advocacy.²² A famous example of differential parenting by socioeconomic status is the study by Betty Hart and Todd Risley, who intensively observed the language patterns of 42 families with young children. They found that in professional families, children heard an average of 2,153 words per hour, while children in working class families heard an average of 1,251 words per hour, and children in welfare-recipient families heard an average of 616 words per hour. By age four, a child from a welfare-recipient family could have heard 32 million words fewer than a classmate from a professional family.²³

One of the most important parenting differences between advantaged and disadvantaged parents is in how much time the parent spends with the child. Annette Lareau's qualitative study of family life reported that middle-class parents target their time with children toward developmentally enhancing activities. In her study, middle-class families (whose jobs, by her definition, require college-level skills) engage in a pattern of "concerted cultivation" to actively develop children's talents and skills. By contrast, in lower-class families, Lareau identified a pattern that she calls "the accomplishment of natural growth," wherein parents attend to children's material and emotional needs but presume that their talents and skills will develop without concerted parental intervention.²⁴

Numerous quantitative studies not only show large differences in the time investments of advantaged and disadvantaged parents but also that these gaps remain large even when other differences across families, such as employment hours and schedules, are accounted for.²⁵ Work by Ariel Kalil, Rebecca Ryan, and Michael Corey further shows that highly educated mothers are more "efficient" in their parental time investments by tailoring their specific activities to children's developmental stage. This research also shows that with respect to total childcare time, the educational gradient is most apparent in households with the youngest children, a point also made by Erik Hurst, Daniel Sacks, and Betsey Stevenson.²⁶

Economically advantaged mothers, more so than their less advantaged counterparts, may have learned the message that parental investments in early childhood are key ingredients in children's long-run success.²⁷

High-income parents appear to be investing more parenting time than ever before in their children's cognitive development and educational success.²⁸ This increase may mean that high-skilled parents are responding to the increased returns to having high-skilled (highly educated) children.²⁹ Work by Erik Hurst, Daniel Sacks, and Betsey Stevenson further show that all of the increase in childcare time between 1985 and 2003 has come from households with children ages 5 and younger, and Evrim Altintas shows that the growing education gap in time with young children is driven by time in educationally enriching activities.³⁰

Increases in the parenting gap are expected to be relevant for socioeconomic status-based gaps in children's development. Observational research suggests that the quality of the home learning environment as measured by the HOME score accounts for up to half of the relationship between socioeconomic status and disparities in children's cognitive test scores.³¹ In a descriptive analysis of U.S. data from the Early Childhood Longitudinal Study-Birth Cohort, Jane Waldfogel and Elizabeth Washbrook conclude that parenting style (in particular, mothers' sensitivity and responsiveness as well as the home learning environment) is the most important factor explaining the poorer cognitive performance of low-income children relative to middle-income children, accounting for between a quarter and a third percentage of the gaps in literacy, mathematics, and language.³²

What's the role for public policy?

Few trends are more ominous than the increases in both the class gaps and achievement gaps between low- and high-income children in the United States. The rising income-based achievement gaps call into question whether the American Dream of intergenerational mobility is now beyond the reach of many children raised in low-income families.³³

Policy approaches to addressing increasing disparities in outcomes for children from low- and high-income families can take a number of forms. Some of these will boost families' economic security, others can help support parents' engagement in their children's development, and others can provide educational supports directly to children. Such approaches can be pursued simultaneously. These include policies such as the Earned Income Tax Credit that redistributes income

and relies on parents to use the added income to promote their children's development; policies such as the Nurse Family Partnership that teach high-risk parents about positive parenting practices and about the nature of early childhood development; policies such as Pell Grants that encourage would-be parents to acquire post-secondary schooling; and policies such as state pre-Kindergarten programs that provide educational services directly to young children.³⁴

Given the importance of parental engagement in children's development, it may be especially fruitful for policies to focus on boosting parents' ability to provide a cognitively stimulating and emotionally supportive home environment. Gaps in children's skills could be narrowed if less-advantaged parents adopted the parenting practices of their more-advantaged peers. Notably, a leading family intervention for low-income children—the Nurse-Family Partnership program—is being targeted for substantial expansion by the federal government from the Administration on Children and Families' Maternal, Infant, and Early Childhood Home Visiting Program demonstration. The program provides weekly in-home visits by trained nurses from pregnancy through the child's second birthday.

One mission of the Nurse-Family Partnership program is to improve children's health and development by helping young, economically disadvantaged parents provide more competent care. Some experimental evaluations of the program show it reduces child maltreatment. In one study, mothers in the treatment group who received nurse visits during their pregnancy and the child's infancy had 0.29 substantiated reports of child abuse and neglect at some point before the child turned 15. Mothers in the control group, in contrast, had on average 0.54 such reports.³⁵ This is important because child maltreatment is costly for the individual affected and for society.³⁶

The Nurse-Family Partner program also yields long-run benefits for some children. By age 19, girls in the treatment group had fewer arrests and convictions; a subset of these girls had fewer children and less Medicaid use than their comparison group counterparts.³⁷ Although there is room for improvement in the design and delivery of this and similar intervention programs, research underscores the merit of the new federal emphasis on supporting parenting in educationally disadvantaged families.

Important new evidence also is emerging that suggests that low-cost “light-touch” efforts can be highly successful in helping low-income parents support their young children's learning and development.³⁸

Conclusion

The United States has made little progress toward narrowing the achievement gap between advantaged and disadvantaged children. This is in part because public policy has neglected the critical role of parenting in children's development. Parents do more than spend money on children's development; they also promote child development by spending time in cognitively enriching activities and by providing emotional support and consistent discipline.

All parents want the best for their children, but the "parenting divide" between economically advantaged and disadvantaged children is large and appears to be growing over time.³⁹ The main barrier to designing and scaling up parenting interventions nationwide is the currently limited understanding of the key ingredients of successful programs. Policymakers need to become better informed on effective interventions that can motivate and support parents to engage effectively in their children's development.

—Ariel Kalil is a professor of public policy at the Harris School of Public Policy Studies, University of Chicago

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Policy Issue: Social Security

Expand Social Security

By **Jesse Rothstein, University of California-Berkeley**

The economic security of the broad middle class in the United States has eroded in recent decades, with stagnating wages, vanishing job security, and necessities such as child care, higher education, and healthcare becoming less and less affordable. Restoring economic security should be the center of the next Administration's domestic agenda.

One area that needs to be rethought is retirement. This was traditionally seen as a three-legged stool, with retirees relying in roughly equal parts on Social Security benefits, employer-provided pensions, and private savings. This was never the universal reality—even 30 years ago, barely half of workers nearing retirement participated in employer-based plans.¹ But today, all three legs of the stool have been whittled away to almost nothing:

- Defined-benefit pensions have largely disappeared. In 2010, only 22 percent of full-time, private-sector employees had a defined-benefit retirement plan,² and public-sector pension funds (along with remaining private-sector funds) face serious financing shortfalls.
- Less than 60 percent of near-retirement-age households have any retirement savings,³ and among those the median balance is only \$91,000.⁴ This would purchase an annuity (at age 65) of only \$5,000 per year.
- Fewer and fewer Americans—about half in recent Gallup polling⁵—believe that Social Security will be there for them in retirement.

In this environment, only the wealthiest Americans can feel any sense of confidence about their retirement. Policy changes that strengthen the retirement system have tremendous promise to improve people’s feelings of security—not just retirees but also people in the prime of their lives.

Fortunately, the solution is simple. Our efforts should focus on strengthening and growing the part of the system that works well: Social Security. Fixing the financing shortfall and growing the system to provide real economic security in retirement, on its own, are affordable and feasible, and should be an important part of the middle class security agenda.

The problem: Inadequate retirement security

Nearly every retiree receives Social Security benefits—about 40 million retired workers, plus millions more of their spouses, their other dependents, and survivors of those who die early.⁶ These benefits average under \$1,350 per month,⁷ with 30 percent of retirees receiving less than \$1,000 per month.⁸ This is not enough on its own to finance a decent standard of living.

Unfortunately, the other two legs of the three-legged stool, pensions and private savings, are no longer reliable. Half or less of workers nearing retirement age participate in employer-based retirement plans,⁹ and among full-time, private-sector workers with plans, most have only a defined-contribution plan, such as a 401(k); only about one-third have a defined-benefit plan (a traditional pension).¹⁰ As for private saving, less than 60 percent of near-retirement-age households have any savings in retirement accounts (including employer-based accounts).¹¹ For those that do have savings, the median balance is only \$91,000.¹² If this were all converted to an annuity at age 65, it would provide less than \$5,000 per year in retirement income. While a very small number of high-income retirees have substantial savings, this is very much not the norm.

Accordingly, Social Security makes up a very large share of most retirees’ incomes. For nearly half of married retirees and nearly three-quarters of unmarried retirees, Social Security benefits provide more than half of the household’s income.¹³ Over one-fifth of married retirees and nearly half of unmarried retirees rely on the program for fully 90 percent of their income.¹⁴ These benefits are not enough to support a comfortable retirement. Nine percent of seniors live in poverty.¹⁵ Using the U.S. Census Bureau’s new supplemental poverty measure that accounts for

medical costs, geographic differences, and transfer payments, the proportion in poverty grows to 15.8 percent.¹⁶

No real prospect of restoring security via pensions or private savings

Traditional, employer-provided pensions fit poorly with today's labor market, where few workers can expect to remain at a single employer their whole careers. Moreover, in today's financialized world employers find it too easy to renege on commitments to their past workers, leaving the government holding the bag and retirees without the pensions they were promised. Many private pension funds have gone broke; others have been closed to new enrollees. In the public sector, where it is harder for governments to slip out of past commitments, many public pension funds face serious gaps between promised benefits and funds with which to pay them, putting severe stress on state and local budgets.

Efforts to shore up the old pension system have had little success. Coverage rates, especially in the private sector, have plummeted. Recent efforts have focused on designing portable pensions that are not tied to specific employers. These efforts, while worthy, face fundamental challenges of financial viability, administrative complexity, and legal constraints. They are unlikely to reach many workers in the short run.

Efforts to promote retirement savings in defined-contribution plans, including IRAs and 401(k)s, have by and large been unsuccessful. Tax subsidies for retirement saving largely serve to induce households that would have saved anyway to shift from unsubsidized to subsidized accounts, with little impact on overall savings.¹⁷ While some “nudge” programs have been found to have larger effects,¹⁸ decades of policy and research work have failed to dent the problems of low participation rates and low balances among those who save.

For those who do manage to save, private accounts are a poor solution. Savers pay high fees on their investments, and often make bad investment decisions (in many cases under instruction from advisors facing serious conflicts of interest). Even wise investment plans expose savers to substantial market risk, as many Baby Boomers discovered in 2008.

Moreover, private savings plans have not solved the fundamental challenge of retirement savings—the need to insure the individual against uncertainty over the

length of the retirement period and over investment returns. While retirees are often advised to buy annuities, these are very expensive and few retirees purchase them. Absent annuities, the only way individuals can be confident that they will not outlive their savings is to save much more than they will likely need, and to limit their drawdown, to preserve money that they will likely never spend. While some wealthy individuals may want to leave substantial bequests for their heirs, most would be better off under a retirement system that allowed them to spend down their savings during their lives, confident that they would be protected if they lived longer than expected.

The solution is simple: Expand Social Security

Fortunately, it is possible to dramatically expand retirement security without fixing the problems with employer-provided pensions and private savings. Social Security has worked for decades and can easily be scaled up to fill in the holes in the retirement puzzle.

As a social insurance program, Social Security builds in protection against longevity and earnings risk, and shields retirees—most of whom have no interest in or capacity to participate in financial markets—from bad markets and unscrupulous or incompetent investment advisers. Its funding is not tied to the continued viability of any single employer, and while occasional adjustments are needed as demographic and economic realities diverge from earlier projections, these are small relative to the volatility faced by pension funds or private savings.

Policymakers should therefore pursue a major expansion of Social Security. There are a number of attractive ways to do this. I articulate three principles that should guide such an expansion, then describe three options that would satisfy the following principles:

- Social Security benefits should be enough for retirees to live on, on their own
- The features that have made the program such a success to date, including its universality and its dedicated, untouchable financing stream, should be preserved
- The existing program's long-term financing shortfall should be closed via new revenues rather than benefit cuts, with the pain of this offset by real, visible benefits in the form of higher payments to retirees

The following three policy options are consistent with these principles.

Three policy changes to expand Social Security

Expand the program via proportionate increases to tax rates and to all recipients' benefits

A modest increase in the payroll tax rate of less than one percentage point—from 6.2 percent to 7.2 percent, respecting the current taxable earnings cap—on both workers and employers would finance a 15 percent benefit increase for all current and future retirees as well as survivors and disabled workers. This could (and should) be scaled to provide larger increases—for example, a 2 percentage point increase in the tax rate would finance a 30 percent increase. If disabled workers' benefits were excluded from the expansion, the benefit increase would be larger, 18 percent per percentage point on the tax rate.

Eliminate the current taxable earnings cap, and split the revenues among increasing benefits for those who pay higher taxes, closing the financing gap, and increasing benefits for the lowest earners

Earnings above \$118,500 per year are exempt from Social Security taxes, specifically the Federal Insurance Contributions Act, or FICA, taxes. Only 6 percent of workers earn more than this amount, but the share of wages above the threshold has grown as these income earners have pulled away from the rest of the workforce.¹⁹ Eliminating the cap, without increasing benefits, would yield more than enough revenues to close the 75-year projected finance shortfall for Social Security and Social Security Disability Insurance.²⁰

More consistent with the principles above would be to use some of the revenues to increase benefits for high earners in order to preserve the program's universality while imposing a reasonable cap on the size of the individual benefit. Another portion should go toward increasing benefits for lower-earning recipients. This would help promote retirement security and would create a constituency to support the cap elimination. The remainder could still make a substantial downpayment toward eliminating the financing gap.

If earnings were subject to taxes without a cap but non-wage income remained exempt, many high earners might reclassify their earnings as capital gains or business income. To prevent evasion while being consistent with the overall structure

of the program, the FICA tax might be applied to all personal income above the taxable earnings cap, regardless of whether that income comes as earnings or in another form. This would raise dramatically more money, more than enough to close the entire financing gap and support larger benefit increases for low-income retirees. While a few very high-income individuals would face sharply increased tax bills under this proposal, dedicating the revenues to the Social Security trust fund, just as FICA taxes are today, would promote the tax increase's political viability and protect it from attack.

Create an optional extra tier of Social Security, into which workers could contribute in order to purchase extra benefits when they retire

Some higher-income workers may want more retirement consumption than even an expanded Social Security benefit can support. As discussed above, pervasive market failures make private retirement saving very inefficient. The government can solve this problem by allowing savers to use the existing Social Security infrastructure, with its built-in mechanisms, to pool and share risks at much lower “load” than any private savings vehicle.

Pricing of optional add-on benefits would need to account for a modest degree of adverse selection, as those with longer life expectancies would be somewhat more likely to participate. It would also be more expensive to administer than the current system, though likely much less so than existing private annuity products given the existing infrastructure to track contributions and benefit eligibility. But even with pricing that accounts for these extra costs—set to ensure that the new tier of optional add-on benefits is entirely self-financing—this would be a very attractive option relative to the private annuity market. Participants would contribute throughout their careers, with no need to make investment decisions, pay fees, or face market risk. In return, they or their survivors would receive higher benefits when they retired, became disabled, or died.

Other proposed changes that are similarly consistent with the principles enumerated above are also worthy of consideration. It is noteworthy, however, that recent discussions have moved away from the ideas of pre-funding Social Security benefits and investing trust funds in equities. These do nothing to address the above principles, and only expose the program (and the retirees it supports) to political and market risk.

Countering the objections to expanding Social Security

There are three primary objections to the above proposals. None are compelling.

The first is that Social Security would be too expensive. It is undeniable that larger Social Security benefits would require correspondingly more revenue. But there is no way to support higher consumption for retirees—no way to address the retirement security problem—without in some way directing additional resources to these retirees. Any alternative would impose equal or higher costs, if not as higher payroll taxes than as higher diversion of before- or after-tax income into private savings or pension funds. It is much more efficient to route the needed resources through Social Security. Moreover, taxpayers see Social Security taxes as worth paying, tied as they are to eventual benefits.

The second objection is that higher tax rates would reduce the incentive to work. Again, Social Security expansions would not dramatically change the effective “wedge” between earnings and consumption—the money that would be collected through higher payroll taxes either represents new additions to the taxpayer’s consumption possibilities in retirement or merely displaces private savings with, if anything, a positive impact on retirement consumption. Thus any labor supply impacts would be very small.

The above proposals to uncap income subject to FICA taxes, while capping benefits, would expand the wedge for the highest-income workers. There is little evidence that these workers’ labor supply is very responsive to taxes, and the scope for evasion (which is more responsive) could be minimized by assuming that tax increases apply to a broad income base. In any case, this objection applies equally to any proposal to increase top income tax rates, a move that is likely inevitable as the share of national income accruing to the top 1 percent continues to grow.

The third objection is that expanding Social Security would crowd out private saving and reduce national savings. This is a prediction of standard economic models. But these models do not reflect reality. In fact, most workers have very little savings to be crowded out, and those who do save are not primarily saving for retirement (though they may store their savings in retirement accounts in order to obtain tax benefits).

Regardless, the national savings rate is simply not a first-order policy concern today. Finance is increasingly global, and profitable U.S. investments can be

financed by savers elsewhere. Moreover, concerns about promoting saving are yesterday's problem. Today, the evidence indicates that the nation and the world face a serious savings glut, not a shortfall. In today's world, there is little if any reason to prefer prepaid to pay-as-you-go retirement systems.

— **Jesse Rothstein is a professor of public policy and economics and Director of the Institute for Research on Labor and Employment at the University of California-Berkeley**

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Policy Issue: Unemployment Insurance reform

Unemployment Insurance reform: A primer

By **Till von Wachter, University of California-Los Angeles**

The Unemployment Insurance system provides temporary and partial earnings replacement for workers that have become unemployed through no fault of their own and are actively searching for work. To facilitate reemployment, the UI system is complemented by job search assistance and training services. Within a common federal framework, states set the main parameters of the UI system and are responsible for financing benefits via payroll taxes, though federal funding has played an increasing role, especially in economic downturns.

In the United States, and most other developed countries, unemployment insurance is the main program helping to buffer the shock of layoffs and unemployment. The UI system provides vital benefits for laid off workers and families to weather the high and persistent costs of layoffs, especially in recessions. By preventing cuts in consumption, UI benefits can also function as an automatic stabilizer in economic downturns. Given high layoff rates even in normal economic times, the insurance provided by UI also plays an important role by supporting a well-functioning, dynamic labor market.

The need for common sense and evidence-based unemployment insurance reforms

While most observers agree that the current structure of the unemployment insurance system is fundamentally sound, there is also widespread agreement that the UI system is in need of reform. There are several major issues to be addressed, First, the current UI system suffers from financial instability that risks compromising its major role as adjustment mechanism in recessions. Second, the coverage of

UI has eroded over time, with a declining fraction of workers receiving lower benefits amounts. Third, UI does little to avert the large, long-lasting earnings losses among reemployed workers. And fourth, there are persistent questions about the effectiveness of UI and related programs to quickly reemploy job losers.

The good news is that, in many ways, unemployment insurance appears to be an ideal target for bipartisan reform. First, there is a set of straightforward, common-sense goals for a well-functioning UI system. These goals include, among others: that UI should provide a sufficient buffer to avoid financial difficulties after layoff, especially for families with children; that UI should encourage speedy reemployment of the unemployed; that UI plays a clear role in economic downturns, and hence should not be at the discretion of local or federal politics; and that UI should be financial sound.

Second, Unemployment Insurance reform is an almost ideal example of the potential for evidence-based reform. There is a lot of high-quality evidence on the working of the UI system. A lot of the additional evidence needed for more-informed policymaking can potentially be obtained at arm's length, especially in a data-rich environment. The following "primer" discusses and summarizes core pieces of recent evidence on job loss, unemployment, and the current UI system, and then relates them to a series of reform proposals. The reform proposals can be grouped into those that deliver a basic "tune up" of the current UI system, and those that provide more fundamental "modernization." These are summarized here:

"Tune-up" (minimal) reforms:

- Prevent erosion of benefit generosity by mandating minimum UI benefits
- Institutionalize federal emergency unemployment compensation
- Fix outdated system of data collection to enable evidence-based policies
- Expand coverage of UI to fit structure of modern workforce
- Resolve financing short-falls in states' UI trust funds by modifying tax base

Modernization reforms:

- Institute functioning system of job sharing to prevent costly layoffs
- Experiment with wage insurance to aid workers returning to employment

These proposals will be related to the issues they resolve and the evidence they rest on after a brief primer on the main available evidence about the UI system.

A primer on evidence about the Unemployment Insurance system

A few key themes arise from extensive research on core aspects of the Unemployment Insurance system.¹ While additional research is needed, the good news that the much of the data needed is potentially available at low cost from the UI system itself.

Point 1: The current benefit levels and durations appear appropriate. An increasing number of studies have shown that current Unemployment Insurance benefits provide an important buffer against consumption losses for a substantial number of unemployed workers. While a large number of studies have established that UI also tends to prolong unemployment and hence reduce tax revenues, it appears at current levels that the social benefits outweigh the budgetary costs. Recent research also gives clear guidance that UI benefits should be extended in recessions, and when they should be targeted to certain groups of individuals.

Point 2: The coverage of Unemployment Insurance has eroded over time. It is well known that on average only half of the unemployed receive UI benefits, substantially limiting the program's scope to insure individual earnings shocks and provide an automatic stabilizer. This is partly because up until recently UI rules in most states explicitly exclude certain groups of unemployed—those engaging in full- or part-time education, those seeking part-time employment, or those with low earnings. Partly it arises because of a low take-up rate of benefits among those eligible.

Point 3: The effects of layoff are felt long after unemployment. An increasing amount of evidence suggests that the effects of job loss are felt long beyond reemployment, including effects on earnings, health, and child outcomes.² Children of job losers suffer from the consequences even as adults. Overall, research suggests UI benefits only make up a small portion of the earnings lost at job loss.

Point 4: Current reemployment efforts show mixed success. While many programs aiming to aid Unemployment Insurance recipients to find work are successful and sometimes cost-efficient, increasing evidence suggests that substantial hurdles for successful reemployment remain, especially for older and longer unemployed workers. Especially for these individual, longer UI benefits do not improve and may even reduce job quality. Although the evidence is mixed, an ongoing concern is UI may damage reemployment prospects by lengthening the unemployment spell.³

Point 5: The federal-state relationship needs to be fixed. Although in principle the nature of Unemployment Insurance taxes should lead state UI trust funds to balance over the business cycle, reductions in UI tax rates and a low tax base have led to financing shortfalls. As a result, benefit extensions during recessions have been increasingly financed by ad hoc federal measures. To partly resolve budget short falls, several states have begun cutting benefits. Currently, political constellations at the state level have led to a patch-work of UI reforms, exposing similar workers to different UI systems. The current system also suffers from a wasteful lack of data-sharing that prevents meaningful management and study of the UI program.

Proposals for “tune up” (minimal reforms) of the Unemployment Insurance system

Policy analysts and researchers have discussed the need to modernize the unemployment insurance system for some time. This discussion received momentum during the Great Recession. The result has been a series of well-articulated proposals, and convergence on a list of basic fixes. Several of these reform proposals have made it into President Obama’s Budget Proposal for fiscal year 2017, which begins in October 2016. The following is a list of the core proposals, including a brief summary of their justification.

Prevent erosion of benefit generosity by mandating minimum duration of 26 weeks

The issues. Partly to counter funding difficulties in the aftermath of the Great Recession, several states have cut benefit durations below the typical 26-week mark. Similarly, there is substantial heterogeneity in benefit levels across states. Yet, there are no compelling reasons why similar workers in different states should be treated different by the Unemployment Insurance system. Research provides justification for the optimal generosity of UI benefits, and when these should vary

with characteristics of workers or local labor markets. Hence, the choice of benefit parameters and how they vary in the population or over time should not be a function of the local political process or short-term funding needs.

Proposed changes. Federal law should mandate a minimum amount of potential duration of Unemployment Insurance benefit of 26 weeks, an average effective replace rate of 50 percent of benefits (with gradual adjustments of the maximum benefit amount), and a dependent allowance to support families with children with higher consumption commitments. To ensure states update their laws, the federal government can limit the credit for the State Unemployment Tax employers receive against the Federal Unemployment Tax.

Institutionalize federal emergency Unemployment Insurance benefits as function of local unemployment

The issues. Research clearly indicates that Unemployment Insurance benefits should be extended in recessions. This is because the benefits to workers at risk of exhausting their benefits are greater, the inefficiency costs are not larger and perhaps smaller, and the potential of stimulating effects is greater. The experience in the aftermath of the Great Recession has shown that leaving extensions of UI benefits to the political process can lead to gaps in coverage that are damaging to affected workers. For most recessions, there is no evidence indicating a need for wasteful and potentially harmful discretion.

Proposed changes. The federal Emergency Unemployment Compensation program should be made a permanent program. A straightforward way to achieve is to reform the current Extended Benefit program and make it 100-percent federally financed. In the course of such a reform, the trigger structure should be modified to keep the fraction workers covered by UI approximately constant over the business cycle.

Fix outdated system of data collection to enable evidence-based policies

The issues. To maintain daily operations of their Unemployment Insurance programs, states collect information on workers' wages, UI claimants' benefits, and their employers' UI taxes. This information is vital for an efficient administration of the UI system, including understanding which parts of the system are cost effective. Yet the current law only requires states to share the data with federal agencies

for extremely limited purposes. Moreover, many of the data sets lack basic information, such as on worker age or gender. Ample experience now exists to cheaply handle and combine sensitive administrative data.

Proposed changes. The data collection should be modernized by adopting four complementary strategies: enhance data collection by states; establish a national data clearinghouse of Unemployment Insurance data at either the U.S. Bureau of Labor Statistics or the U.S. Census Bureau; support these changes by providing a common software and offering moderate grants for upgrade hardware; and establish a protocol to allow to access the data for research purposes and to improve the UI system. It is important to include an enforcement mechanism to ensure states' compliance with this requirement.

Expand coverage of Unemployment Insurance to fit structure of modern workforce

The issues. The current Unemployment Insurance system does not serve a large fraction of the unemployed. This is partly due to changes in the structure of the workforce, with increasing amounts of low-wage workers in unstable jobs or rising part-time employment especially among women. Through incentives provided by the American Recovery and Reinvestment Act of 2009, a substantial number of states have now made benefits more easily accessible by adopting a range of proposals.

Proposed change. A reform should provide pathways to harmonize eligibility for Unemployment Insurance across states and increase take-up rates among eligible individuals. There is little justification for the current patchwork of eligibility, and meetings of state and federal UI officials should provide a system of best practices for eligibility requirements and outreach. Eligibility requirements should include those proposed in the American Recovery and Reinvestment Act, among them allowing for training of UI beneficiaries, enabling part-time workers to claim benefits, enhancing the mobility of working couples by making moves for family-related reasons a qualifying event for UI, and instituting the alternative base period. In addition, some of the gradual restrictions imposed over the last three decades to lower UI payments should be reviewed and possibly modified as well.⁴

Resolve financing short-falls in states' UI trust funds

The issues. As a consequence of growing wages (and hence benefits) and low taxable wage bases that are not indexed to covered wages, just 25 percent of earnings covered by Unemployment Insurance laws nationally are currently subject to state UI payroll taxes. The minimum taxable wage base, set by the federal government, is currently \$7,000 and has not changed since 1983. Similarly, the net federal tax rate—as defined under the Federal Unemployment Tax Act, or FUTA—has been 0.8 percent for more than 30 years, depressing revenues that pay, among others, for UI administration by federal and state agencies.⁵ Many states' UI taxes—as defined by their State Unemployment Tax Act, or SUTA—have remained low as well, and states have increasingly resorted to borrowing to finance UI benefits in recessions. Hence, even without the large increase in UI payments during and after the Great Recession the financial soundness of the UI system was steadily eroding.⁶

Proposed changes. Several sensible reforms of the complex financing system have been proposed. One is to raise the federal taxable wage base, index it to wage growth, and correspondingly lower the FUTA tax rate.⁷ Another is to institute federal penalties for states that fail to carry sufficient forward balances in their trust funds during expansions.⁸ And a third is to prevent payroll taxes from rising in the midst of a protracted recovery by extending the 2-year window until FUTA tax credit expires, institutionalizing interest wavers, and encouraging states to also delay automatic tax triggers aimed at balancing their trust funds.

Additional proposal worthy of consideration but not discussed further here

There are additional interesting proposals meant to fix additional shortcomings of the current unemployment insurance system. In addition, there are challenging open questions that have not yet been addressed. These proposals and open questions include, among others:

- A modernization of the administration of Unemployment Insurance, including information technology used to administer claims, which is found to be often outdated and underfunded by the federal government⁹
- A reform of firms' UI tax rates to better internalize the costs of layoffs, reduce the cost to the UI system, and achieve similar cost of layoffs across states

- An optional private unemployment account to cover the self-employed or independent contractors¹⁰
- A “job seeker allowance” to aid young workers not qualifying for UI because of a lack of earnings history¹¹

Proposals for innovation of the Unemployment Insurance system

Even if sufficiently modernized according to these basic reforms, Unemployment Insurance as it is currently designed can neither prevent nor buffer much of the large and lasting earnings losses due to layoffs. This also affects the UI system’s efforts to reemploy workers, who may wait too long to engage in the long process of rebuilding their careers. Yet several innovations of the existing UI system have been proposed that could greatly expand the reach of UI without the need to establish a new program.

Institute a functioning system of work sharing to prevent costly layoffs

The issues. An increasing number of U.S. states have instituted programs of work sharing—also called short-term compensation, or STC—that allow workers to draw pro-rated UI benefits while on the job as an alternative to layoff. Evidence from other countries suggests work sharing can achieve substantial reductions in layoffs. Yet, take-up of the programs by employers in the United States has been low, partly because of restrictive program rules and partly because of a lack of awareness about the program.

Proposed changes. Several policy options are available to strengthen the use of STC across and within states, especially during recessions. One would be to continue to incentivize adoption of the program, with 100 percent of STC outlays funded federally for the first three years after adoption, or alternatively require states to establish STC programs. To raise attractiveness to employers, during this period states should be required to not charge employers for their uses (meaning there should be no experience rating). Another policy option would be to encourage states to share best practices and harmonize their efforts in outreach, and consider targeting employers using industry-level indicators of economic activity

or those in the WARN system.¹² A third policy option would be to encourage widespread use of short-term compensation during recessions when Extended Benefits are turned on by having STC benefits 100-percent federally financed; by suspending experience ratings; and by not having STC benefits deducted from workers maximum UI eligibility. Finally, research should continue to assess what prevents adoption of the STC program, and best practices for eligibility requirements should be developed.

Experiment with wage insurance to aid workers returning to employment

The issues. Since Unemployment Insurance only insures a minor fraction of the total earnings risk of job losers, its role as insurance mechanism and automatic stabilizer in recessions is substantially below potential. As a result, a growing number of researchers have suggested complementing the current UI system with a system of wage insurance. Wage insurance is likely to provide substantial additional insurance value. In addition, it may provide cost-savings by lowering UI payments. And it is unlikely to further reduce wages, and may raise them by shortening unemployment.¹³ Yet, currently little is known on potential effects of wage insurance.

Proposed changes. A series of proposals have been made to extend existing wage-insurance plans for trade-related layoffs to all workers covered by Unemployment Insurance.¹⁴ Given the evidence on job loss, introducing a version of wage insurance is sound policy, but an experimental evaluation will be important to better understand the effects. Policy parameters should be set with core facts in mind—for example, average wage losses of displaced workers with three years or more of tenure from good employers in a recession are about \$15,000 per year in the first couple of years,¹⁵ so \$10,000 over two years replaces only 30 percent of the loss.¹⁶ Similarly, insurance benefits should be extended to workers earning more than \$50,000 on their new job since this would exclude substantially affected middle-class employees and their families from insurance.¹⁷ Since most evidence suggest that earnings losses last at least three years, and likely many more, a proposal with sharp limits has to educate workers about the long path to recovery.

—*Till von Wachter is a professor of economics and associate director, California Center for Population Research, University of California-Los Angeles*

Endnotes

- 1 For a more extensive recent survey and discussion of these points, see Johannes Schmieder and Till von Wachter. "The Effects of Unemployment Insurance Benefits: New Evidence and Interpretation," *Annual Review of Economics* (Forthcoming).
- 2 See Till Von Wachter, "Measuring the cost of job displacement in terms of worker and family outcomes," University of California-Los Angeles, Working paper (2015), for an extensive survey of the measurement and outcomes of job loss.
- 3 See Johannes Schmieder and Till von Wachter, "The Effects of Unemployment Insurance Benefits: New Evidence and Interpretation," *Annual Review of Economics* (Forthcoming) for a discussion of UI and job quality. See Jesse Rothstein and Till von Wachter, "Social Experiments in the Labor Market," *Handbook of Field Experiments* (Forthcoming, 2016), edited by Abijit Banerjee and Esther Duflo, for an overview of evidence on reemployment services. See Henry Farber, Dan Silverman, and Till von Wachter, "Determinants of Callbacks to Job Applications: An Audit Study," *American Economic Review Papers and Proceedings* (2016) Vol. 106, No. 5, pp. 314-18 on evidence of hysteresis effects and a discussion of the literature.
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- 10 Lori G. Kletzer and Howard F. Rosen, "Reforming Unemployment Insurance for the Twenty-First Century Workforce," Hamilton Project Discussion Paper No. 2006-06. Washington, DC: The Brookings Institution (2006).
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- 12 The Worker Adjustment and Retraining Notification (WARN) Act requires companies with hundred employees or more to give six months notice before a plant closing or a layoff.
- 13 In Canada, workers taking up wage insurance saw substantial income increases (see Howard Bloom, Saul Schwartz, Susanna Lui-Gurr, and Suk-Won Lee, "Earnings Supplement Project (ESP)—Testing a Re-employment Incentive for Displaced Workers," Social Research and Demonstration Corporation. Report, 1999); yet, consistent with evidence from reemployment bonuses in the United States (see Bruce D. Meyer, "Lessons from the U.S. unemployment insurance experiments," *Journal of Economic Literature* 33 (March): 91–131, 1995), the cost saving from lower UI spells from wage insurance in Canada was moderate. All estimates from the United States indicate that UI benefits do not affect wages, and UI benefits tend to lower wages for those with longer spells (see Schmieder and von Wachter 2016).
- 14 Stephen Wandner, "Wage Insurance as a Policy Option in the United States." Upjohn Institute working paper 16-250 (2016).
- 15 Numbers are from Till Von Wachter, Jae Song, and Joyce Manchester, "Long-Term Earnings Losses Due to Mass Layoffs during the 1982 Recession: An Analysis Using Longitudinal Administrative Data from 1974 to 2008," working paper, University of California-Los Angeles (2011).
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Policy Issue: U.S. labor market mobility

Labor mobility: Guidance for the next Administration

By Abigail Wozniak, University of Notre Dame

Many Americans take pride in the idea that our country offers frequent opportunities for determined individuals to improve their economic lot in life. We imagine earlier generations moving West when agricultural conditions deteriorated during the 1930s; or moving North to fill in-demand blue collar jobs in our manufacturing centers in the 1940s and 1950s; or quickly moving through a series of entry level jobs before settling into the right job match. Yet economists who study these issues have reached a high level of consensus that these types of transitions have declined over the past three to four decades.

Regardless of how labor transitions are measured—as a change of employer, change of industry or occupation, change of location, or movements into or out of work—all are at substantially lower levels today than they were at the close of the 1970s. Rates of employer-to-employer job change have declined 25 percent, and inter-state moves are down 15 percent or more. According to one summary measure, overall fluidity has declined by 10 percent to 15 percent since the late 1970s.

The numbers are clear and there is widespread agreement—something about labor mobility in the United States has certainly changed. But it is less clear, and there is less agreement, about whether this change is good or bad. One leading economist remarked at a recent conference that if we replaced the word “mobility” with “turnover” then we would be celebrating its decline.

This remark highlights that transitions can happen for good and bad reasons. Transitions can indicate that workers are taking advantage of improved opportuni-

ties and are reaching better work and location arrangements. Or they can indicate that opportunities are scarce and require extensive searching. Conversely, the decline in transitions may indicate that workers are better matched to or better compensated by their current firms, requiring fewer changes. Or the decline may mean that opportunities for advancement have become fewer and farther between, and possibly, that the risk of an unsuccessful change has become greater.

What do we know about why labor mobility has declined?

The broad consensus around declining U.S. labor mobility is a recent development. Although some key research on the question began in the late 1990s, interest in labor market adjustments among scholars and the public took off as the country began what would be a long recovery from the Great Recession of 2007-2009. It was clear to all that many changes would have to be made to return U.S. workers to a situation like that of the mid-2000s. Families would have to move to booming cities from elsewhere. College graduates would have to switch into jobs that more intensively used their skills. Workers who had become discouraged and left the labor force would have to search for and return to employment. Yet as scholars began to look more systematically at measures of these transitions at the close of the last recession, it became apparent that not only had such transitions declined during the recession but in fact had been in decline for decades.

Given that the consensus of broad-based decline in labor mobility is a recent development, it is not surprising that scholars have yet to settle on a single explanation. There is a long list of potential explanations, however, that have been considered, and there has been some success in determining which of these are most plausible.¹

Here are four plausible explanations that deserve more investigation:

- ***Rising compensation flexibility may mean workers are paid what they earn more consistently, reducing the need to change employment to adjust wages.***
The data to fully investigate this are limited and restricted to a small set of researchers. There is some evidence that earnings volatility has risen, which might reflect more frequent compensation adjustments, but there is little evidence of an ongoing trend toward greater volatility.
- ***Declining firm dynamism (fewer start-up firms) may have reduced opportuni-***

ties for workers to jump ship from stagnating firms to high-potential new firms, lowering overall labor movement. There is ample evidence of a decline in the rate of new firm formation. But the links between this and overall labor market fluidity are the subject of ongoing research.

- ***Employers may be sharing fewer productivity gains with workers, limiting their incentive to change their employment situations.*** This is equivalent to an explanation that says bargaining power of workers has declined. Stagnant wage growth may be one symptom of this, but as with compensation flexibility, the data to fully investigate this are lacking, and it seems at odds with an increasingly competitive product market.
- ***Lower social capital and trust may make both employers and workers reluctant to change their situation, slowing overall fluidity in the labor market.*** There is strong evidence of declining trust and social capital (connectedness) in the United States dating back to the 1970s, but as with declining firm dynamism, the connection between the two declines has not yet been fully tested by researchers.

Here are seven explanations that have been investigated and found to play little role:

- ***Aging population and other demographic changes*** lead to fewer transitions in the labor market as workers age and become more settled (for example, through home purchases), but these changes are too modest to explain the overall fluidity decline.
- ***Occupational licensing*** now affects one-quarter of the U.S. workforce, and licensing requirements may slow movement into and out of licensed jobs, or across states. But evidence of the rise in licensing at the state level does not appear related to state declines in fluidity, casting doubt on it as an explanation for the overall decline.
- More sophisticated job search and recruiting may lead to ***better matching between workers and firms***, reducing the need for employment changes, but since this is not reflected in worker wage growth, the decline in fluidity seems unlikely to be the result of better worker-firm pairings.
- As jobs become more technology-intensive, firms may ***increase employer-provided training*** to workers, raising their incentive to retain workers and making worker knowledge more specialized. This could reduce employment transitions, but there is little direct evidence to support an increase in employer-provided training.

- **Health insurance-related job lock** is an unlikely explanation, since fluidity has fallen for workers both with and without employer-provided health insurance.
- **Dual-career spouses** can face challenges when co-locating in a city, making them reluctant to move once a workable arrangement is reached. However, they should make other types of employment changes at similar rates, and their rise in the population is too modest to explain the fluidity decline.
- **Changes in homeownership, land regulation, industrial regulation, and formalization of hiring** have been tested and do not correspond to declining fluidity at the state-level.

Why do people feel like their economic situation is unstable if fluidity is declining?

Before transitioning to an examination of policies that could boost labor mobility, it is worth pausing to acknowledge what appears to be a puzzle: If employment transitions are declining then why do workers feel so insecure in their jobs? Can it really be the case that workers are staying with their jobs longer when there is broad consensus that the era of “career jobs” is over? The answer to the second question is yes. Job duration has increased at the same time that labor market fluidity has declined. This is in part because of a decline in short-duration jobs—those lasting less than a year or less than a quarter. Yet this brings us back to the first question: Why, then, do workers feel less secure? Potentially it is because the incidence of very long duration jobs has also fallen. So the era of career jobs is ending, but the era of staying with an early employer for months or years longer than one’s parents did is here.

Workers may also feel a heightened sense of insecurity because finding a new job after losing one has become harder. The data show that movement into employment out of non-employment or unemployment has also declined. Separating from an employer without a new job in hand therefore means a longer period of unemployment and job searching than in the past. Although the length of unemployment spells received increased attention during the Great Recession, these are longer-run trends that date back several decades and reflecting a changed landscape of employment in the United States.

How the next Administration should act on labor mobility

The forces behind declining labor mobility likely have deep roots. The fact that they have been in operation for at least three decades suggests they are unlikely to be affected by short-run policy. The fact that the forces themselves remain to be fully determined mean that it is not yet clear what the appropriate long-run policy responses would be. Still, there are at least five concrete policy steps that are appropriate now:

- **Step 1:** Reform the Unemployment Insurance system to reflect the fact that unemployed workers face longer spells of unemployment, and are more skilled and older than in the past
- **Step 2:** Develop a pilot program of relocation vouchers for young workers, and use gold-standard methods to evaluate its success
- **Step 3:** Assist community colleges and four-year colleges in counseling students who will face longer tenures with any given employer and heightened difficulty changing employment
- **Step 4:** Pivot the policy focus on occupational licensing to emphasize job access and rationalizing the burden on practitioners across fields and states
- **Step 5:** Develop and improve access to data on the specifics of how firms hire and compensate workers

These steps will inform the ultimate long-run policy response and greatly help workers adapt to the situations they face today. Let's examine each of them in turn.

Reform the Unemployment Insurance system to reflect the fact that unemployed workers face longer spells of unemployment, and are more skilled and older than in the past

Given longer tenures that workers have with a given employer, the typical worker may experience unemployment spells that are more distant than in the past. With the decline of “career jobs,” more experienced and higher-skill workers will enter the Unemployment Insurance system. Both forces suggest that UI should be reformed to better serve clients who are at more advanced stages of a developed career. Older UI requirements may be a hindrance to such workers. In many states, for example, job search is monitored by requiring UI recipients to apply regularly

for available jobs in their fields. This may not be appropriate for more experienced workers, who may rightly pass on applying for a job in their field that entails significantly less responsibility than they had before. Such workers also may be actively searching without applying for jobs, for example, by attending networking events or arranging informational interviews.

Yet it is important to consider the rising share of unemployed workers who face longer spells of unemployment than in the past. These workers will need longer access to assistance in order to keep them connected to the labor market and prevent large negative consequences to their household budgets. There are many ways to support such workers. The UI system could use data it has at its disposal to try to identify workers most at risk of a long unemployment spell, and direct them to enhanced resources sooner.

Benefits also could be offered at a tapered rate to such workers. The idea here is to lower the monthly benefit amount for at-risk workers in order to extend the total months of benefits. Such workers also might qualify for enhanced benefit access, for example, while they are enrolled in a training program. Increased targeting of benefits streams to those at risk for long-term unemployment seems likely to lead to greater welfare gains than other types of expanded access to UI, such as expansions to allow receipt while holding part-time employment.

Develop a pilot program of relocation vouchers for young workers, and use gold-standard methods to evaluate its success

There is limited but compelling evidence that relocation can benefit individuals who are strongly encouraged to do it, leading to higher earnings, better health outcomes, and better schooling outcomes for children.² The evidence is limited, however, and there is also evidence that some families and individuals fare poorly after relocation. It is therefore appropriate to proceed with a limited program using cutting-edge design and careful monitoring to evaluate its impacts. Evidence and theory suggests that the groups most likely to benefit from such a program are young workers and families with young children. Relocation entails fewer benefits for older children and can potentially be detrimental.

The limited evidence also suggests that any voucher amount would need to be fairly large to encourage take up, perhaps equal to 20 percent to 50 percent of the price of a modest home. Such a program might be financed by allowing individuals to borrow (in whole or in part) against future Unemployment Insurance or

Earned Income Tax Credit entitlements. The program could, but need not be, targeted by place of origin. Such programs have been tried on a small scale in the United States in the past. Anecdotally these seem to have had low take-up, and there is little evidence of success.³ Improved targeting and high-subsidy amounts could lead to substantially greater successes for such a program.⁴

Assist community colleges and four-year colleges in counseling students who will face longer tenures with any given employer and heightened difficulty changing employment

Students need to understand that their first job will have a greater impact on their lifetime career path than it did for their parents. They should be encouraged to search more intensively during their first major period of job search. This is a key time in which marginally greater investment in job search could have payoffs decades into the future. Students should be encouraged to be more ambitious than “just finding a job” by sorting out what they want to do later. That first job is increasingly important for their career path, and they should plan accordingly.

Pivot the policy focus on occupational licensing to emphasize job access and rationalizing the burden on practitioners across fields and states

Many licensing practices can be reformed to rationalize the system and promote access for new entrants, but the evidence is scant that this will substantially jump start labor mobility. Policy on licensing should therefore primarily focus on access and appropriate burden (requirements) and secondarily on labor fluidity.

Develop and improve access to data on the specifics of how firms hire and compensate workers

All available evidence points to key changes in the way that firms hire and compensate workers, but researchers have limited access to the best available data for investigating these issues and no access to other key information because it simply is not collected. While we collect large amounts of information on individuals and families, the information we collect on what firms are doing to attract and retain workers is extremely limited. The last time the U.S. Bureau of Labor Statistics was able to field a survey to ask firms about their employer provided training was in 1995.⁵

—*Abigail Wozniak is an associate professor of economics at the University of Notre Dame*

Endnotes

- 1 Key surveys of this literature include: Steven Davis and John Haltiwanger, "Labor Market Fluidity and Economic Performance," NBER Working Paper #20479 (Cambridge, MA: National Bureau of Economic Research, 2014); Raven Molloy, Christopher L. Smith, Riccardo Trezzi, and Abigail Wozniak, "Understanding Declining Fluidity in the US Labor Market," *Brookings Papers on Economic Activity* (2016, forthcoming).
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- 4 A related proposal was made in Jens Ludwig and Stephen Raphael, "The Mobility Bank: Increasing Residential Mobility to Boost Economic Mobility" (Washington, DC: The Hamilton Project, 2010), http://www.hamiltonproject.org/assets/legacy/files/downloads_and_links/Final-Ludwig_DiscussPaper_Oct2010.pdf.
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Policy Issue: Trade and worker welfare

International trade and U.S. worker welfare: understanding the costs and benefits

By David Autor, Massachusetts Institute of Technology

Economists have long recognized that free trade has the potential to raise living standards in all trading countries. The logic is sound and simple. A given country, say the United States, will want to buy goods from another country, say China, only if the United States receives goods from China that are worth more to it than the goods it is trading in return. Similarly, China will want to trade with the United States only if the goods it receives in return are more valuable to it than the goods it is trading. That is, countries trade if they both view themselves as getting the better end of the bargain. How can it be that both get the better end of the deal? When the United States sells China civilian aircraft and buys Chinese-made apparel and consumer electronics, the United States and China each end up with a bundle of goods (aircraft, apparel, consumer electronics) that it prefers to the goods it had originally. In this sense, trade among nations is akin to a vast open-air market: each country displays its wares and makes mutually beneficial swaps with other countries.

Countries do not simply sell the surplus stuff that they have on hand, however; they make goods specifically for trading. And this adds to the gains from trade. Knowing that there is a vast world market, countries focus their resources on making the goods that they are best at making. They then swap these goods for the items that other countries are best at making. It is no accident, of course, that the United States is exporting aircraft and importing footwear. As a technologically advanced, high-skill nation, the United States can make aircraft better, cheaper, and faster than other countries. In economic lingo, it has a comparative advantage in producing aircraft. China, as a rapidly developing country with an abundance of capable but not (yet) highly educated workers, has a comparative advantage in making labor-intensive goods such as apparel, footwear, and assembled electronics. Thus, both gain from trade.

This logic offers a strong *prima facie* case for why policy makers should foster free trade. Lifting quotas and tariffs and removing artificial trade barriers abets national growth by lowering consumer and producer prices and permits countries to specialize in doing what they do best. Trade raises gross domestic product whether countries run trade deficits or surpluses; whether countries specialize in high-tech or low-tech goods; and whether trade is among rich countries (the United States and Germany), among poor countries (Zimbabwe and Mozambique), or among rich and poor countries (the United States and Bangladesh). It is not an overstatement to say that trade among consenting nations raises GDP in all of them.

Winners and losers

What applies to the welfare of a country in aggregate, however, does not necessarily apply to all of the citizens within a country. Consider again the case of aircraft and apparel. As the United States opened to trade with China, it began producing more planes and fewer articles of clothing than it otherwise would have done. Employment rose in the domestic aircraft industry, accordingly, and fell in the domestic apparel industry (again, relative to what would have occurred). If workers in apparel and aircraft had identical skillsets and, moreover, lived and worked in the same towns, then displaced apparel workers might quickly be rehired in aircraft manufacturing, perhaps at better wages. All good!

In reality, there are two reasons why this all-good scenario will not happen in practice. First, workers cannot change jobs at no cost. Decades of economic research demonstrate that workers who are involuntarily displaced from career jobs—particularly manufacturing jobs—suffer substantial earnings losses. These losses average one-and-a-half to nearly three years of annual earnings over the following 20 years, with the deepest scars felt by workers who are displaced during recessions.

Even more fundamentally, trade integration reshapes labor markets in a way that is likely to be permanently beneficial for some skill groups and permanently harmful to others. The reason is that when the United States integrates with large, labor-intensive countries such as China, the aircraft-apparel parable plays out on a vast scale. The United States gains employment in numerous skill-intensive sectors, such as aircraft, pharmaceuticals, passenger vehicles, integrated circuits, and high-tech metals. It simultaneously loses employment in many labor-intensive sectors, such as apparel, footwear, furniture and bedding, toys and sports equipment, and assembled electronics. The aggregate contraction in labor-intensive production

depresses the employment-and-earnings opportunities of workers who compete most directly with Chinese workers, typically high-school educated workers, many of them males and minorities.

Meanwhile, the expansion of skill-intensive production raises the real earnings of highly educated workers, those who might design and build the high-tech products that the United States exports. And there's the rub—even as trade increases the size of the national pie, it shrinks the slices received by some citizens, most especially, blue-collar, non-college workers.

This analogy also suggests its own solution. If trade makes the pie larger then isn't it feasible in principle to restore every slice to its original size and still have some extra pie left over to share? And the answer is emphatically yes: because the pie is bigger it is possible for every person to have a bigger slice. But this will not happen without policy intervention. Absent active redistribution, trade will create both winners and losers—larger and smaller slices.

The evidence

That's the theory. What is the evidence? For the first three or four decades of the post-war era, there was little occasion to scrutinize the benefits of trade. Most goods flowed “North to North,” that is, between nations with relatively similar average incomes, which helped to subdue distributional impacts. When U.S. inequality began to rise in the 1980s, economists vigorously renewed their study of the impacts of trade on labor markets. They found, reassuringly, that trade had not had substantial adverse distributional effects, either for low-skill workers specifically or for import-competing industries more generally. The broad sentiment that emerged at that time was that the rise of earnings inequality was primarily attributable to technological changes that complemented high-skill workers and reduced labor demand in manufacturing. The impact of international trade seemed to be modest, at best.

Just as the economics profession was reaching consensus on the consequences of trade for wages and employment, an epochal shift in patterns of world trade was gaining momentum. China was finally emerging as a great power after decades as an economic laggard, toppling established patterns of trade accordingly. China's rise has provided a rare opportunity for studying the impact of a large trade shock on labor markets in developed economies.

The advance of China also toppled much of the received economic wisdom about the impact of trade on labor markets:

- The consensus that trade could be strongly redistributive in theory but was relatively benign in practice has not stood up well to these new developments
- The belief that trade adjustment is relatively frictionless, with impacts that diffuse over large skill categories rather than being concentrated among groups of workers in trade-competing industries or locations.

After quantifying these impacts and adjustment frictions, current research finds that the short- and medium-run adjustment costs demanded by large trade shocks are sizable entries in the accounting of gains from trade.

What these findings mean in practice is that not only does trade create winners and losers but also the losses are much more concentrated than economists had previously understood. They are borne most heavily by workers originally employed in import-competing sectors, such as those footwear workers, secondarily by the surrounding local labor market in which those employers are housed, and only thirdly by the overall “skill group” to which displaced workers belong.

Concretely, employment at U.S. textile plants has fallen by nearly two-thirds (from more than 700,000 to less than 250,000) over the past 20 years as fabric production and apparel manufacturing shifted overseas in search of lower labor and production costs.¹

The elimination of nearly half-a-million textile jobs appears enormous, but it is actually a drop in the bucket for a U.S. labor market of 150 million workers—and hence unlikely to substantially affect earnings opportunities for blue-collar workers nationwide. But this contraction constitutes a powerful and sustained blow to the regions of the United States that formerly engaged heavily in textile production. In 2000, half of U.S. textile and apparel production was located in just eight southeastern states (Alabama, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee, and Virginia). And within those states, productions was heavily concentrated in counties where it constituted more than 15 percent of employment.² And within those counties, the workers employed in career textile jobs were most adversely affected.

Main implications

There are seven main implications:

1. Trade among consenting nations raises GDP in all of them. Policymakers should always be looking for ways to take advantage of the opportunities that trade offers.
2. Because trade grows the national pie, it creates an opportunity for every citizen to acquire a modestly larger slice. No one necessarily need have a smaller slice.
3. Absent policy intervention, trade will almost necessarily shrink some slices of the pie even as it causes the pie to grow.
4. The benefits from trade tend to be small at the individual level but broadly shared—that is, they are diffuse. Importing Chinese apparel rather than producing it domestically, for example, lowers the costs of clothing nationwide—and perhaps lowers it most for consumers who purchase clothing inexpensively from big box retailers and fast-fashion outlets. Aggregating across all goods, these benefits amount to one or two percentage points of annual income for most households. That’s meaningful, but it’s not life changing.
5. Conversely, the adverse impacts of trade are highly concentrated among specific worker groups and locations. These losses can be quite sizable, as the apparel example highlights. Thus, it is entirely possible for trade to grow the size of the national pie by one percent or two percent while shrinking some individual slices by 20 percent or 30 percent.
6. Recognizing these points, policymakers should refrain from asserting that ‘everyone wins’ from trade. When rich countries primarily traded among themselves in the first few decades after World War II, trade likely had very modest distributional costs in rich countries—that is, there were many winners and few losers. That era is behind us. Over the past two decades, trade integration between the developed and developing world—most particularly between China and the West—has produced large aggregate gains in GDP in rich and poor countries alike. It also has generated concentrated economic costs for low-skill workers in wealthy countries. Those harms have not been offset either by lower consumer prices (cheaper apparel) or by the very modest set of policy tools that the United States has used to assist workers adversely affected by trade

7. While discussion of trade policy has entered U.S. politics with a ferocity not seen in decades, this discussion is largely reactive and backward looking. Looking forward, the great China trade shock may soon be over, if it is not already. China is moving beyond the period of catch up associated with its market transition and becoming a middle-income nation. Rapidly rising real wages (after accounting for inflation) indicate that the era of cheap labor in China is no more. China's comparative advantage in the future will likely be less about making cheap goods and more about making high-quality products that compete with those made by middle- and high-income countries such as Japan, South Korea, Mexico, and the United States. Absent any change in U.S. trade policy, the next decade of trade integration will be far less dramatic and wrenching than the two decades that preceded it.

Policy options

There is no magic policy that can fully shield workers from the challenges of trade adjustment while simultaneously allowing the nation to realize all of the benefits that come from trade integration. When industries contract or shut down—due either to trade, technological advances, or even to shifts in consumer tastes—workers in those industries typically experience real and sustained economic losses. These losses are larger among less-educated workers, who tend to lack the skills and flexibility to quickly adapt to new circumstances, and these losses are larger when they occur during recessions because workers tend to remain involuntarily employed for extended durations.³ The following policy ideas address some of those costs.

Increasing the accessibility and flexibility of Trade Adjustment Assistance

The current U.S. Trade Adjustment Assistance program is difficult to access and places artificial strictures on workers' reemployment options. To access TAA, a group of workers (generally employees of the same firm) must petition the U.S. Department of Labor to recognize that they have experienced a reduction in employment or wages due to foreign trade. If their petition is granted after investigation, then the workers may access services that include job training, job search and relocation allowances, income support, and assistance with healthcare premium costs. In general, these services are only available while displaced workers are undergoing training and remain out of the labor market. If a displaced worker

wanted instead to take a new job at a lower wage soon after losing her original position, TAA would not provide assistance.

Providing wage insurance

Workers displaced from career jobs typically have trouble getting back into the labor market. One psychic barrier is that the jobs available to displaced workers often pay less than their previous work. Concretely, consider what occurs when an apparel factory shuts down. Because of widespread contraction of the apparel sector, displaced apparel workers are unlikely to find equally well-paid jobs nearby. But many displaced workers will be reluctant to immediately take a large pay cut, locking in a lower standard of living and, arguably, acknowledging economic defeat.

But waiting is costly. The longer workers spend unemployed, the harder they find it to get a new job. Economic research demonstrates that employers are reluctant to hire the long-term unemployed. And when workers are unemployed for extended periods of time, they may lose confidence and motivation. Thus, getting displaced workers back into the game is potentially valuable—even if it means taking a pay cut.

In January of 2016, the Obama administration proposed a so-called wage insurance policy that was intended to facilitate this goal.⁴ The president's plan would provide workers with an insurance policy that would replace half of lost wages, up to \$10,000 over two years. Displaced workers making less than \$50,000 who were with their prior employer for at least three years would be able to leverage these resources to help them get back on their feet and on the way to a new career.

The simple idea of wage insurance is to ease the economic and psychic pain of transitioning to a new line of work. If a displaced worker must take a pay cut to get reemployed then the wage insurance policy would meet them half way. Once reemployed, workers may find that they are able to move quickly up the wage ladder, in which case, the wage insurance policy would not make further payments. If this doesn't occur, however, then workers would be afforded up to two years to make other adjustments.

Of course, a policy as generous as the president's proposed wage insurance plan must also be carefully targeted, otherwise the fiscal cost would be prohibitive. The need for careful targeting has costs—it makes the program difficult to access and may deter deserving beneficiaries. Moreover, a policy targeted only at trade adjust-

ment does not assist workers displaced by other exogenous economic events such as firm failure or technological advances that make their skills redundant, the latter of which is surely even more important than trade for job loss over the longer run.

Extending the Earned Income Tax Credit to workers without qualifying children

The Earned Income Tax Credit is among the nation's most significant tools for reducing poverty and encouraging people to enter the workforce. In 2014, the EITC and the refundable Child Tax Credit supported 32 million working families, many with children. Because receipt of the EITC is contingent on work, much reputable economic research confirms that the EITC increases both income and employment.

Workers without qualifying children, however, miss out on the anti-poverty and employment effects of the EITC. In 2015, workers with three-plus dependent children could receive up to \$6,242 in EITC income from the federal government. By contrast, adults without children and non-custodial parents could receive at most \$503 in EITC income—which in economic parlance is *bubkas*. As such, the EITC provides little cash assistance or employment incentive to childless workers and non-custodial parents.

Many of the individuals who do not qualify for EITC due to childlessness or non-custodial status are low-educated males and minority males. Ironically, low-education and minority males are also disproportionately likely to be impacted by adverse shocks to manufacturing.⁵ Thus, unintentionally, the EITC appears targeted to not help the group that is arguably most sorely in need of such assistance.

The White House proposed in 2014 to expand the EITC to cover childless workers and non-custodial parents.⁶ This is an excellent idea. In addition to facilitating trade adjustment, the proposed EITC expansion would ameliorate another pressing economic problem: the declining labor force participation rate of prime-age males in the United States. Since 1990, the United States has experienced the second-largest decrease in prime-age male participation among all the developed or leading developing member nations of the Organisation for Economic Cooperation and Development. At present, the United States has the third-lowest labor force participation rate in this group. The fall in participation for prime-age men has largely been concentrated among those with a high school degree or less, and participation rates have declined more steeply for black men than for white men. Expanding the EITC may help to stem or even reverse this ill tide.⁷

The proposed EITC expansion would also assist workers suffering adverse employment consequences from any of multiple causes—trade exposure, technological displacement, and general declines in economic conditions—all of which are economically damaging, and most of which are outside of workers’ individual control.

While there is no magic policy that makes trade adjustment painless, the policy options above are better than the ones that the United States is currently pursuing. Moreover, the natural alternative policies of either restricting trade or refusing to acknowledge the distributional costs of free trade are the worst options of all. Restricting trade and rejecting forward-looking trade deals such as the Trans Pacific Partnership would reduce long-run U.S. prosperity and cause considerable collateral damage to U.S. allies. (It bears note that China would likely be delighted if the TPP were scrapped.) The latter idea—insisting that “everyone wins” from trade—is also counterproductive. Indeed, the Pollyannaish boosterism surrounding past trade agreements is arguably one key reason why trade deals have become increasingly unpopular.

Placing China’s growth in historical and global context

It is fair to say that China’s rise has likely done more to alleviate global poverty and reduce world inequality than any single economic event occurring in centuries. China’s economic growth has lifted hundreds of millions of individuals out of poverty. The resulting positive impacts on the material well-being of Chinese citizens are abundantly evident. Just consider Beijing’s seven ring roads, Shanghai’s sparkling skyline, and Guangzhou’s multitude of export factories—none of which existed in 1980 and all of which are indicative of China’s success. China’s growth generated a commodity boom that spread prosperity across South America and the commodity-producing regions of South Asia and Southeast Asia. China also has emerged as Africa’s largest trading partner, providing demand for the continent’s energy and minerals. China’s newfound wealth has permitted it to make large direct investments in Africa, often in some of the poorest countries from which Western investors have historically shied.⁸

Politicians should not lose sight of these enormous gains in world welfare when lamenting the comparatively modest adverse impacts felt by some U.S. workers. China is right to suspect that many U.S. politicians would rather see China’s billion citizens face economic stagnation rather than allowing a comparatively small set of American manufacturing workers face new competitive challenges.

—David Autor is a professor of economics at the Massachusetts Institute of Technology

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Policy Issue: Supply chains

Supply chains and equitable growth

By Susan Helper, Case Western University

The U.S. economy has undergone a structural transformation in recent decades. Large firms have shifted from doing many activities in-house to buying goods and services from a complex web of other companies. These outside suppliers make components, and provide services in areas such as logistics, cleaning, and information technology. Although this change in the structure of supply chains began decades ago, neither public policy nor business practice have adequately dealt with the challenges posed by this restructuring.

As a result, weakness in supply chains threatens U.S. competitiveness by undermining innovation and contributes to the erosion of U.S. workers' standard of living. This essay suggests policies to promote supply chain structures that stimulate equitable growth—that is, policies that both promote innovation and also insure that the gains from innovation are broadly shared.

The role of supply chains in the U.S. economy

A supply chain links companies, often in multiple industries and multiple locations, to design, produce components, assemble and distribute a final product, such as a car, a computer, or a restaurant meal.¹ For much of the 20th century, a significant part of the U.S. economy was characterized by supply chains that were vertically integrated.² Beginning in the 1970s and 1980s, large firms in many industries began to sell off assets and outsource work. Today, a lead firm typically designs products and directs production by multiple tiers of suppliers in many locations, but does not own most of these suppliers.³

Supply chains made up of these financially independent firms are now the largest driver of firms' costs. The average U.S.-based multinational firm buys intermediate inputs that comprise about 75 percent of the value of its output; a domestically owned firm buys intermediate inputs equal to about 50 percent of output value.⁴ Contrary to the common impression, most of these suppliers are domestic, even in manufacturing.⁵

These outsourced supply chains differ from vertical integration in that the lead firm does not own supplier facilities. The lead firm benefits from this arrangement by gaining access to products made by suppliers with experience in making similar products for multiple customers and by not being responsible for subsidiaries' fixed costs.

These supply chains also typically differ from economists' model of perfect competition, in which transactions between firms are at arm's length and the only information that crosses firm boundaries is price information. In contrast, many suppliers make products specifically tailored to meet the needs of the lead firm and frequently exchange information with the lead firm regarding designs, production processes, and future plans. Lead firms find this arrangement advantageous because they are able to quickly obtain components tailored to their specific needs. The complementary disadvantage is that firms are often unable to change suppliers easily.

On one hand, sharing suppliers with other lead firms has significant benefits, such as shared knowledge across customers and reduced fixed costs. On the other hand, lead firms may lack incentive to invest in upgrading the supplier's capabilities if that supplier may also use those capabilities to serve a competitor. Firms' success depends upon having robust networks of suppliers, but no one firm is responsible for keeping these networks healthy.

Implications of supply chain structure for innovation

Because innovation is concentrated in manufacturing—two-thirds of private-sector research and development is performed in manufacturing—this section looks at supply chains in manufacturing only (data is not readily available for innovation in other sectors.)⁶

Firms with fewer than 500 employees are an increasing share of manufacturing employment, accounting for 42 percent of such workers in 2012. These small firms struggle at each phase of the innovation process. They are only 15 percent as likely to conduct research and development as large firms. Small firms also

struggle to obtain financing and a first customer to help them commercialize a new product or process. Finally, small manufacturers have trouble adopting new products or processes developed by others, due to difficulty in learning about and financing new technology. As a result, small manufacturers are only 60 percent as productive as large firms.⁷

A skeptic may ask why large lead firms cannot innovate enough to support their entire production network. But problems such as reducing the vibration of a wind turbine requires holistic problem-solving; a machine composed of many parts that exert strong forces on each other cannot simply be divided into one problem for the gearbox manufacturer to solve, one for the rotor manufacturer to solve, and another for the assembly team to solve. Limiting innovation to lead firms deprives the supply chain of insights that come from being very close to a particular type of production or use.⁸ In addition, long-term supplier-customer relationships built upon trust and collaboration best facilitate progress toward these goals; lack of such relationships accounts for many of the problems U.S. industries face in moving new technologies from lab to market.

Implications of supply chain structure for job quality

Workers are employed in supply chains in a variety of ways. Instead of being hired directly by lead firms as regular employees, workers may be hired by temporary help agencies and are often referred to as “contingent workers.” Alternatively, they may be hired as regular workers at supplier firms or as independent contractors.

A variety of studies find that these forms of outsourcing of employment, especially as carried out in the United States, typically create undesirable outcomes for workers in areas such as wages, benefits, job security, and safety.⁹ Contingent workers earn 10.5 percent less per hour and 47.9 percent less per year than non-contingent workers, and are more likely to suffer workplace injury.¹⁰ Workers employed at suppliers, even as regular workers, generally earn less than workers at lead firms, which tend to be larger.

Wages are typically lower at suppliers than at lead firms because of the barriers to innovation discussed above, which reduce productivity; the absence of pressures to reduce wage differentials within a firm due to norms of fairness; and greater pressure on wages at outside suppliers, which are more easily replaced than are internal divisions.

Market and network failures in supply chains

Three forms of market failure contribute to the central tendency of U.S. supply chains to suppress innovation and make jobs worse:

- ***Free-rider problems between firms.*** When a lead firm makes investments in upgrading its suppliers—by providing technical assistance to suppliers, training supplier workers, or helping them invest in new equipment—some of this improved capability will often spill over to benefit a supplier’s other customers, including the lead firm’s rivals. Lead firms thus have less incentive to invest in their suppliers than would be socially beneficial.¹¹
- ***Siloes within firms.*** Internal conflicts between departments within a lead firm can mean a focus on finding suppliers with low prices rather than on those providing high quality and innovation. An easy way for firms to evaluate their purchasing departments, for example, is the extent to which they reduce the price per unit they buy. A purchasing agent could thus be rewarded for choosing a supplier whose costs are \$1,000 less than a rival supplier’s—even if that supplier’s skimping on quality control later causes the shutdown of a production line that costs the operations department \$100,000. It may seem unlikely that sophisticated companies would fall prey to such problems, but quality and innovation are harder to measure than prices, and their benefits often accrue to departments other than purchasing.¹²
- ***Profit protection.*** Outsourcing of work often reduces workers’ access to profits earned by the lead firm. Organizational structures tend to minimize wage differentials within firms, due to both norms of fairness and to a desire to promote cooperation within an organization. Firms with a high degree of market power have lots of profits to protect, which they often do by adopting policies that make their suppliers interchangeable, even at a cost to efficiency.¹³

The result of these market failures is an emphasis in the United States on arm’s length rather than collaborative governance of supply chains, and a hollowing out of productive eco-systems, as firms set up incentives for their purchasing departments that privilege supplier firms that can win competitive bidding wars. These “winners” tend to be small firms with low expenditures on overhead costs, covering such things as salaries for managers and engineers and worker training. In extreme cases, such as garment production or janitorial services, competition is so fierce that firms compete in part by violating laws on safety, minimum wages,

overtime, and disposal of toxic waste. In the rare instances in which these firms are caught, they often can file for bankruptcy and re-open under another name.¹⁴

Policies to promote innovative supply chains with good jobs

Outsourcing has its advantages, principally in making possible a potentially efficient division of labor in which specialist firms can achieve economies of scale and diffuse best practices by serving a variety of customers. Yet lead firms' zealous embrace of the non-collaborative version of this strategy has resulted in significant weaknesses in innovation and job quality in the United States. Tackling these challenges will help address some root causes of wage inequality and productivity stagnation in U.S. manufacturing and service industries. Policies in five areas will help:

Encourage firms to adopt collaborative supply-chain practices

Public support for economic growth has long focused on the diffusion of physical technologies, yet the diffusion of operational insights may be just as valuable. Evidence suggests supply chains with more collaborative practices are more innovative.¹⁵ The next Administration should use its convening power to encourage lead firms to take steps such as:

- ***Offer suppliers assurance that they will receive a fair return on investments they make in new technologies and in upgrading their capabilities.*** In order to become partners in innovation, suppliers need to develop better capabilities in product and process design and to upgrade equipment.
- ***Promote information-sharing and make changes in their own operations as a result of supplier suggestions.*** A key insight from the Toyota Production System is that firms and workers who are close to production have access to information not easily available to those at the top of the chain.¹⁶ Firms that establish mechanisms to learn from their suppliers can significantly improve cost and quality.
- ***Use a "total cost of ownership" approach when making purchasing decisions.*** Firms should consider impacts of sourcing decisions on quality and innovation as well as on price per unit purchased.¹⁷ Forming long-term, collaborative relationships with highly competent suppliers may be in a firm's best overall interest, yet purchasing departments are not always incentivized to consider these benefits.

Nurture productive eco-systems of firms, universities, communities, and unions

One reason for the struggles that small- and medium-sized U.S. firms face is that they are “home alone,” with few institutions to help with innovation, training, and finance.¹⁸ For reasons of both equity and efficiency, these firms should not depend solely on their customers for strategic support.

Policies that nurture small firms, local universities, their communities, and unions could help the firms leverage their advantages over their larger brethren in nimbleness and strong community ties. Germany’s Mittelstand (medium-sized firms) are the backbone of the German manufacturing sector due to the help they get from community banks, applied research institutes, and unions.¹⁹ In the United States, the unionized construction sector has developed structures that create good jobs and fast diffusion of new techniques, even though the industry remains characterized by small firms and work that is often intermittent. Building trades unions work with signatory employers to provide apprenticeships, continuing education programs, and portable benefits.²⁰

Federal technology assets should be better deployed as well, continuing the work begun by the Obama White House Supply Chain Innovation Initiative.²¹ National labs can be encouraged to work with small as well as large firms, for example, and the Manufacturing Extension Partnership can expand its efforts to work with entire supply chains (rather than firms one by one) to identify sources of inefficiency. A century ago, the federal government played this role in agriculture by funding land grant universities, which led not only to the creation of knowledge, but also created durable networks of researchers and practitioners through which such knowledge could quickly spread.²²

Promote formation of supply chains in industries that advance national goals

The free-rider problems discussed above are likely to be particularly acute in forming collaborative supply chains for new products, such as improved solar panels or wind turbines. These industries face additional market failures leading to underinvestment in addressing climate change. The Obama Administration’s Clean Energy Manufacturing Initiative helps to move new technologies out of the laboratory and into production. It would be useful to explicitly address the incen-

tive and information issues in supply chains for producing and installing these products. The next administration could convene firms throughout the supply chain to engage in value analysis to improve product designs, to uncover hidden pockets of inventory, and to adopt total-cost-of-ownership techniques.

Promote good jobs and high-road strategies

Much research documents the ways that firms can utilize “high-road” policies or “good-jobs” strategies to tap the knowledge of all their workers to create innovative products and processes.²³ High-road firms remain in business while paying higher wages than their competitors because their highly skilled workers help these firms achieve high rates of innovation, quality, and fast response to unexpected situations. The resulting high productivity allows these firms to pay high wages while still making profits that are acceptable to the firms’ owners. Collaborative supply chain governance plays an important role in providing the stability needed to support these strategies, from which lead firms also benefit.

Dis-incentivize low-road production strategies

Even in collaborative scenarios, wages are often less than in the old vertically integrated model. The corrosion of labor union power enables outsourcing, and the increase in outsourcing has, in turn, further decreased workers’ bargaining power.

Thus, as important as it is to “pave the high road,” it is also important to “block the low road.”²⁴ The Department of Labor has begun to take advantage of modern supply chains’ emphasis on “just-in-time” delivery, recognizing that reduced inventories make regulators’ threat to shut down suppliers for violation of wage and hour laws a more potent threat.²⁵ New policies could combine such sticks with some carrots. The federal government could offer technical assistance, for example, to help small garment manufacturers move away from the existing low-road model, in which ill-trained workers typically do one simple operation to a garment and then pass it on to the next worker. Instead, these firms could adopt a more agile production recipe, one that involves more broadly trained and higher-paid workers collaborating in teams—a high-road model sustained by greater productivity and reduced lead times.

Government should implement collaborative supply-chain practices within its own purchasing, building on the Obama Administration’s nascent efforts to

measure total cost of ownership and to ban supply chains with recent violations of labor and other laws from selling to the government.²⁶

Current outsourcing practices allow lead firms and their suppliers to reap the benefit of paying workers only when needed, while the risks of being left without earnings are borne by workers. Several proposals could improve the balance here: encouraging work-sharing in downturns (which would make hiring regular workers less costly), continuing to improve the portability of benefits across firms, and promoting schedule stability.

Retooling supply chains for equitable growth

Decisions about how to structure supply chains matter greatly for working Americans, yet this topic rarely takes a front seat in policy discussions of how to address rising inequality and stagnating productivity. In order to promote equitable growth, policymakers must understand how the economic pie is created—not just how it is divided.

Fundamental changes in the way supply chains operate threaten U.S. economic competitiveness by undermining innovation, and erode American workers' economic security. The rise over the past few decades of supply chains with small, weak firms leads to an increased presence of firms that innovate less and pay less. It is unlikely and undesirable, however, that the United States would return to the often bureaucratic and stifling vertically integrated supply chains of the mid-20th century.

We can do better. This essay outlined government and corporate policies to promote both more innovation and better job quality in supply chains. In particular, more collaborative supply chains and better-supported local eco-systems could significantly improve the viability of “good jobs strategies.” The way the economic pie is created affects the way it is divided.

— ***Susan Helper is the Frank Tracy Carlton Professor of Economics at the Weatherhead School of Management at Case Western University***

(For more detail on these proposals and the analysis behind them, see Susan Helper and Timothy Krueger, “Supply chains and equitable growth,” Washington Center for Equitable Growth, September 29, 2016, <http://equitablegrowth.org/report/supply-chains-and-equitable-growth/>.)

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Policy Issue: Consumer credit

What new administrative data reveals about access to consumer credit and the U.S. economy

By Kyle Herkenhoff, University of Minnesota, and Gordon Phillips, Dartmouth College

The aim of this essay is to provide several pertinent facts about the way unemployed households in the United States use consumer credit and the way bankruptcy flags affect job finding rates and business creation. These facts can be used by policymakers, including legislators and central bankers, in order to better understand the implications and feasibility of both consumer credit regulations and monetary policy.

The basis for these facts is a new dataset whose construction was funded by the National Science Foundation, implemented in large part by one of the co-authors of this essay, Gordon Phillips, and University of Maryland finance professor Ethan Cohen-Cole, and recently analyzed in joint work with the other co-author of this issues brief, Kyle Herkenhoff.¹ There were four major observations and implications that came out of our dataset:

1. Credit cards are a form of unemployment insurance
2. Expansionary monetary policy (lowering interest rates) may give unemployed consumers more ‘breathing room’ and allows them to find jobs at higher paying, larger, and more productive firms
3. Access to consumer credit facilitates self-employment as well as the transition into hiring an entrepreneur’s first employee
4. Bankruptcy flags disrupt job finding, business creation, and reallocation of workers across jobs

In the remainder of this essay, we explain each of these findings, circumstances under which the findings were obtained, and the implications for policymakers and lawmakers.

Credit cards are a form of unemployment insurance

Our first main finding is that consumer credit (credit cards, personal revolving loans, and other forms of revolving credit) has an effect on unemployed households that is comparable to unemployment insurance. In simple terms, being able to borrow allows unemployed households to search more thoroughly for a job. Just like unemployment insurance, credit cards and other forms of revolving credit allow unemployed individuals to “hold themselves over” by, say, buying groceries, or in economic terminology, it allows them to “smooth consumption”. Therefore, consumer credit allows them to find better job matches, and, as a consequence, they are paid higher wages.

We begin with a sample of 3 million workers. We first focus on a set of 20,000 displaced workers, some of whom have significant amounts of credit limits, while others have very limited consumer credit access. We use exogenous increases in credit that result from the removal of bankruptcy flags and from automatic increases in credit to isolate credit increases that are not related to an individual’s job prospects and their underlying employability or quality. We find that the more credit unemployed workers have, the longer they take to find a job. Among those who find a job, they find jobs with higher wages.

These findings suggest that consumer credit acts in a very similar way to unemployment insurance. Existing unemployment insurance studies find that unemployment insurance protracts unemployment durations, and workers generally find higher paying jobs. (This is true in the United States and Europe;² European estimates, however, are sometimes insignificant or negative).³ The similarity between the way unemployed individuals use consumer credit and unemployment insurance suggests that households have some degree of private insurance against job loss through credit markets, and that government programs in which consumer credit is extended to unemployed individuals rather than as a transfer payment may produce similar disincentive effects.

Expansionary monetary policy may give unemployed consumers more breathing room to find better jobs

What are the implications of our findings for monetary policy? The new dataset allows us to measure the impact of consumer credit access on labor market outcomes for the first time. Our results suggest that if interest rates are lowered, or if the government provides some more “breathing room” for unemployed consumers, then they may take longer to find a job, and they may ultimately find better job matches. A direct consequence of this mechanism is that if the government lowers interest rates then the unemployment rate may initially increase. With lower interest rates, and a greater ability to smooth consumption, households may be able to hold themselves over while searching more thoroughly for a job.

Consequently, the duration of unemployment and the unemployment rate will initially be higher following an interest rate decline. Yet the wages of those workers who find jobs will be higher because they are searching more thoroughly and finding better matches. Thus, our research suggests that a central economic-performance indicator of the Federal Reserve should be the wages of new hires, not necessarily the unemployment rate. We believe that by focusing on measures of match quality, the Federal Reserve can take into account the role that credit plays in household job-search decisions as well as have a more complete picture of the health of new labor market matches.

Access to consumer credit facilitates self-employment as well as the transition into hiring an entrepreneur's first employee

Consumer credit is not just used to facilitate a thorough job search. It is also a critical component of financing for the self-employed and job creation.⁴ To examine the importance of consumer credit for the self-employed, we build another new dataset with 200,000 individuals who have previously filed for bankruptcy and link these individuals to Internal Revenue Service entrepreneur tax records with administrative employment histories, credit histories, and so called SS-4 IRS business ownership data.

Using this dataset, we are able to follow individuals over time and observe all possible employment transitions, comprised of: transitions in and out of working for another business; transitions in and out of self-employment; and transitions

in and out of owning an employer firm in the Integrated Longitudinal Business Database, or ILDB, which is the merged dataset of SS-4 ownership records with firm employment.⁵ Our main source of exogenous variation in credit access comes from the removal of consumers' bankruptcy flag.⁶ We show that following bankruptcy flag removal, individuals receive a large increase in consumer credit access. Following this large, discrete, and unanticipated increase in consumer credit access,⁷ we find what we call the "credit access effect".

Bankruptcy flags disrupt job finding, business creation, and reallocation of workers across jobs

We show, for the first time to our knowledge, that consumer credit is critical for making the leap from a non-employer business to an employer business. In other words, consumer credit facilitates the hiring of the first initial employee, allowing individuals to make the transition out of self-employment into becoming a job-creating entrepreneur. Specifically, we find that:

- Flows into self-employment increase disproportionately after credit access improves. Those individuals who start new businesses earn 4 percent more Schedule C Net Income (\$1,000) versus comparable bankrupt individuals who have not yet had their bankruptcy flag removed.
- Following the discrete rise in credit access, these individuals are more likely to become employer firms in the Integrated Longitudinal Business Database
- New-firm owners in this database borrow \$40,000 more using mortgages and home equity lines of credit

These findings suggest that consumer credit matters for the subgroup of individuals who want to start a business, and moreover, it matters disproportionately for those individuals who want to grow their businesses.

A crucial fact for subsequent mortgage regulation is that self-employed individuals who make their initial hire borrow \$40,000 more than the control group, and they primarily use mortgage credit to facilitate this transition. In particular, they borrow using home equity lines of credit and other forms of high-interest-rate revolving credit.

This is an important set of facts for regulatory institutions, such as the Consumer Finance Protection Bureau, because this implies that restrictions on access to mortgage credit have direct implications not just for “mom-and-pop” self-employed individuals but also for those who intend to grow rapidly and hire additional employees. Consumer credit may not be the only source of financing for these businesses, but our results indicate that it is, on average, an important part of the debt portfolio of young, growing firms.

The United States is currently witnessing a long-run trend decline in startups.⁸ By further curtailing or restricting consumer credit, startup rates (and in particular high-growth startup rates) may drop. Our research therefore calls for follow-up studies on regulations that the CFPB may consider, and in particular, mortgage restrictions, especially home equity lines of credit.

Using the same dataset, we are able to measure the impact of bankruptcy flag removal on employment prospects and wages as well as on self-employment and business income. Our final policy relevant finding on the topic of consumer credit is that bankruptcy flags are likely misallocating workers across sectors. Using the same dataset of 200,000 individuals who previously filed for bankruptcy, we are able to study the way bankruptcy flag removal affects labor markets, self-employment, and earnings. We notice four broad patterns following bankruptcy flag removal:

- Individuals flow into formal sector unemployment-insured jobs. In simple terms, following bankruptcy flag removal, individuals find jobs that qualify them for unemployment insurance. These jobs provide a safety net to the worker in the case of job loss.
- Those who flow into formal-sector jobs after bankruptcy flag removal earn significantly more and are extremely attached to the formal sector. In simple terms, they earn more and are less likely to end up non-employed than are other comparable individuals without a flag removal.
- Individuals flow out of “informal” sector self-employed jobs. In simple terms, individuals leave self-employment after bankruptcy flag removal, and they subsequently find jobs in the formal sector.
- Individuals also flow into “informal” sector self-employed jobs (as mentioned above). With greater credit access, nascent entrepreneurs can quit their formal sector jobs and use credit to finance their ideas.

The main policy implication of our bankruptcy-flag removal findings has to do with the current debate over the use of credit checks by human resource departments.⁹ Our results indicate that after bankruptcy flag removal, there is a significant amount of reshuffling of workers across sectors. In economic terms, there appears to be reallocation, although whether this is a welfare-improving reallocation remains to be determined. Based on the wages of new hires and their subsequent job transitions (especially the fact that they do not exit to non-employment), our findings suggest workers with bankruptcy flags are not going to the jobs that value them the most. We therefore suggest to policymakers who are considering credit-check bans to consider the impediments that bankruptcy flags generate for self-employment, formal-employment, and new employment in their cost-benefit analyses.

—**Kyle Herkenhoff is an assistant professor of economics at the University of Minnesota. Gordon Phillips is the C.V. Starr Foundation Professor and Academic Director of the Center for Private Equity and Entrepreneurship at the Tuck School of Business, Dartmouth College**

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Policy Issue: Wealth transfer taxation

The “Silver Spoon” Tax: How to Strengthen Wealth Transfer Taxation

By Lily L. Batchelder, New York University School of Law

Wealth transfer taxes are a critical policy tool for mitigating economic inequality, including inequality of opportunity. They are also relatively efficient. This essay summarizes why and how wealth transfer taxes should be strengthened. Reform options that our next President should consider include increasing the wealth transfer tax rate, broadening the base, repealing stepped-up basis, addressing talking points against wealth transfer taxes with little or no factual basis, and converting the estate and gift taxes into a direct tax on the recipients of large inheritances.

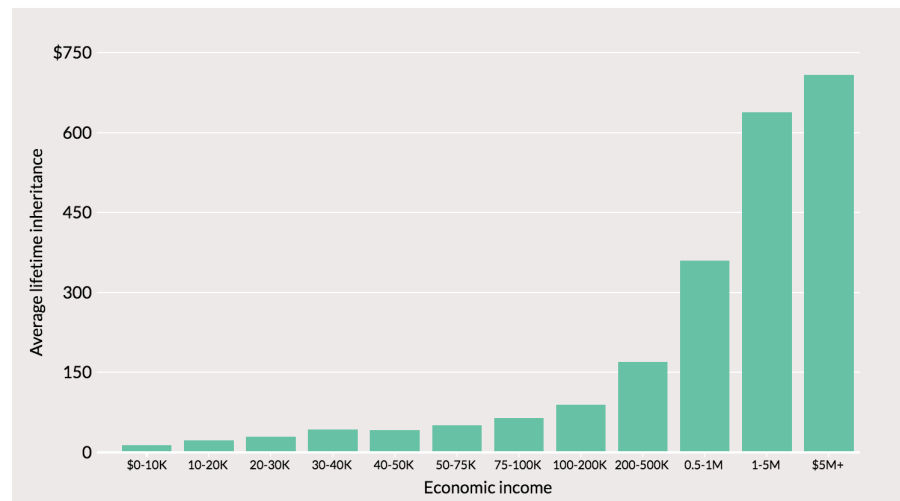
Why wealth transfer taxes should be preserved and expanded

For those concerned about economic inequality, taxing wealth transfers is a critical policy tool, mitigating inequality in ways that other taxes cannot. Inheritances represent roughly 40 percent of all wealth¹ and about 4 percent of annual household income.² Bequests alone total about \$500 billion per year.³

There are two types of inequality that policymakers should care about. The first is within-generation disparities in income, wealth, or other measures of economic well-being. Both income and wealth inequality are extremely high in the United States. The top 1 percent of households receives 15 percent of all income and holds 35 percent of all wealth.⁴ Wealth transfers increase within-generation inequality on an absolute basis (See Figure 1.), but not on a relative basis. This is because of what economists call regression to the mean.⁵ Someone who earns \$100 million per year, for example, is likely to have a child whose income is slightly lower, even including

the child's inheritance. Conversely, someone who earns \$10,000 per year is likely to have a child whose income is slightly higher than her own.

FIGURE I
Average lifetime inheritance
Thousands of US dollars



Source: Lily L. Batchelder, "What Should Society Expect from Heirs? A Proposal for a Comprehensive Inheritance Tax," *Tax Law Review* 63 (2009): 20.
Note: Economic income includes the annuitized value of inheritances.



But equally important is a second type of inequality: inequality of economic opportunity. A child whose parents earn \$100 million will, on average, be radically better off than a child whose parents earn \$10,000. The United States has one of the highest levels of opportunity inequality among its competitors.⁶ In the United States, a father on average passes on roughly half of his economic advantage or disadvantage to his son. Among most of our competitors, the comparable figure is less than one-third, and for several it is less than one-fifth.⁷

Financial inheritances worsen this inequality of life chances dramatically. Indeed, 30 percent of the correlation between parent and child incomes—and more than 50 percent of the correlation between the wealth of parents and the wealth of their children—is attributable to financial inheritances.⁸ This is more than the impact of IQ, personality, and schooling combined.

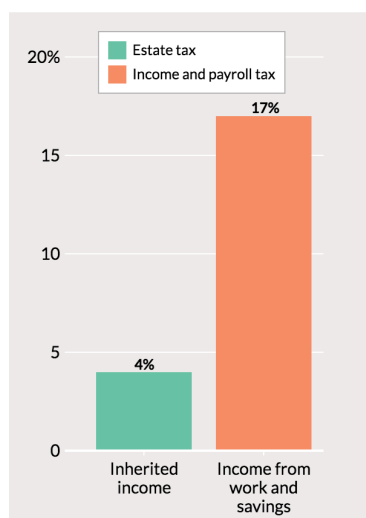
Increasing the progressivity of income and payroll taxes would go a long way toward addressing both of these types of inequality.⁹ But it would leave significant holes if not accompanied by stronger taxes on wealth transfers. Under current law, for example, if a wealthy individual bequeaths assets with \$100 million in unrealized gains, neither the donor nor the heir ever has to pay income or payroll tax on that \$100 million gain. In addition, the recipients of large inheritances never have

to pay income or payroll tax on the value of inheritances they receive, whether attributable to unrealized gains or not.¹⁰

Some argue that any income or payroll tax previously paid by a wealthy individual on gifts and bequests they make should count as tax paid by the heir. But they are two separate people. When a wealthy individual pays his assistant's wages out of after-tax funds, we don't think the assistant has thereby paid tax on their own wages. In short, today the income and payroll taxes effectively tax unearned income in the form of inheritances at a zero rate.

Wealth transfer taxes play an important role in partially addressing this inequity of excluding inherited income from the income and payroll tax bases.¹¹ But inherited income is still taxed at less than one-quarter of the rate on income from work and savings. (See Figure 2.)

FIGURE 2
Average tax rate, 2009



Source: Lily L. Batchelder, "What Should Society Expect from Heirs? A Proposal for a Comprehensive Inheritance Tax," *Tax Law Review* 63 (2009): 20.



A fairer tax system would tax income in the form of large inheritances at a higher rate than income from work. Recipients of large inheritances are better off than people who earn the same amount of money by working. In economist-speak, they have no "opportunity cost;" they have not had to give up any leisure or earning opportunities in order to receive the inheritance. All else equal, it is therefore fairer for them to pay more taxes, not less. But all else is not equal. Heirs of large inheritances also typically have a huge leg up in earning income if they choose to work—with access to the best education, influential family friends, interest-free or low-interest loans, and a safety net if they take risks that don't pan

out. This further strengthens the case for taxing inheritances at a higher rate.

More progressive income and payroll taxes cannot address this inequity in the tax system and ensure that large inheritances are taxed at higher rates than wage income.¹² The same is true of proposals to adopt a tax on wealth as opposed to wealth transfers.

Importantly, bipartisan experts agree that wealth transfer taxes are largely borne by the heirs of large estates, not their benefactors.¹³ As a result, it would be more accurate to

call wealth transfer taxes “silver spoon” taxes, not “death” taxes as their opponents prefer.

In addition to playing a critical role in making the tax system fairer, wealth transfer taxes are relatively efficient. It is an article of faith among estate tax opponents that wealth transfer taxes harm the economy because they discourage work and saving among very wealthy individuals. But in order to have these effects, the wealthy would need place a high value on the amount their heirs will inherit after-tax when making work and saving decisions. In fact, a large body of empirical research finds this is not the case, and that the amount that the affluent accumulate for wealth transfers is relatively unresponsive to the wealth transfer tax rate.¹⁴

People with very large estates typically have saved for multiple reasons. They may enjoy being wealthy, with the prestige and power that it confers while they are alive. They may have saved to have enough for their retirement needs, including unanticipated health expenses. And they may, of course, have saved to give to their children. But the empirical evidence to date suggests the first two motivations are so strong that the wealthy do not reduce their saving by all that much if they expect their estate to be taxed at a high rate. Put differently, a lot of the reason why people save is to have wealth while they are alive, which wealth transfer taxes do not affect.

Moreover, any negative incentive effects of wealth transfer taxes on wealthy donors are at least partially offset by their positive incentive effects on the next generation. Such taxes induce heirs to work and save more because heirs do not have as large an inheritance to live off of as a result.¹⁵ Wealth transfer taxes also improve business productivity. Several studies have found that businesses run by heirs perform worse because nepotism limits labor market competition for the best manager.¹⁶

For all these reasons, wealth transfer taxes may be more efficient than comparably progressive income and wealth taxes¹⁷—in addition to playing a unique role in mitigating inequality of economic opportunity.

How to strengthen wealth transfer taxes

There are two main components of the wealth transfer tax system: the estate tax on bequests and the gift tax on wealth transfers made during life.¹⁸ In 2016, transferors are entitled to a lifetime exemption of \$5.45 million (\$10.9 million per couple). If their combined gifts and bequests exceed this threshold, the excess is taxed at a rate of 40 percent. Transferors also can exclude \$14,000 in gifts each year to a given heir

from (\$28,000 per couple), meaning such gifts don't even count toward the lifetime exemption. Currently only 0.2 percent of estates owe any estate tax.¹⁹

Option #1: raise the rate

The simplest way to strengthen wealth transfer taxes would be to raise the rate. Restoring the 2009 estate tax parameters (a \$3.5 million exemption and a 45 percent rate) would raise \$160 billion over 10 years.²⁰ Also raising the rate to range from 50 percent to 65 percent to the extent that estates exceed \$10 million to \$1 billion would raise about \$235 billion over 10 years instead.²¹

At a minimum, large inheritances should be taxed at the top marginal tax rate that applies to labor income—roughly 50 percent when one includes state and local income taxes.²² But a higher rate would be fairer and more efficient. The optimal tax rate on extremely large inheritances is estimated to be between 50 percent and 80 percent.²³

Reducing the lifetime exemption amount also is worth considering, but it should be a lower priority. A higher rate focuses wealth transfer taxes on the wealthiest heirs and limits compliance costs.

Option #2: replace the estate and gift taxes with an inheritance tax

A more fundamental improvement would be to replace the estate and gift taxes with an inheritance tax. The lifetime exemption for the estate and gift taxes applies to the amount transferred, not the amount inherited by the heir. Suppose Richie Rich is an only child and receives \$5 million in bequests from each of his parents and step-parents. Under current law, the \$20 million he inherits is exempt from estate and income taxes because each bequest is under the exemption. But under an inheritance tax, the exemption would be based on how much he receives instead.

I propose requiring heirs of large inheritances to pay income tax plus an inheritance surcharge on amounts they inherit above a large lifetime exemption. If the lifetime exemption were \$2.1 million and the surcharge were 15 percent (roughly equal to the maximum payroll tax rate) then such an inheritance tax would raise roughly \$200 billion more over 10 years than the current estate tax. Dialing the rates up or the exemption amount down could raise more revenue. (See Figure 3.)²⁴ To state the obvious, \$2.1 million is a lot of money. An individual who inher-

its \$2.1 million at age 21 can live off her inheritance for the rest of her life without anyone in her house ever working and, on average, her annual household income will still be higher than about 7 out of 10 American families.²⁵

FIGURE 3

Exemption	Inheritance Surcharge	Estimated Revenue Raised (2016-2026)
\$2.1 million	15%	\$199 billion
\$1.8 million	10%	\$199 billion
\$1.25 million	15%	\$670 billion

Source: Author's calculations based on Batchelder (2009); JCT (2015); JCT (2016).

There are several advantages of an inheritance tax relative to an estate tax. First, it would more equitably allocate wealth transfer taxes among heirs. Both types of taxes are borne by wealthy heirs and not their benefactors. But not all large inheritances come from the largest estates, and some small inheritances come from relatively large estates.

In addition, the type of inheritance tax outlined here would apply different rates to heirs based on their total income. As a result, about 30 percent of the burden of the inheritance tax in dollar terms would fall on different heirs than under a revenue-equivalent estate tax.²⁶ While roughly one-third of heirs burdened by the estate tax have inherited less than \$1 million, none would owe any inheritance tax.²⁷

These differences should not be taken as a fundamental critique of the estate tax. It is overwhelmingly borne by the recipients of large inheritances: Less than 4 percent of the revenue comes from individuals inheriting less than \$1 million. Its burdens are just allocated among the recipients of large inheritances less precisely than under an inheritance tax.

A second, and perhaps even more important, advantage of an inheritance tax is that it could better align public understanding of wealth transfer taxes with their actual economic effects. The structure of an estate tax makes it easy for opponents to characterize it as a double tax on the frugal, generous entrepreneur who just wants to take care of his family after his death. In fact, nothing could be further from the truth. The estate tax is actually the only tax that ensures wealthy heirs pay at least some tax on their large inheritances—even if at a much lower rate than their personal assistants. But this imagery is powerful. Perhaps as a result,

most countries around the world that historically had estate taxes have repealed them, while those with inheritance taxes have not.²⁸

The structure of an inheritance tax makes the inequities of our current system clearer. It simply requires wealthy heirs to pay income tax on their large inheritances just as all American workers pay tax on their earnings. Even with a surcharge, wealthy heirs would still typically pay a lower rate of tax on their inherited income than workers pay on a similar amount of labor income because of the large exemption, which workers cannot claim on their wages.

There are ancillary advantages of an inheritance tax as well. It would be simpler because it permits a wait-and-see approach for split and contingent transfers, rather than requiring taxpayers and the Internal Revenue Service to guess upfront what portion of the transfer will ultimately go to tax-exempt individuals or charities. At the margin, it could induce the wealthy to share their estates more broadly. And it is clearly administrable. Inheritance taxes are far more common than estate taxes cross-nationally.²⁹

Option #3: repeal stepped-up basis

Regardless of whether the estate tax is expanded or replaced with an inheritance tax, policymakers should repeal stepped-up basis.³⁰ This is the provision that completely exempts all accrued gains on bequeathed assets from income and payroll taxes, by “stepping up” the basis of asset to its fair market value when it is transferred.

President Obama has proposed repealing stepped-up basis, subject to several carve-outs including an exemption for the first \$100,000 in accrued gains (\$200,000 per couple).³¹ Together with raising the capital gains rate to 28 percent, this proposal would raise \$210 billion over 10 years and significantly more over time as it fully phases in.³² While not technically an estate or gift tax reform, repealing stepped-up basis would accomplish all the same objectives as strengthening those taxes. It is highly progressive because inheritances are distributed so unequally and accrued gains are distributed even more unequally.³³

The U.S. Department of the Treasury estimates that 99 percent of the revenue raised would come from the top 1 percent and 80 percent from the top 0.1 percent.³⁴ It helps ensure that large inheritances are taxed at a rate closer to income from working. And it is highly efficient. Indeed, repealing stepped-up basis is even

more efficient than raising wealth transfer tax rates because it reduces current law’s “lock-in” incentives to hold on to underperforming assets purely for tax reasons.

If repealing stepped-up basis is not an option then the next best solution would be to apply carryover basis to bequests.³⁵ This would allow heirs to delay paying income tax on accrued gains on their inheritances indefinitely. But heirs would at least need to pay the associated income tax when they ultimately sell the asset. As a result, it would reduce lock-in incentives, but not by nearly as much as stepped-up basis repeal. It would also raise significantly less revenue.³⁶

Option #4: broaden the wealth transfer tax base

A number of smaller reforms to broaden the wealth transfer tax base should also be pursued. Many of these proposals, such as limiting gaming around grantor-retained annuity trusts, are in President Obama’s budget. Together, these budget proposals would raise \$17 billion over 10 years.³⁷ The next President should also finalize the current Administration’s recently issued regulation addressing loopholes using valuation discounts, and ensure that Congress does not repeal it.³⁸

An additional option worth considering is harmonizing the tax treatment of gifts and bequests. Currently gifts are often tax-advantaged because of the annual gift tax exclusion, the lack of present-value adjustments when calculating the lifetime exemption, and the fact that the top rate on very large gifts is effectively 29 percent, compared to 40 percent for bequests.³⁹ Cutting the other way, bequests are tax-advantaged because they are eligible for stepped-up basis while gifts are not. These countervailing incentives create substantial tax planning costs, traps for the unwary, and inequities between similarly situated heirs. These problems could be largely addressed by repealing stepped-up basis, indexing the value of gifts to a market interest rate when calculating the lifetime exemption, and taxing gifts at the same rate as bequests.⁴⁰

Option #5: address strawman arguments against wealth transfer taxes

Finally, policymakers should consider addressing talking points against wealth transfer taxes that resonate but have little or no basis in fact. A prime example is family farms. A principal rallying cry against the estate tax has long been that it

forces families to sell their farms. But neither the American Farm Bureau nor *The New York Times* has been able to identify a single instance of this happening, even when the exemption was much lower.⁴¹

To counter this argument, one option is to adopt the proposal by former Senate Finance Committee Chairman Baucus (D-MT) to allow taxpayers to defer indefinitely any estate tax payments due on farm land at a market interest rate, provided the farm continues to be actively managed by the family.⁴² Because it is so rare for such farms and ranches to be subject to the estate tax, the proposal would only cost \$5 billion over 10 years.⁴³

To be clear, this proposal should only be considered if it includes all the guardrails in the full Baucus proposal and interest accrues at a market interest rate. Otherwise, it could become a large loophole and reduce the number of farms owned and actively managed by families as opposed to passive investors in large corporations.

Conclusion

Wealth transfer taxes play a critical role in mitigating economic disparities, especially inequality of opportunity. The proposals offered here would soften the relative advantages of being born at the very top while leaving more than 99 percent of financial gifts and bequests unaffected.⁴⁴

At the same time, these reforms options would raise a significant amount of revenue that could be used to mitigate the barriers to economic mobility that children from low- and middle-income families face. Effectively, they could fund a form of social inheritance through investments that partially make up for such families being unable to fund large financial wealth transfers to their children. The hundreds of billions of dollars raised could be used to fund universal pre-Kindergarten, expand the child tax credit for low- and middle-income working parents with young children, or increase the wage subsidy provided by the Earned Income Tax Credit for childless, frequently young adults. These proposals are estimated to significantly improve infant health, heighten academic achievement, boost labor force participation, and increase lifetime earnings for children from relatively disadvantaged backgrounds.⁴⁵

President Franklin Delano Roosevelt once said “inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our government.” The

same could be said today. Rather than falling near the bottom among our competitors on this score, we can recommit to creating a society where one's financial success depends relatively little on the circumstances of one's birth. A first step is to start taxing extraordinarily large inheritances like we tax good, old hard work.

—*Lily L. Batchelder is a professor of law and public policy at New York University School of Law*

(I am grateful to Len Burman, Michael Graetz, Chye-Ching Huang, and Wojciech Kopczuk for helpful suggestions. All errors are mine.)

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- 7 Ibid.
- 8 Samuel Bowles, Herbert Gintis, and Melissa Osborne Groves, "Introduction," in *Unequal Chances: Family Background and Economic Success* (Princeton, NJ: Princeton University Press, 2005), 18-19. Financial inheritances account for 30 percent of the parent-child income correlation, while parent and child IQ, schooling, and personality combined only account for only 18 percent. Adrian Adermon, Mikael Lindahl, and Daniel Waldenström, "[Intergenerational Wealth Mobility and the Role of Inheritance: Evidence from Multiple Generations](#)," (working paper, July 26, 2016). Bequests and gifts account for at least 50 percent of the parent-child wealth correlation, while earnings and education account for only 25 percent.
- 9 Lower levels of inequality are correlated with higher levels of relative intergenerational economic mobility. See Corak, "Income Inequality." However, this is less true when changes in inequality occur just in the upper tail of the economic distribution. See Raj Chetty, et al., "Is the United States Still a Land of Opportunity? Recent Trends in Intergenerational Mobility," National Bureau of Economic Research Working Paper No. 19844 (2014): 11. This implies that, in order to improve relative economic mobility, more progressive taxes need not just to raise revenue from the wealthiest but also increase income after taxes and transfers for low- and middle-income households.
- 10 If it is saved, the earnings on those savings will be taxed, but not the amount inherited.
- 11 For 2016, the differential would be even larger because of cuts to the estate tax, the expiration of the high-income Bush tax cuts, and the tax increases on high-income households in the Affordable Care Act. Other income tax cuts (such as expansions to tax credits for low- and middle-income families) would partially but not fully offset these increased income taxes on the wealthy since 2009.
- 12 As explained below, more progressive income and payroll taxes could address this inequity if broadened to repeal exemptions specifically for inheritances.
- 13 "As a first approximation, it would make more sense to distribute the burden of the tax to the estate's beneficiaries rather than to the decedent." N. Gregory Mankiw, [Remarks, National Bureau of Economic Research Tax Policy and the Economy Meeting from Council of Economic Advisers](#) (Nov. 4, 2003). For an explanation of why this is the case, see Lily L. Batchelder and Surachai Khitatrakun, "[Dead or Alive: An Investigation of the Incidence of Estate Taxes and Inheritance Taxes](#)" (working paper, 2008).
- 14 For a review of the empirical evidence on this issue, see Batchelder, "What Should Society Expect from Heirs," 41-44; Wojciech Kopczuk, "Taxation of Intergenerational Transfers and Wealth," chap. 6 in *Handbook of Public Economics*, vol. 5 (Amsterdam: Elsevier, 2013): 337-341.

- 15 See Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics* 108, no. 2 (May 1993): 413–35; Jeffrey R. Brown, Courtney C. Coile, and Scott J. Weisbener, "The Effect of Inheritance Receipt on Retirement," *Review of Economics and Statistics* 92, no. 2 (2010): 425–434.
- 16 See Francisco Pérez-González, "Inherited Control and Firm Performance," *American Economic Review* 96, no.5 (2006): 1559–88. For more studies see Batchelder, "What Should Society Expect from Heirs," note 251.
- 17 The empirical evidence is far from conclusive on this point and, when comparing the efficiency of different tax bases, it is important to compare comparably progressive taxes. But to provide a rough sense, a review of the literature the elasticity of taxable income with respect to the net-of-tax income tax rate concluded that "the best available estimates range from 0.12 to 0.40." Emmanuel Saez, Joel Slemrod, and Seth H. Gieritz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," *Journal of Economic Literature* 50 (2012): 42. In contrast, a review of the literature on the elasticity of estates to the net-of-tax estate tax rate concluded "all these papers estimate a similar baseline elasticity of net worth/reported estate estimates with respect to the net-of-tax rate of between 0.1 and 0.2." Kopczuk, "Intergenerational Transfers," 365. Several caveats are in order. These elasticities include avoidance responses as well as real behavioral changes. They are not strictly apples-to-apples because one is a stock and one is a flow. The taxable income elasticities include both capital and labor income and are not limited to the top of the income distribution. Nevertheless, they suggest that, as a first pass, wealth transfer taxes may be more efficient than comparably progressive income and wealth taxes. All of this is not to say that income taxes on high earners are as inefficient as some believe. Indeed, Saez et al., conclude in their review that "there is no compelling evidence to date of real economic responses to tax rates... at the top of the income distribution." Saez, Slemrod, and Gieritz, "Elasticity of Taxable Income," 42.
- 18 There is also a "generation-skipping" transfer tax on transfers to heirs who are two generations younger than the donor.
- 19 Joint Committee on Taxation, [History, Present Law, and Analysis of the Federal Wealth Transfer Tax System \(JCX-52-15\)](#), (March 16, 2015): 25, tbl.2.
- 20 Joint Committee on Taxation, [Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2017 Budget Proposal \(JCS-2-16\)](#), (July 21, 2016).
- 21 Frank Sammartino et al., "An Analysis of Senator Bernie Sanders's Tax Proposals," (Tax Policy Center, March 4, 2016). Specifically Senator Sanders's proposal would raise the estate tax rate to 50 percent for estates between \$10 million and \$50 million (\$20 to \$100 million per couple), to 55% for estates between \$50 million and \$500 million (\$100 million and \$1 billion per couple), and to 65 percent for estates to the extent they exceed \$500 million (\$1 billion per couple).
- 22 This assumes a top state income tax rate of 6.6 percent. Tax Policy Center, "Individual State Income Tax Rates 2000-2015," (February 16, 2015). Actual top state income tax rates range from 0 percent to 13.3 percent.
- 23 Batchelder, "What Should Society Expect from Heirs," 39–46, 50; Thomas Piketty and Emmanuel Saez, "A Theory of Optimal Inheritance Taxation," *Econometrica* 81, no. 5 (2013): 1851–86.
- 24 I have grossed up the exemptions in Batchelder, "What Should Society Expect from Heirs" for inflation, and the revenue estimates to account for the top income tax rate having risen from 35 percent to 39.6 percent since 2009 (estimates ignore FICA and SECA).
- 25 \$2.1 million would produce inflation-adjusted annual income of about \$102,000 to age 102, assuming a 5 percent real rate of return. The 60th percentile of household income was \$72,000 in 2015 and the 80th percentile was \$117,000. Bernadette D. Proctor, Jessica L. Semega, and Melissa A. Kollar, "Income and Poverty in the United States: 2015," (United States Census Bureau, September, 2016): 31, tbl. A-2. This example considers the expected, not guaranteed, consumption potential of such an heir. In order to guarantee income exceeding the 80th percentile household every year, the heir would need to purchase an annuity, which would presumably entail a lower rate of return.
- 26 Batchelder, "What Should Society Expect from Heirs," 76.
- 27 Batchelder and Khitatrakun, "Dead or Alive," 41, tbl.A14. 37% when lifetime exemption was \$3.5 million.
- 28 Batchelder, "What Should Society Expect from Heirs," 117–18.
- 29 *Ibid.*, 51.
- 30 For further discussion of this proposal, see David Kamin, "Taxing Capital: Paths to a Fairer and Broader U.S. Tax System," (Washington Center for Equitable Growth, August, 2016): 23–24; Laura E. Cunningham and Noël B. Cunningham, "Commentary: Realization of Gains Under the Comprehensive Inheritance Tax," *Tax Law Review* 63 (2009): 271–83.
- 31 Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," February 2016: 156. The proposal would also exempt all gains on the sale of tangible personal property, and would effectively establish a \$500,000 per-couple exemption for gains on residences.
- 32 JCT, "President's FY 2017 Budget Proposal;" Kamin, "Taxing Capital," 23.
- 33 James Poterba and Scott Weisbener, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," in *Rethinking Estate and Gift Taxation*, ed. William G. Gale, James R. Hines Jr., and Joel Slemrod (Washington, D.C.: Brookings Institution Press, 2001): 439–40. Untaxed accrued gains compose 36 percent of the value of all bequests, but 56 percent of bequests over \$10 million.
- 34 Executive Office of the President and U.S. Treasury Department, [The President's Plan to Help Middle-Class and Working Families Get Ahead](#), (April, 2015): 35. The distributional effects would be somewhat less concentrated if household pre-tax income was defined to include the portion of the gain accrued in the current year, rather than the full gain realized under the proposal—or if the burden of the tax was allocated to the heir(s).
- 35 Carryover basis currently applies to wealth transfers during life.
- 36 Congressional Budget Office, *Budget Options* (March, 2000): 311–12. This report estimated that replacing stepped-up basis with carryover basis would raise 61% of the revenue raised from repealing stepped-up basis.
- 37 JCT, "President's FY 2017 Budget Proposal."
- 38 See Estate, Gift, and Generation-Skipping Transfer Taxes, 81 Fed. Reg. 51413 (proposed August 4, 2016). For example, Sens. Rubio, Moran, and Flake have proposed legislation blocking the regulation. Protect Family Farms and Businesses Act, S. 3436, 114th Cong. (2016).

- 39 Unlike the estate tax, the gift tax applies to the after-tax transfer. For example, the gift tax is \$40 on a pre-tax gift (above the lifetime exemption) of \$140, for a tax rate of 29%.
- 40 For further potential base broadeners, see Paul L. Caron and James Repetti, "Revitalizing the Estate Tax: 5 Easy Pieces," *Tax Notes* 142, (2014): 1231–41.
- 41 David Cay Johnston, "Talk of Lost Farms Reflects Muddle of Estate Tax Debate," *New York Times*, April 8, 2001; Michael J. Graetz and Ian Shapiro, *Death by a Thousand Cuts: The Fight Over Taxing Inherited Wealth* (Princeton, NJ: Princeton University Press, 2005): 32–40. According to the Tax Policy Center, only about 20 small business and farm estates owed any estate tax in 2013, and their average estate tax rate was 4.9%. Chye-Ching Huang and Brandon DeBot, "Ten Facts You Should Know About the Federal Estate Tax," (Center on Budget and Policy Priorities, March 23, 2015).
- 42 [The Middle Class Tax Cut Act of 2010](#), S.A. 4727 to H.R. 4853, (proposed December 2, 2010).
- 43 Joint Committee on Taxation, [Estimated Budget Effects of the Revenue Provisions Contained in the Senate Amendment to H.R. 4853 \(JCX-53-10\)](#), (December 2, 2010).
- 44 Fewer than 0.3 percent of estates exceed \$3.5 million. Tax Policy Center, "[Baseline Estate Tax Returns: Current Law and Multiple Reform Proposals, 2011-2021](#)," T11-0156 (June 1, 2011). The inheritance tax proposal would similarly apply only to the most wealthy. Among those receiving a bequest, 99.1 percent inherit less than \$1 million and 99.9 percent inherit less than \$2.5 million. Batchelder, "What Should Society Expect from Heirs," 110, tbl. A1.
- 45 Chuck Marr, Chye-Ching Huang, Arloc Sherman, and Brandon DeBot, "[EITC and Child Tax Credit Promote Work, Reduce Poverty, and Support Children's Development, Research Finds](#)," (Center on Budget and Policy Priorities, October 1, 2015); Executive Office of the President and U.S. Treasury Department, [The President's Proposal to Expand the Earned Income Tax Credit](#), (March, 2014).

Policy Issue: Monetary policy

What to do about the Federal Reserve

By Alan Blinder, Princeton University

The short answer is: not much. Hippocrates offered good advice when he said “first do no harm.”

This does not mean that the Federal Reserve is perfect. Parts of its governance structure read like they date from 1913 (as they do) and could use a tune-up. But by and large, the Fed continues to perform the functions assigned to it by Congress well—even in this time of dysfunctional government—and to be genuinely non-political (see below). The next president should not upset either of these apple carts.

Federal Reserve independence

Four points are important to understanding the independence of the Fed. All should be preserved.

1. Federal Reserve independence is limited to monetary policy. The Fed is engaged in other functions, such as financial regulation and supervision, where it generally shares responsibility with other agencies. In those other domains, the Fed has relatively little ability to take unilateral action, that is, little independence. Preserving the Fed's independence in monetary policy is extremely important to the nation's economic health and does not require independence in other domains.

2. Federal Reserve independence is not absolute, even in monetary policy. In fact, it's based more on tradition than law. Congress can abolish Federal Reserve independence (or the Federal Reserve itself) any day it chooses if the President would sign the bill. That creates a certain fragility and causes angst at the Fed

whenever Congress considers ideas that would encroach on its independence. The new President should vigorously support Federal Reserve independence as it exists today. Writing it into law would be even better, if possible. But it probably isn't, so I wouldn't advise expending much political capital on this.

3. *The President, with the consent of the Senate, appoints the Board of Governors of the Fed, most notably its Chair.* This appointment power is an important—probably the most important—element of political influence on monetary policy. And it's entirely legitimate, even necessary; the Fed should not be a self-perpetuating oligarchy. The appointment of a new (or the same) Fed chair in early 2018 will be among the most important appointments the new President ever makes. It merits serious consideration early in the administration, and should be resolved by late summer or early fall 2017, lest it become a source of market jitters.

4. *While appointments to the Federal Reserve Board are “political” in the literal sense, the appointees themselves have generally not been very “political” people (with a few notable/notorious exceptions).* Janet Yellen, a Democrat appointed by Barack Obama, is a non-political technocrat. Prior to that, President Obama had reappointed Ben Bernanke, another non-political technocrat, even though he was a Republican originally appointed by George W. Bush. That non-partisan tradition goes back a long way (Ronald Reagan reappointed Paul Volcker, a Democrat.) We do not want to turn top Fed appointments into partisan political donnybrooks like Supreme Court appointments. Sadly, Senate Republicans have started down that path in recent years by blocking or refusing to consider appointments to the Federal Reserve Board. That tendency should be fought.

Troublesome bills now in Congress

I started with “first do no harm” because Congress is now considering three very bad ideas.

1. *Audit the Fed:* H.R. 24 and S. 2232 are two versions of what used to be called “Audit the Fed.” A more accurate name would be “Institutionalize Browbeating of the Fed.” The Federal Reserve's books are already audited, and have been for years. This bill would give Congress (using/abusing the Government Accountability Office as a vehicle) more ways to second-guess the Fed's monetary policy decisions. Individual members of Congress can, of course, do that whenever they please—and some do.

Why would anyone want to give Fed-bashing institutional stature and legitimacy? The answer is obvious: to intimidate the Fed.

2. *Form Act:* Formerly the FRAT Act, H.R. 3189, which includes “Audit the Fed,” would also add a requirement that the Fed enunciate—and explain why it ever deviates from—a mechanical formula for monetary policy. (There are counterpart bills in the Senate.) There is a long academic debate over “rules versus discretion,” but that debate preceded the unprecedented circumstances the Fed has faced since 2008. It is frightening to contemplate what might have happened if the Fed had followed a pre-2007 rule under those never-before-imagined circumstances. Legislating compliance with a rule now seems both dangerous and irresponsible.

3. *Congressman Hensarling’s proposed replacement for Dodd-Frank.* Proposed legislation by Rep Jeb Hensarling (R-TX) has many bad features, one of which would subject the Fed’s budget to annual congressional appropriations. Freedom from annual appropriations is perhaps the lynchpin of the Federal Reserve’s independence. No central bank can be independent if a displeased legislature can squeeze its budget as Congress routinely does with other regulatory agencies.

The new President should oppose these three anti-Fed bills, and veto them if Congress passes any of them.

What (that’s sensible) might be changed?

According to a wise old principle, if it ain’t broke, don’t fix it. The Fed is not “broke.” So preserving the status quo is not a bad policy.

It is true that, were the Federal Reserve Act being written today rather than in 1913, it would look different in several respects. For instance, the boundaries of the 12 Federal Reserve Districts and the locations of the 12 Federal Reserve Banks would certainly be different. Those boundaries, which reflect the economic geography and political logrolling of 1913, look a little comical in 2016. But moving them is almost certainly not worth the political fight it would provoke.

A better case can be made for revisiting the 1913 Wilsonian compromise between two competing visions of a central bank: one controlled by private parties (mainly bankers), the other controlled by the federal government. The Federal Reserve

Act (and its 1935 amendments) split the difference by dividing power between a seven-member, politically appointed Board of Governors in Washington and 12 Federal Reserve Banks, which are joint-stock companies owned by member banks, and whose presidents are not political appointees. (They are, instead, selected by each bank's board, just as private corporations do.) The Fed's powerful Open Market Committee consists of the seven Washington-based governors and the 12 bank presidents (only five of whom get to vote at a time). It is odd, to put it mildly, to have men and women with no political legitimacy making national economic policy.

In increasing order of “radicalness,” the Wilsonian balance could be tilted more in the governmental direction by:

1. Removing all bankers from the boards of the Reserve Banks (doing so, however, would create an odd legal situation since the private banks are the Reserve Banks' shareholders.
2. Making the President of the Federal Reserve Bank of New York, which has a special status within the Federal Reserve System, a presidential appointee confirmed by the Senate, just like the Board of Governors
3. Making all 12 Federal Reserve Bank presidents political appointees, appointed either by the president or by the Board of Governors
4. Converting all the Federal Reserve banks into government agencies, with their presidents appointed by either the Board of Governors or the President

Another sensible reform would be to shorten existing term limits. Under current law, a Federal Reserve governor (including the chairman) could, in principle, serve almost 28 years. Although this has never happened, Alan Greenspan did chair the Fed for 18½ years, and William McChesney Martin served a few months longer than that. For such a powerful position, that seems too long. When he retired in 2014, Ben Bernanke did not try to set a “George Washington” precedent that two four-year terms is enough. Perhaps we should write that into law.

What about the next recession?

Should the U.S. economy encounter a recession any time soon—say, within the next two years—the old “leave-it-to-the-Fed” attitude will probably not suffice. For one thing, interest rates will still be very low, leaving the Fed limited scope for cutting rates. For another, the Fed’s balance sheet will still be huge, leaving it limited scope for further “quantitative easing”—not to mention the fact that quantitative easing probably ran into sharply diminishing returns years ago. All this is not to say that the Fed would be powerless to fight, say, a 2017 recession, but only that it will be considerably less powerful than it has been in the past, leaving the nation more vulnerable.

What to do? The obvious answer would be to deploy fiscal policy—that is, government spending and tax cuts—as was done in 2009. But, depending on the composition and attitudes of the next Congress, that might prove challenging (or impossible) politically.

So the first, and easy, policy recommendation is that the new administration should quickly formulate contingency plans for a possible fiscal stimulus and, to the maximum extent possible, seek buy-in from the congressional leadership.

That “maximum extent possible” might prove to be zero, however. So the new administration should also consider legislation that would increase the strength of the automatic stabilizers.

1. Any increases in marginal tax rates, or in the marginal generosity of transfer payments such as unemployment benefits and food stamps, will have this effect as a by-product. If marginal tax rates were higher, however, tax bills would fall faster when incomes declined.

2. In addition, the new administration should consider legislation that raises unemployment benefits and food stamps formulaically and automatically when the economy crosses certain (adverse) thresholds—when the unemployment rate rises above 6 percent, 7 percent, and so on. President Obama made such a proposal for unemployment benefits this year.

—Alan Blinder is Gordon S. Rentschler Memorial Professor of Economics and Public Affairs at Princeton University and former vice chairman of the Board of Governors of the Federal Reserve System

Policy Issue: Home mortgages

Shared responsibility mortgages

By Atif Mian, Princeton University and Amir Suffi, University of Chicago

The mortgages that are predominantly used in U.S. housing finance, and explicitly promoted by the federal government, place an undue amount of risk on families who own their homes. Our main policy recommendation is to encourage the Federal Housing Finance Agency to declare more “equity-like” mortgages as mortgages conforming to the federal government’s securitization guidelines. This would enable these mortgages to be securitized by the federal housing finance giants Fannie Mae and Freddie Mac, which would promote their growth in the home mortgage marketplace.

The widespread use of such mortgages will protect families from unforeseen downturns in the housing market, and will reduce the painful boom-and-bust episodes that have characterized housing markets in recent years. The economic benefits are large. We believe that the Federal Housing Finance Agency must play a critical role in overseeing and enforcing the use of such equity mortgages.

Why debt mortgages are problematic

A home mortgage that currently satisfies the conforming mortgage definition is a standard debt contract, which places a great deal of risk on the homeowner. Suppose a homeowner buys a home for \$100,000, using an \$80,000 debt mortgage. The homeowner has \$20,000 of equity in the home. If house prices drop by 20 percent then the home is worth only \$80,000. But the interest payments on the mortgage and the mortgage balance remain the same. House prices fall during economic downturns, which make homeowners less able to pay the mortgage payments. Further, if the homeowner sells the home for the new price of \$80,000 then the homeowner must pay the \$80,000 mortgage and is left with nothing. The

homeowner loses 100 percent of her equity even though house prices dropped only 20 percent.

This is the effect of debt. Debt contracts force losses on the homeowner before the lender bears any loss. This makes no economic sense. The average homeowner in the United States is far less able to bear house-price risk than the investors putting money into the financial system. The use of debt contracts means homeowners are bearing this risk when it would be far better for investors to bear that risk.

In our 2014 book, “House of Debt: How They (and You) Caused the Great Recession and How We Can Prevent It from Happening Again,”¹ we show that the use of debt contracts in housing finance amplifies housing price booms, and makes housing price busts painful for the entire economy. Research shows that severe economic downturns are preceded by mortgage debt-financed housing booms. When house prices fall, the losses are born disproportionately by middle- and low-income homeowners. Further, foreclosures skyrocket, which depresses house prices even for those that continue to pay their mortgage. Homeowners reduce spending dramatically in response to the decline in housing wealth. The sharp drop in consumer spending sends the economy into a tailspin. This cycle explains the Great Depression in the 1930s and the Great Recession of 2007-2009 in the United States as well as the severe economic downturns seen in Ireland and Spain during the previous decade.

The financial system must overcome its addiction to mortgage debt. By uniquely allowing straight debt mortgages to be securitized by Fannie Mae and Freddie Mac, the federal government encourages the exact type of mortgages that we know are bad for homeowners and the overall economy. The government should instead push for more equity-based mortgages, which would provide relief to the homeowners that most need it in case of a downturn in the housing market.

What is an “equity-like” mortgage and why would it help?

How does a more “equity-like” mortgage work? The mortgage contract we promote in our book is the Shared Responsibility Mortgage. In this mortgage, the principal balance of the mortgage and the interest payments are linked to a local house price index that measures the average value of houses in the zip code of the purchased home. If house prices in the neighborhood fall, the principal balance and interest payments automatically adjust downward. This provides relief to the

homeowner exactly when it is most needed: when difficult economic circumstances arise in the neighborhood.

In our book, we use the example of a mortgage in which the principal balance and interest payments adjust downward by the same percentage point as the fall in house prices. So if a homeowner has a monthly payment of \$1,000 and house prices in the zip code fall by 20 percent then the monthly payment automatically adjusts downward to \$800. If house prices rise once again, the monthly payment will increase up to \$1,000, but the payment can never be higher than the original amount of \$1,000 paid when the home was purchased, no matter how high house prices go in the neighborhood.

In return for the protection against house price declines, the lender who provides the mortgage is given an extra payment in case house prices rise and the homeowner sells the home. So, for example, if the home increases in value from \$100,000 to \$120,000 and the owner sells the home, then a part of the capital gain of \$20,000 would be paid to the lender. We calculate that only 5 percent to 10 percent of the capital gain would need to be paid to ensure the lender is properly compensated for the downside protection. In this example, this implies a payment of \$1,000 to \$2,000 out of the \$20,000 capital gain.

An interesting related idea is the ratchet mortgage by housing finance specialists Bert Ely and Andrew Kalotay. It is essentially a one-way adjustable rate mortgage where the interest rate paid by the borrower is tied to a long-term government bond rate such as the 10-year Treasury bond. The key characteristic is that interest rates only adjust downward: if the reset formula yields a higher interest rate than the current rate paid by the borrower then the current rate prevails. Interest rates tend to fall in recessions, which would provide automatic savings to homeowners exactly when they need it. Further, homeowners would not bear the risk that interest rates rise in the future. Of course, the initial interest rate on a ratchet mortgage would be higher than a fixed-rate mortgage, but the protection offered would be advantageous to the homeowner and to the broader economy.

Both of these types of mortgages more equitably share house price risk than traditional mortgages. This has large benefits for the economy. When house prices fall, middle- and low-income homeowners using an equity-like mortgage would not bear the lion's share of the burden. Their interest payment would automatically decline, and their housing wealth would be preserved. As a result, they would not cut spending so dramatically. Equity-like mortgages provide exactly the type of automatic stabilizer the economy needs to avoid severe recessions.

Further, tying mortgages explicitly to house prices would lessen the likelihood of unsustainable bubbles emerging in the first place. Research shows that debt fuels bubbles by engendering false security among lenders. Lenders feel they are immune to the bubble when providing debt financing because homeowners bear almost all of the risk. Explicitly tying house prices to mortgage payments would force lenders to think twice about lending into an unsustainable housing boom.

Are “equity-like mortgages” feasible in today’s mortgage market?

Yes.

PartnerOwn, a firm based in Chicago, is commercializing a version of the Shared Responsibility Mortgage. Their work has given context to the theoretical benefits for mortgage borrowers, lenders, and investors while also highlighting some of the remaining obstacles.

PartnerOwn’s surveys show that mortgage borrowers prefer the Shared Responsibility Mortgage relative to current mortgage product offerings. In a sample of 40 borrowers at Chicago Housing and Urban Development Homebuyer Workshops, 80 percent preferred it to a 30-year fixed rate mortgage after watching a 15-minute in-person presentation. Sixty percent of online respondents similarly preferred the Shared Responsibility Mortgage after watching a 3 minute-video about the product. Perhaps most encouraging, 80 percent of respondents were able to correctly articulate the payoff structures in multiple scenarios of the product. Millennials, a demographic that is often priced out of more “price stable” neighborhoods, have been among the most interested groups.

Regional banks have been receptive to the Shared Responsibility Mortgage for ensuring the stability of the local market that they serve, and PartnerOwn has begun work on a fund that sources capital from multiple regional banks to provide liquidity for the new home mortgage product. The Federal Reserve Bank of Chicago recently highlighted it in its publication *ProfitWise* as a tool for Community Reinvestment Act: Shared Responsibility Mortgages, it said, “would also provide benefits to the bank or institution that holds the mortgage, such as helping expand lending to new potential borrowers who are concerned about house price volatility, and potentially helping lenders earn CRA credit for serving LMI [low-to-moderate income] communities.”

Institutional investors are encouraged by the new mortgage's incorporation of frictionless modifications for mortgage borrowers and the reduction in defaults at a portfolio level. The Great Recession revealed that various government programs, such as the Home Affordable Modification Program and Home Affordable Refinance Program, showed the strains that take place when developing modification rules and applying these on behalf of investors in mortgage-backed securities amid an economic downturn. The Shared Responsibility Mortgage provides modifications when they are needed in a local economy to help keep mortgages performing, and the resultant effects from fewer defaults and streamlined modifications ultimately trickle up to institutional investors.

PartnerOwn's biggest task is now in ensuring compliance with the various regulatory agencies for residential mortgages, consumer finance, and banking to provide mortgage lenders with regulatory assurance should they become Shared Responsibility Mortgage lenders.

Why does the federal government need to be involved?

The federal government has been incredibly influential in the U.S. mortgage market since the Great Depression by serving as a provider of liquidity to mortgage lenders and by lowering the cost of funding mortgages. This consideration is even truer today since 94 percent of residential mortgage-backed securities are issued by Fannie Mae and Freddie Mac.²

The two housing giants also have historically defined what mortgages are available to market participants. In the 1970s, their standardized mortgage contracts, such as the 30-year fixed rate mortgage, became available for resale to institutional investors. More recently, the Consumer Financial Protection Bureau has defined a "qualified mortgage" to provide clarity to mortgage-market participants about the rules governing various mortgage products to prevent the more outrageous terms and practices that contributed to the debt buildup that led to the Great Recession.

The government should be involved in promoting the use of mortgage contracts that have better economic properties. We give three specific reasons for government involvement below.

First, by securitizing debt mortgages and not securitizing Shared Responsibility Mortgages, the federal government through Fannie Mae and Freddie Mac provide a

huge cost advantage to debt mortgages that meet the definition of a conforming mortgage. The government currently tilts the game toward the mortgages that have bad economic properties. The Federal Housing Finance Authority should even the playing field by declaring the Shared Responsibility Mortgage a conforming mortgage.

Second, the economic benefits of Shared Responsibility Mortgages may not be reflected in private market pricing because of externalities. More specifically, research shows that debt contracts have large negative externalities on the economy that are not properly priced among private parties. The most obvious example is foreclosures. Foreclosures are the direct result of mortgage debt contracts that force the homeowner to bear the losses when house prices decline; a foreclosure has negative effects on house prices throughout the neighborhood. The entire neighborhood is made better off if the lender and any given homeowner agree on an Shared Responsibility Mortgage instead of a debt mortgage. Because such externalities are present, the government should play an important role in promoting this new home mortgage product.

Third, the Federal Housing Finance Authority, and potentially the Consumer Financial Protection Bureau, should play an important role in setting the terms for Shared Responsibility Mortgage contracts, which are more complex than the 30-year fixed rate mortgage contract—and more complexity often comes with manipulation and misleading practices by financial intermediaries. We show in our book that a Shared Responsibility Mortgage with an equivalent interest rate as a 30-year fixed rate mortgage should only require the homeowner to pay the lender 5 percent to 10 percent of the capital gain at sale. One worry would be that a financial intermediary would take advantage of the complexity of the new mortgage product by offering contracts that take much more of the capital gain than is fair. We believe the Shared Responsibility Mortgage has large economic benefits, but the complexity comes with the need of oversight.

A more stable housing market

Housing is crucial to sustaining a strong middle class, but the current mortgage finance system encourages volatility and excessive risk-bearing by homeowners. More equity-like mortgages such as the Shared Responsibility Mortgage would stabilize the housing market and protect homeowners against economic downturns. The benefits would accrue to the entire economy.

— Atif Mian is a professor of Economics and Public Affairs at Princeton University and Director of the Julis-Rabinowitz Center for Public Policy and Finance at the Woodrow Wilson School at Princeton University. Amir Sufi is the Bruce Lindsay Professor of Economics and Public Policy at the University of Chicago’s Booth School of Business.

Endnotes

1 Atif Mian and Amir Sufi, *House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent it from Happening Again*, (Chicago, IL: University of Chicago Press, 2014).

2 See issuance data from the Securities Industry and Financial Markets Association available at (<https://www.sifma.org/uploadedfiles/research/statistics/statistics-files/sf-us-mortgage-related-sifma.xls>).

Policy Issue: Geography of economic inequality

Geography of economic inequality

By Kendra Bischoff, Cornell University

Why does it matter where you live? Or where a child grows up? Neighborhoods are a primary non-familial context by which lives are shaped—residential context plays a significant role in access to education and other public services, opportunities for social interactions, labor market prospects, the frequency and nature of encounters with the police, and the freedom enabled by one’s real or perceived physical safety.

The geography of economic inequality refers to the spatial sorting of individuals by income, and the correlated patterning of economic resources and opportunities. The ability to pay has always determined the latitude of one’s residential choices as well as one’s capacity to afford certain neighborhoods. Research shows, however, that residential sorting by income has significantly increased over the past 45 years.¹ This sorting has resulted in more Americans living in communities that represent the poles of the income distribution rather than the middle. In 1970, two-thirds of families in large metropolitan areas lived in middle-income neighborhoods. By 2012, just 40 percent of families lived in such neighborhoods.

Similarly, the percentage of families living in affluent or poor neighborhoods more than doubled from 15 percent to 34 percent over that same time period.² This pattern is particularly problematic for lower income individuals. The most recent American Community Survey data show that approximately 12 percent of all poor individuals, and nearly a quarter of poor individuals in urban areas, live in “distressed” neighborhoods, defined as census tracts with poverty rates greater than 40 percent. This means that more than five million Americans face the double disadvantage of individual and contextual poverty.³

What are the causes and consequences of spatial economic inequality?

The spatial sorting of economic resources results from many regional factors, including income inequality, suburbanization patterns, the age and quality of housing stock, school and municipal boundaries, zoning and land-use regulation, and current and historical housing policies.⁴ Income segregation is more pronounced among families with children than it is among the general population, and most of the increase in income segregation that has occurred since 1990 can be accounted for by the residential choices of parents.⁵ This means that children, in particular, experience stratified residential contexts, and that parents are increasingly choosing to live with others similar to themselves.⁶

It is common sense that the lived experiences of people in neighborhoods characterized by high poverty rates, low employment rates, and routine violence are dramatically different than those of people in wealthy, protected neighborhoods. The concentration of social, financial, and environmental resources and hazards form the context in which children develop and adults live, which not only affects day-to-day experience but also is thought to affect educational achievement and attainment, adult earnings, mental and physical health, and attitudes toward society and the government.

In addition to the direct effects of neighborhood conditions, highly segregated neighborhoods make it less likely that advantages afforded by those with more resources will be shared, or will spill over, to those who are less fortunate. Economically heterogeneous schools, for example, ensure that the time and money that middle- and upper-class families have to invest in their children's schools, such as through the parent-teacher association, fund-raising, event planning, and curricular decisions, will also benefit children with fewer resources who share that educational environment.

There is great interest among social scientists and policymakers in understanding how residential context matters, especially for the trajectory of children. Understanding the link between neighborhoods and individual or distributional outcomes is challenging—people are not randomly assigned to residential location, and the degree of segregation in a city or metropolitan area is likely related to characteristics of the area itself. But using high-quality research designs such as controlled and natural experiments, longitudinal analyses, and carefully crafted observational studies, there is an ever-growing and improving body of evidence on whether, how,

and under what conditions neighborhoods affect individual and distributional outcomes, net of personal characteristics. In these studies, disadvantaged neighborhood contexts are defined by the concentration of poverty, but also sometimes by other indicators of neighborhood advantage or disadvantage, such as rates of unemployment, educational attainment, family structure, and welfare receipt.

Educational outcomes are probably the most-frequently studied outcome relating to neighborhood composition. In these studies, the authors seek to understand how neighborhood poverty affects the lives of individuals (as opposed to trying to understand the effect of the distribution of income across neighborhoods). Evidence suggests that exposure to a disadvantaged neighborhood context negatively affects educational outcomes such as high school graduation rates and test scores, and reduces children's verbal ability by as much as one year of learning.⁷ Long-term residence in the most disadvantaged neighborhoods, as compared to the most advantaged ones, severely reduces the odds of graduating from high school, and these conditions have a larger depressive effect on educational attainment for African American children than they do for other children.⁸ The effects of neighborhood disadvantage on high school graduation rates appear to be especially acute during adolescence, and are most harmful for those children who face the double disadvantage of family and neighborhood poverty.⁹ A number of other studies have shown that episodes of neighborhood violence reduce performance on academic tests and diminish the attention span and impulse control of children.¹⁰

Experimental evidence from housing programs on the effect of neighborhood composition has been more mixed. The well-known Moving to Opportunity study, for example, offered a random sample of participants a voucher to induce them to move to more advantaged neighborhoods. Comparisons between those who received the voucher and those who did not showed few long-term differences, which led people to conclude that neighborhoods, in and of themselves, had limited effects on individuals.¹¹

Yet, recently completed, longer-term evidence from the Moving to Opportunity data show that children who moved to low-poverty neighborhoods before the age of 13 have reaped significant benefits. They were more likely to attend college, had significantly higher earnings by their mid-20s, and lived in less disadvantaged neighborhoods as adults—all compared to those who did not receive the voucher in the experimental project. Results for children who moved after the age of 13 were nil or even negative, suggesting that stability and consistent social environments may be more important in late adolescence.¹²

Finally, a study of a housing program in Montgomery County, MD found significantly higher academic achievement among low-income students who lived in low-poverty school zones, compared to similar peers in high-poverty school zones.¹³ Taken together, there is a fairly strong body of evidence supporting the fact that childhood neighborhood context matters for contemporaneous and long-term outcomes, but that the effects differ by family income, race/ethnicity, and age.

There is less evidence on the consequences of economic segregation itself, a characteristic not of individual neighborhoods but of the arrangement of neighborhoods in a city. The existing research has demonstrated that metropolitan- and state-level income segregation increases inequality of educational attainment and infant health outcomes and shows that income segregation in U.S. metropolitan areas weakens economic mobility, establishing an important link between the geography of economic inequality and intergenerational mobility.¹⁴

Concluding thoughts and policy directions

The spatial dimension of economic inequality is a persistent feature of U.S. cities and communities. The magnitude of residential sorting continues to increase, closely tracking the steady rise in income inequality. Over one third of all families in large metropolitan areas now live in relatively poor, or relatively, affluent neighborhoods—neighborhoods that affect our understanding of America as a country of the middle class. Three additional points bear mention in this short brief.

First, neighborhood disadvantage is durable. Segregated neighborhoods are difficult to escape, especially for African Americans. Nearly three quarters of African American children who grow up in America's poorest neighborhoods live in similar neighborhoods as adults.¹⁵ A lack of sufficient resources in the poorest neighborhoods, such as high-quality schools, contributes to the intergenerational transmission of individual poverty and neighborhood disadvantage.¹⁶

Second, the concentration of affluence deserves more attention. The geographic isolation of the affluent is connected to the geographic isolation of the poor. Recent American Community Survey data show that, nationally, the school district at the 10th percentile of the income distribution has a median household income of \$34,000 while the 90th percentile district has a median income of \$74,000. The median household incomes in the very wealthiest districts exceed \$200,000, and fall below \$20,000 in the very poorest.¹⁷ These income gaps are not the whole story, but the gaps are representative of bundles of advantages and

disadvantages comprised of parental education levels and employment status, teacher quality, school facilities, and safety. This matters, in part, because children from poor and affluent neighborhoods are competing for the same seats at elite colleges and universities, and for the opportunity to be leaders in politics, business, academic research, and the arts. The presence of highly polarized neighborhoods ensures that children spend important developmental years in severely unequal environments.

Third, the vast majority of research on the causes and consequences of neighborhood poverty and economic segregation relies exclusively on income as a metric for financial resources. Wealth data are harder to obtain, but it is even more unequally distributed than income and it can be a major factor in residential choice. In 2010, 44 percent of all income in the United States went to the highest-earning 10 percent of the workforce, whereas the top 10 percent of wealth holders controlled 74 percent of all U.S. wealth. Similarly, the income-based Gini coefficient (a widely used measure of inequality in which 1 signifies absolute inequality and zero absolute equality) was 0.55 but the wealth-based figure was 0.87.¹⁸ Wealth segregation may be relatively severe due to the extreme level of wealth inequality in the United States, but less is known about the degree to which families are spatially separated by wealth.

How can public policy address the geography of economic inequality? I offer two brief comments. First, economic segregation and the concentration of poverty are not narrowly local issues. They are regional issues that need regional solutions. This may require collaboration across multiple municipalities, or the formation of regional governance structures that have the authority and mandate to address the division of resources that occurs through municipal fragmentation. Policy tack and the appropriate level of government intervention depend on the boundaries of the geographic inequality—across neighborhoods within a municipality, across schools within a school district, across municipalities and school districts within a metropolitan area, or even between cities or counties within a state or nationwide.

Second, there are remedies for the problem itself, and there are ways to mitigate its negative effects. Policies that encourage mixed-income communities or reduce income inequality refer to the former, while school integration programs and monetary redistribution refer to the latter. These types of policies are not mutually exclusive—society can both pursue bold long-term plans to equalize children's neighborhood contexts while also embracing short-term programs to mitigate the effects of segregation and concentrated poverty.

—Kendra Bischoff is an assistant professor of sociology at Cornell University

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Policy Issue: Neighborhood segregation

Confronting neighborhood segregation

By Patrick Sharkey, New York University

In 1970, 15 percent of families in the United States lived in neighborhoods where most of their neighbors were either extremely rich or extremely poor. By 2012, the percentage of families in such neighborhoods had more than doubled. More than a third of families now live in neighborhoods that can be thought of as mostly affluent, or mostly poor.¹ As the level of economic inequality has risen over the past several decades, families of different economic classes have begun to move away from each other, literally, into separate communities.

And as our nation's cities and communities have become more stratified, the life chances of those within the richest and poorest neighborhoods have become more unequal. Over the past decade or so, research from several different types of studies carried out in entirely different settings shows that growing up in a disadvantaged residential environment hurts the academic progress of children and reduces their chances to move upward in the income distribution.

This research comes from housing mobility programs such as the Dispersed Housing Program in Denver, the Moving to Opportunity program in five different cities, and the Ethel Lawrence Homes development in Mt. Laurel, New Jersey, all of which showed that when children are given the chance to leave communities with concentrated poverty and violence they benefit substantially in the long run.² And it comes from natural experiments that reveal when children are able to attend high-quality schools with diverse student populations, their academic performance begins to steadily improve.³

Most recently, the work of Stanford University economist Raj Chetty and his co-authors sheds light on the tremendous variation in economic opportunity across U.S. counties and commuting zones.⁴ This research is powerful because it makes the

impact of place glaringly visible, and it demonstrates persuasively that our economic outcomes are driven not just by individual traits and skills, and not just by our parents and families, but also by the communities in which we spend our lives.⁵

Any agenda for economic mobility has to consider ways to confront residential segregation in America. There are two sets of approaches to confronting economic segregation and its impacts. The first set focuses on ways to invest in neighborhoods in order to make the consequences of segregation less severe, and the second set focuses on ways to reduce the level of segregation in American neighborhoods directly.

Invest in neighborhoods where poverty is concentrated

Neighborhoods of concentrated poverty have never received the basic investments that are taken for granted in most communities across the country. While programs that confront urban poverty have come and gone, our most consistent, expensive housing investments are programs such as the home mortgage interest deduction, a tax subsidy that disproportionately goes to high-income homeowners in the nation's wealthiest communities.⁶

The first approach to confronting economic segregation is to minimize its consequences by shifting investments into every low-income community across the country. Three types of investments are supported with strong evidence:

- Provide work supports for individuals and families in high-poverty communities
- Invest in evidence-based programs for young people
- Identify or establish a “community quarterback” in every low-income neighborhood

Let's examine each of these briefly in turn.

Provide work supports for individuals and families in high-poverty communities

The New Hope program provided work supports, wage supplements, and temporary, guaranteed public service jobs for low-income individuals in low-income

neighborhoods of Milwaukee who were willing to work at least 30 hours per week. A randomized evaluation found that participants had higher rates of employment and higher earnings while the program was in operation. Further, children of families who took part performed better in school and showed improvements in behavior as well.⁷

The Jobs Plus program, carried out in five cities, provided a range of services to residents of public housing developments in order to improve their capacity to obtain and retain employment over time. The program also provided rent incentives designed to encourage work. The sites that offered the full range of services increased employment of residents by roughly 10 percent and increased earnings of participants by between 8 percent and 19 percent.⁸

Invest in evidence-based programs for young people

Recent demonstrations show that high-quality programs targeting youth in disadvantaged communities can have enormous impacts on their academic success and their involvement in violence. The Becoming A Man program in Chicago provides cognitive behavioral therapy combined with sports activities and lessons. Students randomly assigned to take part are more engaged in school and registered a greater than 40 percent reduction in arrests for violent crimes.⁹ A randomized trial providing “high-intensity” tutoring for one hour a day led to improvement in math scores equal to “an extra one to two years of learning.”¹⁰

What’s more, multiple randomized trials of summer jobs programs show that giving young people the chance to take on meaningful work in the summer, when violence is at its peak, produces substantial effects on violence and academic outcomes.¹¹

Identify or establish a “community quarterback” in every low-income neighborhood

Stories of communities that have transformed over time, such as East Lake in Atlanta, always begin with one strong, stable institution that takes ownership over the community and takes responsibility for all of the residents within it. Purpose Built Communities—an organization that has most successfully worked to turn communities around across the country, including East Lake, calls this type of institution the “community quarterback.”¹²

To begin a process of change, federal resources should be combined with resources from foundations and the private sector to identify or establish a community quarterback in every low-income community across the country, so that everyone within that neighborhood knows there is going to be an institution serving them for the long haul and will have resources sufficient to bring about long-term change.

Expand and preserve affordable housing and provide access to areas of opportunity

The problem of affordable housing has become a crisis in cities across the country, exacerbating the consequences of concentrated poverty and creating severe hardship for low-income families. The instability at the bottom of the housing market makes it extremely difficult for families to have any chance of finding stable employment, to raise their children in stable homes and find quality schools, and to move upward in the income distribution.¹³

At the same time, families receiving housing assistance tend to churn through a small segment of neighborhoods that are characterized by segregation and that offer few opportunities for upward mobility.¹⁴ New approaches to housing assistance are needed in order to address the affordability crisis while also providing families with the capacity to make moves into neighborhoods and cities of opportunity.

This second set of approaches is designed to confront segregation directly, by addressing the affordability crisis while also taking active steps to create economically diverse communities at the bottom and at the top of the housing market. Specifically, this approach calls for:

- Expanding the supply of housing vouchers
- Providing support to allow families to access opportunity neighborhoods
- Providing incentives and regulations to preserve and expand affordable housing in exclusive markets
- Establishing a long-range mobility bank

Each of these approaches are briefly detailed below.

Expanding the supply of housing vouchers

Only 1 in 4 families with income low enough to qualify for housing assistance actually receive any form of assistance, as the supply of vouchers is nowhere near sufficient to meet the needs of low-income renters.¹⁵ A first step in addressing the problem of neighborhood segregation is to take active steps to create affordable housing. Expanding the number of housing-choice vouchers available to very low-income American families so that affordable housing is an entitlement is one straightforward policy option that has received bipartisan support.¹⁶

Providing support to allow families to access opportunity neighborhoods

Even when families do receive housing assistance, they are often left on their own to navigate the housing market without the support and information needed to find housing options in communities that may offer greater opportunities. Evidence from the Baltimore Housing Mobility Program shows that when housing assistance recipients are supported for long periods of time they are able to find and to stay in communities that offer higher-quality schools and greater economic opportunities.¹⁷ New resources are necessary to change the way housing assistance is supplied so that residents are provided support in finding units in new communities and continue to have support, for up to two years, which allows them to navigate their new environments, find transportation to new job opportunities, and locate the right schools for their children.

Providing incentives and regulations to preserve and expand affordable housing in exclusive markets

Growing demand in select U.S. cities, combined with rigid restrictions on real estate development, have created soaring housing prices in some cities and made it difficult for middle- and low-income families to take advantage of new opportunities in hot markets. To preserve affordable housing in such cities, the federal government can provide incentives for local cities and organizations to take active steps to utilize creative ways to take housing out of the market and keep it affordable.

Two approaches are community land trusts and inclusionary zoning. Community land trusts are sections of land that are owned by non-profit organizations and can be sold or rented to families at prices below the local market rate. The federal government also can provide incentives for local jurisdictions to implement mandatory inclusionary zoning plans, which require developers to include a percentage of affordable units in any new development.¹⁸

Both community land trusts and inclusionary zoning are designed to maintain mixed-income communities in markets where housing prices are rising rapidly. In other jurisdictions that have never provided affordable housing, the federal government must continue efforts begun under the Obama Administration to assist local jurisdictions in their efforts to comply with the rule requiring comprehensive plans for affirmatively furthering fair housing. The effort to gradually enforce compliance with this longstanding rule is crucial to breaking down barriers to economically diverse communities in jurisdictions that have resisted the requirement to provide affordable housing.¹⁹

Establishing a long-range mobility bank

Long-range residential mobility, which brings families into different parts of the country with greater economic opportunities, has always been a mechanism for upward mobility. Yet migration into new parts of the country has declined over time, particularly for black Americans. Jens Ludwig at the University of Chicago's Harris School of Public Policy and Steve Raphael at the University of California-Berkeley's Goldman School of Public Policy propose the idea of a "mobility bank" to encourage long-range moves that are risky to individuals and families, and exceedingly uncommon.²⁰ The mobility bank would provide loans for individuals and families that allow them to make long distance moves away from distressed areas and into places that offer greater opportunities.

—*Patrick Sharkey is a professor of sociology at New York University*

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