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WHO IS THE ECONOMY WORKING FOR? THE IMPACT OF RISING INEQUALITY ON THE AMERICAN ECONOMY

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BEFORE THE

SUBCOMMITTEE ON
ECONOMIC POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

EXPLORING THE STATE AND TRENDS OF INEQUALITY AND WEALTH CONCENTRATION IN THE UNITED STATES AND ITS IMPACT ON THE MIDDLE CLASS AND THE ECONOMY OVERALL

SEPTEMBER 17, 2014

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C O N T E N T S

WEDNESDAY, SEPTEMBER 17, 2014

WHO IS THE ECONOMY WORKING FOR? THE IMPACT OF RISING INEQUALITY ON THE AMERICAN ECONOMY

WEDNESDAY, SEPTEMBER 17, 2014

U.S. SENATE, SUBCOMMITTEE ON ECONOMIC POLICY,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:32 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Jeff Merkley, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JEFF MERKLEY

Senator MERKLEY. I call this hearing of the Economic Policy Subcommittee of the Committee on Banking, Housing, and Urban Affairs to order.

This hearing is titled "Who Is the Economy Working For? The Impact of Rising Inequality on the American Economy." And put in simple terms, it is a chance to look at how inequality is driving the results of the economy, and whether it is driving further inequality, and how this reverberates back through our political system in terms of additional drivers of economic policy decisions.

So I am delighted to have our four folks here today to testify. I will make some opening comments, and then if any of my colleagues arrive, we will see if they have opening comments, and we will jump right into your testimony.

Back home in my State of Oregon, I live in the same working-class neighborhood that I grew up in since the third grade. Families are struggling to stay afloat, and there is growing fear that income inequality is undermining the foundations of our economy for working families. We are seeing more and more of the living-wage jobs lost during the Great Recession, replaced with lower-wage jobs that pay minimum wage or near minimum wage. Indeed, 60 percent of the jobs lost in the Great Recession were living-wage jobs, and only 40 percent of the jobs that we are gaining back fall into the same category of living-wage or good-paying jobs. More and more families are chasing part-time jobs, low to no benefits, and near to minimum wage, which is not a foundation for a family to thrive.

This trend of increasing inequality is diminishing not only our economic strength but also our working families' trust in our political system and the ability of policymakers to make smart decisions on economic policy in regard to restructuring the results to enable families to thrive.

Growing inequality has rightfully gained national interest in recent years. A report from the Congressional Budget Office found that from 1979 to 2007 income growth was concentrated among the highest earners, with the average after-tax household income for the top 1 percent rising 275 percent. And for the rest of the top 20, it still did well but rose only 65 percent. But for the bottom 20 percent over that time period, 1979 through 2007, it rose just 18 percent. A very small rise compared to that 275 percent for the top 1 percent.

A separate report from the Economic Policy Institute asserts the income losses during the Great Recession were similarly unequal, with the bottom fifth experiencing an average income loss of 2.7 percent per year while the top fifth dropped an average of 0.4 percent per year.

This difference is particularly pronounced when we look at the cumulative change in real annual wages. Between 1979 and 2012, the cumulative change in wage growth was 34.8 percent. The wage growth for the bottom 90 percent of the people was less than half that, at 17 percent. Thus, profound impacts on the families and across the economy.

Today there is evidence that unequal concentrations of wealth are affecting our policymaking in ways that could make it more difficult for our Nation to create a stronger middle class and reignite the middle-out economic growth. Every day thousands of lobbyists come onto the Hill and seek to influence policy debates, usually in favor of the interests of more affluent citizens. We must make sure that the voices of millions of Americans with low and middle incomes are not drowned out by those with far more resources. It is not a leap to suggest that recent decisions like that of Citizens United has further concentrated such influence.

It is critical that policymakers work to better understand these trends and ensure that we are doing everything possible to support policies that broadly benefit families across America, policies that work for working Americans, and not simply working well for the best-off.

We have with us today a panel of experts who will discuss the trends and economic impacts of inequality in the United States. Thank you, all of you, for your participation today, and I am going to go ahead and proceed with the introductions and then invite your testimony.

Heather McGhee is President of Demos, a public policy organization working for “an America where we all have an equal say in our democracy and an equal chance in our economy.” Before taking over as President in March 2014, Ms. McGhee served as Vice President of policy and outreach at Demos. She is a frequent contributor on MSNBC, and her opinions, writing, and research have appeared in numerous outlets, including the Wall Street Journal, USA Today, National Public Radio, the Washington Post, and the New York Times. Ms. McGhee holds a B.A. in American studies from Yale and a J.D. from the University of California at Berkeley’s Boalt School of Law.

Dr. Amir Sufi is the Chicago Board of Trade Professor of Finance at the University of Chicago Booth School of Business. He graduated with honors from the Walsh School of Foreign Service at

Georgetown University with a bachelor's degree in economics and has earned a Ph.D. in economics from the Massachusetts Institute of Technology. He is co-author of the book "House of Debt," which was published just earlier this year.

Claudia Viek is CEO of California Association for Micro Enterprise Opportunity, a Statewide network of organizations that promotes economic opportunity through entrepreneurial training and micro loans. She has been a pioneer in both the micro enterprise and business incubation fields for over 25 years, including serving as executive director of the Renaissance Entrepreneurship Center and founding the Pacific Network of Business Incubators from Baja to Alaska. She is the past President of the San Francisco Bay Area chapter of the National Association of Women Business Owners.

And Dr. Adam Hersh is a Senior Economist at the Center for American Progress, focused on economic growth and inequality in the United States, China, and the global economy. He has co-authored a report, "The American Middle Class, Income Inequality, and the Strength of Our Economy: New Evidence in Economics." He publishes and is cited regularly in both academic and popular venues and appears regularly on media outlets such as NPR, CNBC, and BBC. He earned a Ph.D. in economics from the University of Massachusetts, Amherst, and a B.A. in international political economy at the University of Puget Sound.

Before we begin, I will just ask if my colleague Senator Warren has any introductory comments she would like to make.

Senator WARREN. No, Senator Merkley. The only thing I want to say is thank you very much for having this hearing, for pulling together such an illustrious panel. This is a topic we need to talk about—we need to do more than talk about; we need to do some things about. And I just appreciate your terrific leadership on this, and I want us to get straight to their testimony and our questions.

Thank you.

Senator MERKLEY. Great. Before I begin, I would like to request unanimous consent to insert into the record letters from the National Asian American Coalition, the Los Angeles Latino Chamber of Commerce, the AME Corporate Partnerships, and Albina Opportunities Corporation of Portland, Oregon.

Senator MERKLEY. Let me also ask that the record remain open for 1 week for additional statements and questions from Members.

With that, we will begin with our 5-minute statements. Ms. McGhee, thank you for coming.

STATEMENT OF HEATHER C. MCGHEE, PRESIDENT, DEMOS

Ms. MCGHEE. Thank you, Chairman Merkley and Senator Warren and Members of the Subcommittee, for this opportunity to testify. My name is Heather McGhee, and I am the President of Demos, a nonprofit public policy organization.

As requested, Demos' testimony lays out the experience of inequality at the household level. Of course, it is actually a story of divergent experiences among our fellow Americans, of rapid wealth accumulation for the already wealthy at a time when half of Americans could not pay a $400 bill without going into debt or selling something.

The testimony includes the tight monthly budget of Patricia Locks, who has worked at the same company for 11 years, and we compare her experience with that of her company's majority owners, the six richest Walton family heirs, whose net worth is higher than the combined assets of at least 41 percent of American households.

We also describe the state of public higher education, formerly the great equalizer, where cuts to taxes and spending have made the new price of entry into the middle class so expensive that a student from a low-income family would have to pay 95 percent of her family's income to go to college for a year, and that is after financial aid.

We also analyze the major structural drivers of inequality from globalization to financialization, and the good news is that these megatrends have not made this degree of inequality inevitable. Policy choices have brought us here, and different ones can lead us out.

So why have our elected representatives not taken urgent national action when the lights are dimming on the American dream?

Today a cashier who earns just $7.25 an hour can only buy $7.25 an hour worth of food for her family. She can only buy $7.25 an hour worth of education for her children. But she also only seems to merit $7.25 worth of esteem in our political culture, and most dangerously, only $7.25 worth of voice in our democracy.

And I would like to spend the remainder of my time on the topic of our democracy, as the data now reveal that economic inequality and political inequality are mutually reinforcing.

In a more than $8 billion election cycle, less than 1 percent of Americans gave over $200 to a Federal candidate in 2012, and it took just 32 super PAC donors to outspend the millions of small donors to Governor Romney and President Obama combined.

So why does that matter? Demos has been working with a group of leading political scientists who are now able to quantify the compound effects of the distortions in our democracy on the very subject matter of this Subcommittee—on our economic policies.

The conclusion? When the policy preferences of the donor class diverge from those of the working and middle classes, Congress votes with the donor class. The policy divergence is most pronounced on economic issues. Significant differences between the wealthy and the general public are evident in such areas as taxes and deficits, trade and globalization, regulation of business, labor protections, the social safety net, and the overall role of Government. The general public is more open than the wealthy to a variety of policy measures designed to reduce inequality and expand economic opportunity.

Take the minimum wage. Over 70 percent of Americans, including over 50 percent of Republican voters, want it to be high enough so that a full-time worker can keep his or her family out of poverty. But when asked, members of the donor class, only 40 percent of them agree with that proposition. So add to the donor class' disapproval that 80 different corporate interests that lobbied against a wage increase in recent years, and the will of the majority gets drowned out.

Or take higher education: 78 percent of the general public believes that the Federal Government ought to do everything in its power to make sure that everyone who wants to go to college can do so. But only 28 percent of the wealthy are in favor.

Fortunately, there are solutions to political inequality. Reforms like the public financing system and the Fair Elections Now Act would allow more officials more time with their constituents and less time on call time with wealthy donors. And the good news is that money and politics reforms are extremely popular with the American public across the ideological spectrum. In fact, support for solutions from public financing to a constitutional amendment do not fall below 7 out of 10 from libertarians to progressives. Demos, when analyzing this bipartisan opinion data, actually ended up calling the report "Citizens Actually United."

Finally, I just will want to conclude with this: We cannot strengthen our democracy and, therefore, our economy without remembering the urgency of addressing the root word of the word "democracy," which is the "demos," the people of a Nation. Ours is the world's great experiment in democracy. The ancestral strangers who have come here with ties from every community on the globe have been met here with the promise that out of many, we could become one.

But forging a sense of common purpose amidst that great diversity is not easy, and it takes leadership. No other Nation has done it on the scale that we are currently endeavoring to do it, and certainly no Nation for whom racial hierarchy was the economic policy for most of our history.

I offer that it is no coincidence that the rules have changed to make it harder for the average American to get by over the same decades when the face of the average American has changed and when social distance has increased between regular citizens and the nearly all-white wealthy donor class which has such outsized influence on our policymaking.

At Demos we believe that if there is such a thing as American exceptionalism, our great diversity is its source. In the 20th century, America placed a bet on the children of immigrants and the descendants of slaves, and those public investments spurred on an economic force that changed the world.

Today the most diverse generation in American history is ready for that same commitment, for that commitment to the human capacity that lies within all of us, and to that very American idea that we all deserve an equal say and an equal chance.

Thank you.

Senator MERKLEY. Thank you very much, Ms. McGhee.

Dr. Sufi.

STATEMENT OF AMIR SUFI, PH.D., CHICAGO BOARD OF TRADE PROFESSOR OF FINANCE, UNIVERSITY OF CHICAGO BOOTH SCHOOL OF BUSINESS

Mr. SUFI. Chairman Merkley, Senator Warren, Members of the Subcommittee, thank you very much for the opportunity to testify. My name is Amir Sufi. I am the Chicago Board of Trade Professor of Finance at the University of Chicago Booth School of Business.

My research area is macroeconomics and finance, and I would like to give you some thoughts on the current U.S. economic situation.

As Senator Merkley noted, it is not good. There is something very wrong with the U.S. economy. We all know that the Great Recession was the most severe economic downturn since the Great Depression. What is perhaps less well understood is that the recovery since 2009 has been dismal. From the end of recession through 2014, real economic growth has averaged 2.1 percent per year, far lower than the 3.5 percent average annual growth that the U.S. economy generated from 1947 to 2007. The decline in the unemployment rate over the past 2 years should not be a cause for celebration. It is driven primarily by households leaving the labor force. There are currently 4 million fewer Americans aged 25 to 54 working today compared to 2006.

How did we get into this mess? And why is it taking so long to recover?

My research with Atif Mian at Princeton University suggests that the culprit is the devastation of wealth suffered by middle- and lower-income American households during the Great Recession. The weak recovery is due to the lack of any rebound in wealth among these households since the end of the recession.

The numbers are simply startling. Americans below the top 25th percentile of the wealth distribution have lower net worth in real terms today than they did 15 years ago. For Americans below the median of the wealth distribution, it is even worse. For example, those in the lower-middle quartile of the wealth distribution have seen their net worth plummet from $65,000 in 2007 to $40,000 in 2010, with a further decline to $38,000 in 2013. That puts their wealth in 2013 below their 1989 level. The Great Recession has wiped out 25 years of wealth accumulation.

The disproportionate negative impact of the Great Recession on the net worth of lower-wealth Americans may at first seem surprising, but it makes perfect sense with an understanding of how the financial system operates. Richer Americans save a much higher fraction of their income, ultimately holding most of the financial assets in the economy: stocks, bonds, money market funds, and deposits. These savings are lent ultimately by banks to middle- and lower-income Americans, primarily through mortgages.

There is nothing sinister about the rich financing the home purchases of the poor. But it is crucial to note that the borrowing takes the form of debt contracts which leave the borrower with the first losses in case house prices fall. The use of mortgage debt within the financial system gives the holders of financial assets protection against a fall in house prices. But it provides this insurance by concentrating the brunt of the economic downturns on borrowers. The standard mortgage contract is inflexible. The same amount is owed even if house prices and the economy collapse. Given that 85 percent of the financial assets in the U.S. economy are held by the top 20 percent of the wealth distribution, the financial system's reliance on inflexible debt contracts means it insures the rich while placing an inordinate amount of risk on middle- and lower-net-worth households.

As we illustrate in our research, it was the massive pullback in spending by indebted households that triggered the Great Recession. The financial system concentrated the collapse in home values on exactly the households that were prone to cutting spending most dramatically in response. Further, the lack of any increase in the net worth of lower- and middle-income Americans helps explain why the recovery in household spending has been so weak.

Going forward, there are two important lessons from the framework we outline in our research.

First, encouraging borrowing by lower- and middle-income Americans may temporarily boost spending, but it is not a path to sustainable economic growth. We witnessed this in the subprime mortgage market during the housing boom, and we are seeing an aggressive expansion of auto loans currently to lower credit score individuals. Credit card originations are following a similar pattern, albeit to a lesser degree. The problem is that these lower credit score borrowers are not seeing any improvement in real income growth. Credit growth without income growth is a recipe for disaster. We desperately need higher income growth for low- and middle-income Americans, and policymakers should tackle this problem directly rather than encouraging the extension of credit. Two suggestions I would make for product would be the expansion of the earned income tax credit and public infrastructure projects that can boost productivity while putting Americans to work.

Second, the financial system in its present form concentrates risk on lower-wealth households who are least able to bear it. The current policy and regulatory framework encourages such a system, even though it has disastrous effects for the economy. We must encourage the financial system to share risk with lower- and middle-income Americans instead of making them bear all the risk themselves.

I am happy to talk more about student debt, which is another market where I see this lesson having a lot of power.

I am happy to expand on these proposals in my remaining time, and thank you for the time.

Senator MERKLEY. Thank you very much.

Ms. Viek.

STATEMENT OF CLAUDIA VIEK, CEO, CAMEO—CALIFORNIA ASSOCIATION FOR MICRO ENTERPRISE OPPORTUNITY

Ms. VIEK. Thank you, Chairman Merkley, and thank you also, Senator Warren, for attending today, and for this opportunity to submit testimony, and I am really going to be talking about the impact on small business and also the opportunities offered.

So let me start out first, though, with a brief story. Johneric Concordia is a young man who was laid off as a baggage handler at United Airlines about 3 years ago. He loved to barbecue in his neighborhood in Filipinotown in Los Angeles. He and his uncles would compete to see who made the best sauce. So when he lost his job, he sought business counseling to realize his dream to start his own barbecue catering business. He raised $8,000 off of his Facebook wall friends and family, and then he bought a truck-mounted barbecue rig. Just about a year later, he opened his first restaurant called Parks Finest in Echo Park neighborhood. He has now hired nine of his homies, his friends, to work for him, and he is ready for a larger loan from a local nonprofit lender.

Now, Parks Finest is not a one-off. I have many, many similar stories from my members like the American Sustainability Business Council, the National Asian American Coalition, and from the 85 CAMEO members who serve entrepreneurs with small-dollar loans and coaching. Johneric and many other people share the desire and ability to contribute to our economy by being their own boss, and then they can go on to employ others. They are exactly the kind of people we should be investing in.

If we are serious about addressing income inequality, then we need to support entrepreneurship across a spectrum, that this is a real pathway to closing the wealth gap and generating new jobs.

There are 26 million small businesses in the United States, and most of them are self-employed people. Just imagine, if one in three created one job, we could have full employment.

I want to point out that a minimum of a million new jobs a year could be created through bank investment in lending and technical assistance programs to startup business. And my friend the Reverend Mark Whitlock, who is chair of corporate relations for the 5,000-member National AME Church, told me recently that these new jobs would address the 50 percent unemployment rate among black and Latino youth.

The Congressional Budget Office found that the richest among us own businesses. So to solve inequality, instead of handouts and promises of trickle-down job creation, let us help people create their own businesses and have them close the income inequality gap themselves.

I am going to refer to something Dr. Sufi is aware of: 88 percent of minority business owners finance their small businesses from home equity compared to about 25 percent overall. So the loss of home equity disproportionately affects minority-owned businesses.

In California, almost 2 million homeowners are still underwater—also true of Nevada, even though Senator Heller is not here. I wanted to say that, too. And from this fact we can assume that minority-owned businesses have not been able to fully recover from the downturn.

Business ownership is an effective strategy to reduce income inequality. The median net worth of business owners overall is 2.5 times that of nonbusiness owners, and the median net work for African American business owners is 8 times higher than nonbusiness owners.

The Association for Enterprise Opportunities' recent report showed that households headed by women who own a micro business generate up to $13,000 more in annual household income than similar households without a micro business owner. Now, this may not sound like a lot of money, but it can be the difference between sending one's child to college or buying a home. And the same report showed that the children in families with a micro business owner do better in terms of education and social mobility. So self-employment, business ownership, and entrepreneur, again, across the spectrum are key ways for lower-income people to become middle-income.

We know from the Aspen Institute studies and I know from my personal experience of 25 years in this field that when businesses get training and coaching help, 90 percent are still in business after 5 years as compared to 50 percent of those that did not get such help. Also, businesses that received capital and services from a nonprofit organization have a median annual revenue growth 30 percent higher than those that do not get help. And when micro businesses succeed, they create on average another two jobs.

Currently, our bank regulators are proposing giving extra Community Reinvestment Act credit to banks that provide small dollar micro loans in low- and moderate-income communities. This policy could have a major impact on new self-employment and job growth in communities that have not recovered from the recession.

So if there is one thing that you remember from my testimony today, let it be how small business creation and entrepreneurship can reduce income inequality, and they can bring hope to our communities that have so much untapped entrepreneurial potential. Thank you.

Senator MERKLEY. Thank you very much for your testimony.

Dr. Hersh.

STATEMENT OF ADAM S. HERSH, PH.D., SENIOR ECONOMIST, CENTER FOR AMERICAN PROGRESS

Mr. HERSH. Chairman Merkley, Senator Warren, thank you so much for inviting me to testify today. My name is Adam Hersh. I am a Senior Economist at the Center for American Progress. I was asked to focus more narrowly on the role of trade in this story of U.S. inequality and economic growth.

International trade and investment are critical parts of the U.S. economy. They always have been, and they always will be. But trade raises complicated policy issues because it is simultaneously a cause of inequality and of the innovation and investment that leads to our growth.

Trade globalization is one factor among several responsible for the staggering rise of U.S. income and wealth inequality since the late 1970s. Declining unionization and the real value of the minimum wage, decreasing tax progressivity, increased business short-termism, and focus on financial profits, and shifting technologies all have played roles. But economists do not really debate whether trade has distributional impacts; we debate how big those impacts are. And estimates that range from about 10 percent to 52 percent of the overall increase in U.S. wage inequality is attributable to increased trade.

Trade's impact on inequality happens both directly through job and income losses when businesses shrink, close, or move overseas, and they happen indirectly through the spillover effects that can saddle entire regional economies in localized states of depression. The combined effects weigh not just on those families and businesses impacted by trade, but they also pass through to our public budgets with lower tax revenues collected and increased expenditures on social insurance.

To be clear, there are many positive economic benefits from trading. Opportunities for bigger markets and specialization create incentives for innovation that propel overall growth. Access to a broader variety of stuff at lower prices raises our living standards. But the trend of runaway inequality over the past generation already takes into account this effect of lower consumer prices when we measure incomes, wages, and wealth adjusted for inflation.

More trade does not automatically equal more people getting ahead. Two new realities face lawmakers in approaching these issues of trade and inequality. First, the gravitational center of the world economy is shifting to the east and to the south, that is, to developing countries, where wages, regulatory standards, and norms of rule of law and transparent commercial exchanges are far from the level that they are in the United States, Europe, or other advanced economies. Already half of world growth is coming from the developing world, and that share is set to rise going forward in the future.

The second new reality is the transnationalization of businesses through offshoring. Trade used to be mainly an arm's-length affair, trading between countries. But today fully half of U.S. imports are transactions between related corporate entities. A substantial additional share of imports are also offshore trade through unrelated business parties.

Transnationalization makes it easier for companies to take advantage of opportunities for labor and regulatory and tax arbitrage. That creates a race to the bottom for economic development and undermines the social contracts underlying our economy and those of our trading partners.

This brave new world requires us to rethink the means by which the United States encourages economic growth beyond just trade policy, as well as rethinking what success means, not being measured just in increases in trade and GDP.

The questions before lawmakers are: How should the United States engage trading partners in an increasingly open and competitive world in order to grow our economy? And what should the United States do to make sure that workers and businesses in the United States can thrive in this environment?

First, in order to have a strong trading economy, we need a strong overall economy, and there is increasingly broad consensus among professional economists that high inequality is extremely detrimental not only to current economic growth but to future growth as well. This is the case because when we talk about the economy, we are talking about what is happening to people and how people are faring in their lives. An economy delivering equitable growth creates the financially secure families who can invest in human capital, the health and education that creates a productive, innovative, workforce. Families can provide a stable, strong consumer demand that entices business investment. And strong families can provide would-be entrepreneurs with the financial security to take the risk on starting a new business.

Economies with lower inequality and stronger middle classes also have more stable financial systems, better investment in public goods, better quality of governance in public and private institutions, lower crime, and less political polarization. Taken as a whole, lower inequality is the central thread that runs through essentially all the factors economists identify as being important for growth. In other words, a vibrant U.S. economy does not trickle down from the super rich but, rather, it springs forth from the well of a thriving middle class. And over the past generation, America's middle-class well seems to be running dry.

Congress should commit to investments that build the foundations for strong growth with a broad middle class in order to have a strong overall economy and a strong trading economy. This means more investments in making broadly available quality education, modernizing our infrastructure, investing in scientific research and development, replacing outdated trade adjustment assistance programs with a more universal dislocated worker program, and upholding standards for workplace rights and protections, including by extending paid sick/family leave and pay equity.

Second, Congress should focus on trade policy as well to grow the economy from the middle out. To do so, Congress should press U.S. trade negotiators to establish strong, enforceable standards for open and fair competition in the global economy. This would include going beyond the May 10th agreement on labor and environmental rights to include things like currency manipulation, ensuring public policy space for nondiscriminatory regulation, enforcing competitive neutrality with State-invested commercial enterprises, and more.

These rules alone mean little if we do not have the ability and resources to enforce the rules to ensure that we are receiving these gains from trade. Therefore, Congress should also increase the resources available for U.S. trade enforcers, doubling the funding to ITEC, the Interagency Trade Enforcement Center, and creating incentives for trade enforcement authorities to take more at-bats, bringing more trade cases to prosecution.

Thank you, and I look forward to your questions.

Senator MERKLEY. Thank you all very much for your testimony, and I believe for three of our witnesses, this is your first testimony in Congress, House or Senate, the first three, and for you, Dr. Hersh, you have testified on the House side but not on the Senate side before. So for all of you, welcome to the Senate, and thank you for bringing your expertise and your insights.

We will take 5 minutes apiece and go back and forth.

Senator WARREN. Thank you very much, Mr. Chairman. I appreciate it, and I appreciate your letting me go first. I am going to apologize in advance. I have got another commitment, and so I can only stay for one round here.

This is a terrific panel, and you all—just great topics that you have hit on and brought some new parts to the conversation. But since I am only going to get to do this once around this discussion, I wanted to raise another issue that layers into this and ask for your thoughts on it.

There is a new report out. I hope you have seen it. It is from Harvard Business School professor Michael Porter and Jan Rivkin, and the report is called "An Economy Doing Half Its Job."

Now, here is what the researchers find, and I just want to quote it to make sure we get this exactly right. They find that "corporate profits in America are at an all-time, and the Dow Jones Industrial Average continues to hit new records." But living standards for the average American have fallen over the last 15 years.

Porter and Rivkin from the Harvard Business School note that this "recent divergence of outcomes, with firms, (especially larger firms) thriving and workers struggling, is unusual in the United States" because "American companies and citizens have tended either to thrive together . . . or to suffer together . . . " But no more.

Now, there is a pretty simple explanation for this recent divergence. Corporations no longer share their prosperity with their workers. They share their prosperity only with their shareholders. According to research by Professor William Lazonick of the University of Massachusetts at Lowell, back in the early 1980s, large corporations dedicated less than half their earnings to their shareholders. The rest went to investment in their equipment and in their employees. But from 2003 to 2012, those big companies dedicated 91 percent of their earnings to their shareholders, either in the form of stock buybacks or dividend payments.

Now, why have companies shifted their priorities so dramatically in such a short period of time? Well, because CEOs are now compensated almost entirely based on the company's share price. As a result, CEOs love buybacks and dividend payments because they boost share prices, even if they come at the expense of long-term investments in the company and in its workers.

So here is my question: If we cannot count on CEOs and senior management to reinvest at least some of the corporate profits in their workers like they used to, what steps should the Government take to fill that void? And I would like to hear from all of you. Ms. McGhee, would you like to start?

Ms. MCGHEE. Thank you, Senator Warren. That is an excellent question, and it really goes to the heart of what our economy is for. Demos has been doing some investigation into these issues of how much increasingly large, low-wage employers that are extremely profitable are financializing, essentially, and concentrating the effort, the result of the production of their workers. My colleague Katherine Roishlin actually wrote a report on our country's largest private employer, Walmart, who spent $6.6 billion just last year buying back its own stock in the market. And she calculated that if that money were instead invested in the human capital of the workers who make that wealth, it could give the lowest paid workers, those who make under $12.25 an hour, which is almost a million Walmart workers, a raise of over $5 an hour just from what they spend buying back their own shares. So this has a very, very real effect on the working lives of workers and families.

So some of the things that Government can do——

Senator WARREN. I am sorry. I have to say, and to think about what it would mean if that million workers made $5 more an hour in terms of what they could buy elsewhere in the economy.

Ms. MCGHEE. Exactly.

Senator WARREN. And the overall growth in the economy and growth in jobs. Growth in demand, growth in jobs.

Ms. MCGHEE. Exactly.

Senator WARREN. Sorry, Ms. McGhee. I did not mean——

Ms. MCGHEE. No, no. Absolutely, because low-paid workers are the job creators who are waiting to have more money in their pockets to spend in our economy.

I will just say a few things that could be done. One, Congress could stop giving preferential treatment to this kind of income, to wealth income—stocks and dividends—over work. It is important to remember that less than half of Americans own any stock at all, so when we give this preferential treatment, we have to remember to whom it is going.

The part of the picture of that declining ability for the people who are actually doing the work to get a bigger slice of the pie that they spend all day baking is the decline in unionization, which has also been as a result of policy choices. So Congress could pass, for example, the Employee Free Choice Act and make sure that there is more collective bargaining power in our economy and in our enterprises.

Thinking about all of that money that unfortunately is not going to the public good in many, many cases, you have to look at the effective corporate tax rate. The Institute for Policy Studies shows that 26 of our biggest corporations spent more—paid their CEOs more than they paid to the Government in taxes. So we should be closing tax loopholes and havens and ensuring that corporations, which are at an all-time high in profitability, are sharing some of that revenue and we can make a new commitment to the quality of life of all Americans.

Senator WARREN. Thank you very much. You may have covered a lot here.

Dr. Sufi, we are over, but would you like to add something to that.

Mr. SUFI. Yes, that is a great question. I think another way of saying the same facts that Professor Porter and his co-author are saying is that the capital share of income, the amount of income that is going to the owners of capital, has gone up dramatically over the last 15 years. And in just thinking about the reasons for that, one reason I think is that capital markets have become quite ruthless in the sense that they want profits and they want them in the short term. And I think, Senator Warren, you are exactly right that we may worry—and I think there is research to back this up—that it excessively leads managers to focus on short-term gains rather than more longer-term investments such as job training, such as trying to boost the productivity of their workers, which I think is the best way ultimately to try to get wages and income up.

So I think going forward, as I mentioned before, I think expansion of the earned income tax credit, I think public infrastructure projects—it is amazing to me the consensus among people, economists, even economists at the University of Chicago who I sit down at lunch with, who we would all consider quite right-leaning, say, look, interest rates are zero, basically, and there may be very good infrastructure projects to do, it may help with this labor share problem. And it seems like that consensus is not here on Capitol Hill, but you definitely see it among economists. I think those are the solutions I would point to.

Senator WARREN. Thank you.

Ms. Viek, would you like to add to it?

Ms. VIEK. I am not the economist in the room, but I would like to just repeat or sort of say certainly closing the tax loopholes and reinvesting in human capital, small business entrepreneurs, it is human capital, and that is what communities need today.

I think also looking at perhaps—and this does not quite address what you are saying, but there are funds that could be used to help deal with this home equity issue, which has a huge impact, and then also reducing student debt.

Again, if you close tax loopholes and you have more income, let us invest in young people so that they do not have to increase their debt to go to a university.

Senator WARREN. Thank you, Ms. Viek.

Dr. Hersh?

Mr. HERSH. I would reiterate and agree with most of what has been said here on the panel so far, and I think that there is a very simple answer to your question of if the private sector is not willing to invest, even though the corporate sector is holding more than $2 trillion in cash reserves, even though they can borrow billions at essentially zero interest rates right now and are sitting on this cash rather than doing something productive with it, if they are not willing to invest, then the public sector has a role to step up and invest. There is no shortage of public goods and public services investments that will increase the productive capacity of the U.S. economy and create jobs that will lead to rising incomes and aggregate demand that will then crowd in investment from businesses. When they see a growing market, the investment will come to serve that market.

And while we are in this time of high unemployment, high excess capacity in the productive economy, this is really the way that we are going to get out of this spot.

Senator WARREN. Well, thank you very much. Those are very, very thoughtful answers, and I very much appreciate it.

You know, my Republican colleagues like to say a rising tide lifts all boats, and what they are saying is if we create the environment where corporations and investors thrive, then working families will thrive, too. We now have two decades of hard evidence disproving that theory. Corporations may be turning their backs on their workers, but that does not mean that the American Government should do the same. We can do better than this, and you have given us some great ideas to work with. Thank you.

Thank you, Mr. Chairman.

Senator MERKLEY. Thank you very much, Senator Warren, and I am sorry you cannot be here for a little while longer to participate in this, but I know this is the conversation that you are engaged in every day, and we appreciate that you are.

Senator WARREN. Yes, you are. Thank you.

Senator MERKLEY. I wanted to just reflect for a moment on the kind of different visions of how you build a successful economy for working America.

On the one hand, we have the post-World War II model in which workers earned more. They bought more products. The products were made in the United States so U.S. employers hired more people to make more things to sell to those folks. And you had kind of an upward cycle that was very powerful over a couple decades.

And then we have the current situation where we have essentially less and less equality, more concentration of wealth, and, therefore, diminishment of purchasing power by the middle class. And in this situation, if they can buy less, employers are going to make less. And between automation and decreased demand, that hurts.

But you have the argument—and Senator Warren was making reference to this. You have this argument among a great number of folks, but wait, the best-off are the job creators, so if we concentrate wealth with the job creators, we will have more jobs. Is there any validity at all left in this theory after the results of the last decade?

Mr. SUFI. So I can take a shot at trying to answer that. One of the things I think the economics profession understands quite well now is that one of the main macroeconomic problems with the U.S. economy is evident in very low real interest rates. So we have seen real interest rates pinned at basically 0 percent on the short end. People say it is all the Fed, but it is not. It shows you that there is in some sense an excessive demand for savings, especially in risk-free assets. And where does that come from? That comes from in large part inequality, because obviously the people at the very top end of the income distribution, the more and more of aggregate wealth they get, the more they are going to put it into savings and not into buying goods.

So I think we have come to a consensus in large part in the last 6 years—maybe not a consensus but at least a large swath of the economics profession does believe that excessive savings, which I think is a product of inequality, is becoming an issue, that we need people to actually go out and spend more. And that is something that I think, you know, inequality actually inhibits and that we do need more income growth, wage growth among the middle class to help try to spur demand. And I think that is something that we all kind of agree with in terms of one of the main frictions facing the economy over the last 6 or 7 years.

Senator MERKLEY. Any other quick comments before I move on? Yes, Dr. Hersh.

Mr. HERSH. I would say that no, there is really no evidence that the trickle-down theory of economics has worked. In fact, we have now more than three decades of evidence that it has not worked. The trickle-down theory said that if we made capital readily available to people who are going to invest it at a low cost, they would make those investments, grow the economy, and create the jobs, and the benefits would trickle down.

Well, we have made the capital available, we have moved the capital into their hands through tax policies, through policies within companies about how income will be distributed between the owners and the workers. We have made those changes, and what we have seen actually is slowing economic growth and more people struggling to maintain their financial security in the American economy.

Senator MERKLEY. So if we are caught in a set of policies right now that are accentuating inequality, we must still recognize that we are here in a democracy where people can vote for changes, and there are a lot more folks outside the top 20 percent than inside the top 20 percent. So why is it that those dynamics are not resulting in election-driven policy changes that revert to strategies that more successfully produce growth in income for middle-class families? Ms. McGhee.

Ms. MCGHEE. That is an excellent question. I think there are a lot of different aspects to it, and I tend to want to go to the structural. I think it is important that we recognize that there are two big pieces of our democracy that are not functioning well right now. One is actually our voting system. One in four eligible citizens is not even registered to vote. That means they are invisible citizens to the political process. They do not get the door knocks. They do not get the campaign materials. Some of us would like not to get that, but at least we are then engaged in the political process.

There are a lot of reforms that we can do to cut the red tape that needlessly catches one in four, 51 million Americans, who should be able to vote and register and are not currently. And that red tape actually traps people in a differential way based on age, race, and income. There is a gap, almost 30 percentage points, in voting between higher- and low-income households. So it is important to note that the electorate is skewed older, less diverse, and more wealthy.

And then, of course, my comments before about the makeup of the donor class. Some of the amazing political scientists who have been doing this work—Martin Gilens, Larry Bartels, Benjamin Page—have recently calculated that the affluent, the donor class has 15 times more policy influence than the average American.

Senator MERKLEY. Yes, Ms. Viek?

Ms. VIEK. I would like to jump in here. I think there is actually a little ray of hope, and it was in the New York Times yesterday, the front page where, in Kansas, there is now kind of a pushback against Mr. Brownback for all these years of disinvestment in the State. And I think that it does end up trickling down eventually where people say, "My God, I cannot send my kid to college. My God, I cannot even buy a car." I mean, just sort of basic stuff: "I cannot pay my electrical bill." And things that we used to take for granted in our culture are not there.

So I think that this—I mentioned investment in human capital. Investment in small business is the same as investment in human capital. I think that we are starting to see some recognition of that, and I always like to take hope wherever I can. So, anyway, that is my 2 cents.

Senator MERKLEY. Well, so what you are describing in Kansas—and I gather it is a close race there, so the outcome is not clear. But you might think of it a microcosm of the Great Depression in which coming out of the failure of that economy, there were many strategies that people collectively supported to strengthen the economy working for families. But in the absence of such a horrendous debacle, how does this turn around?

Let me ask just one example of this. In my community, my blue-collar community, many parents are starting to ask the question about whether or not it is smart for their kids to go to college, and the reason they are asking this question is because they see students coming out of college with debts the size of a home loan and not having jobs that can make the monthly payments, or at least not enough to create some separation so that you have some money left over after the monthly payment. And they feel like, well, do we want our children to have this millstone around their neck for years or decades to come?

And when I hear this conversation, I realize this is not some myth or some unjustifiable fear, because the statistics show that tons of our students are coming out of college and having trouble paying their loans or having the money to live after paying their loans.

And so we see kind of a collapse of the aspirational vision that was so important when I was young. My father, a mechanic, was able to say to me, "Son, if you go through the doors of that schoolhouse and you work hard, you can do just about anything here in America." And he said, "Mom and I are saving a little bit of money so that you will have a chance to go to college, and we hope you go."

And I think about how the cost of college has risen compared to a working wage. That then has not been compensated for by Pell grants. That drives more debt and more debt, and that debt is creating a sense that there is not a pathway for every child to thrive.

So why isn't it in a democracy and with so much of the workers across this country realizing that the path of opportunity is being choked off by the high cost of college, how come there has not been a political pushback to vastly increase Pell grants, control the galloping inflation in tuition, and make student loans a lot less expensive?

Mr. SUFI. Well, let me completely agree with you, Senator. I think one of the issues that we talk a lot about in our research and in thinking about the way debt works, student debt is an exact example of how awful the financial system works for lower- and middle-income Americans. As you mentioned, when someone entered college in 2005, they took on some debt thinking, like you were saying, they were going to get a good job and going to get high wages. Of course, they, like no one else, foresaw the worst economic downturn in U.S. history since the Great Depression. And what happened to those debt contracts when, through no fault of their own—I like to say that in some sense the only fault it was for the class of 2009 was being born in 1987, 22 years before this horrible recession. And yet we impose that risk because the debt does not change. The principal balance is the same. The interest payments are the same. That makes no economic sense. There is nobody that would design a financial system that would place such a huge amount of risk on students, and they are responding, just as you said. They now understand the risk that is being imposed upon them, and a lot of them are saying, look, college might not be worth it—which, of course, in the long run is the worst possible outcome.

So one of the policy ideas we have advocated, in addition to expanding Pell grants and trying to lower the cost of education, is just even in retrospect looking back and forgiving student debt for people who graduated in 2008 or 2009 or 2010. I saw some young faces in the crowd. There may be members of that class right here today. Through no fault of their own, this group of individuals was hit so hard by this recession, and in some sense given that the Government is the main lender, it is a policy that could be implemented potentially quite easily.

In the long run, I completely agree. Expanding Pell grants, expanding access to higher education is a huge part of reducing inequality because ultimately we need to boost productivity of workers in order for them to get higher wages that are sustainable. And I think we really need to rethink the way the financial system works to try to accomplish that.

Ms. MCGHEE. I would just like to add that I do think that this issue of the lack of affordability of higher education should be a signature one for all leaders, because it really goes to the heart of the American dream, the idea that you can succeed in a way that your parents did not. And we are seeing a generation over generation economic decline in this country, and a very big part of that is the fact that we traded away the blue-collar working-class jobs that did not require a college degree, and at the same time started to close the doors to the college degree that then became the most important thing you could do to secure a middle-class life, although not guaranteed.

So Demos has been working on this issue for a long time. We wanted to actually model out. People say, yes, it is true, student debt, it is getting to be $25,000 from public schools, but it is good debt. We wanted to actually test that question, because, in fact, what we found is that $25,000 in student loan debt would actually end up costing the average borrower over the course of their lifetime 4 times that amount in lost wealth, mostly home equity and retirement savings. And so you are saying to two similarly situated students, one who could afford to go to college without having to take on debt and one who could not, that afterwards, 35 years out, the one that started out needing to borrow money should have a lower wealth net worth just because of that fact.

We know that this country can afford to do for this generation and subsequent generations what it did to create the greatest middle class the world has ever known: Make college a public good again. This cost shift that has happened, 26 cents on the dollar just in the past 20 years in terms of States' cutting back support for public higher education, it is no way to run a country in a globalized competitive economy.

Senator MERKLEY. So let me capture your point there. I believe you said that the college debt leads to other economic decisions that decrease lifetime success, and that one of those is home ownership or equity from home ownership. And that can occur in a variety of ways: a delay in the time that you purchase your home, which has a huge effect due to the compounding of value; certainly the size of house you might be and the equity you might acquire in it; or lower downpayments that result in more money going out on the interest side.

And so when you think about the fact that home ownership has been the major source of savings for middle-class America and that students with—well, students 25 through 30 graduating from college with student debt, their home ownership rates have dropped dramatically, so they are buying later, and these are the effects you looked at to see a lifetime impact on wealth and that it is very significant.

Ms. MCGHEE. Exactly. That is exactly right.

Senator MERKLEY. Yes. And I think that is a great point, and I think it was the New York Fed that came out with studies recently looking at, proportionally, as your college debt goes up, how your home ownership goes down. Yes?

Mr. SUFI. And could I just interject one other distortion that student debt has on individuals, which is really quite problematic? It can reduce the incentive to work because at the end of the day, if you think most of your wages are going to go toward interest payments that ultimately you are never going to be able to retire the debt, that if you have these crushing debt burdens, many people may decide, look, it is not worth it for me to even work. So you may actually even have a labor supply effect which would be very detrimental.

So I agree completely. The evidence coming out of the Federal Reserve Bank of New York is quite compelling about student debt burdens having reduced car ownership and home ownership, and I think there is also this knock-on effect and, in fact, there is research that shows more debt forgiveness actually increases labor supply, that people are more willing to work once they have had their debt forgiven because now they know they actually get the returns to their work rather than handing it over to a bank.

Senator MERKLEY. So one idea we have been pursuing—and Senator Warren has been in the forefront of this—is enabling folks to refinance their higher-interest loans to a lower interest. They would still have the same amount of debt, but their payments would be smaller. They would be more able to purchase houses, cars, invest in the economy in other ways—in essence, stimulating the economy in ways that benefit all of us.

Yet another idea and one that has been pursued by a group of students in Oregon called Pay It Forward is essentially a version of a future income-adjusted repayment structure or income-adjusted loan payments. And there are multiple versions of that, but essentially a sense that if your future pay is lower, you pay a maximum proportion of that income so that you will not be trapped between wages that are here and monthly payments on your loan that are at or near—so that you have some gap to live on, if you will. Any thoughts on those two approaches?

Mr. SUFI. Well, I am in very strong support of both. Allowing students to refinance into a lower interest rate to me is a no-brainer. I mean, I think it is something that we allow people to do with mortgages, to prepay and refinance into lower interest rates. I think it would provide a huge boost to the economy overall, not only because it would probably boost spending by these former students who are carrying the debt, but also I do think it might actually affect labor supply decisions and get people to more actively look for jobs if they know they are going to actually get the returns to those jobs.

Our proposal is very similar to the income adjustment, and that is to make student debt contingent on what the unemployment rate is for recent college graduates. If it goes up above 10 percent, you would get automatic debt forgiveness, automatic low interest payments. So very similar to the idea that you were speaking about from Oregon.

Overall, we want to make debt more flexible. We want students to have lower interest payments if the economy collapses, and given that interest rates typically fall during recessions, allowing students to refinance into lower rates would be one way of doing it.

Senator MERKLEY. Anyone else on this?

Mr. HERSH. I have to agree with Dr. Sufi that refinancing student debt should be a no-brainer. This is the only segment of our credit market that really has not been able to benefit from the lower interest rates we have seen coming out of the Great Recession. But just lowering the interest payments on really exorbitant principals of debt that students are paying with the escalating costs of higher education is really not going to be enough to solve the problem of high debt and low prospects for incomes for these recent college graduates. So unless we can go further toward the kind of proposals that Dr. Sufi is discussing to remediate the principals on these debts when unemployment is so high, when the income prospects of newly employed college graduates is not as strong as it needs to be, this is really what is going to impact these people's lives and their ability to contribute to the economy.

Ms. VIEK. I would just like to jump in. You know I am a big proponent for entrepreneurship, but an unintended consequence of the student debt is that, as you were mentioning earlier, people do not fully participate in the economy. And so what we see is more and more people in the informal economy, so they are not even contributing to a tax base that would then help offset some of these other issues. And so I think we need to think about that fact, too, that people are sheltering—I definitely know people are sheltering their income, and that has consequences for our States.

Senator MERKLEY. So I want to go back to this issue of the daunting prospect of the pathway through higher education, because Ms. McGhee noted the impact on home ownership and how that decreased as well. But has anyone got a handle on how the message to our working-class high school students that there may not be a pathway for you to thrive might affect, if you will, the way they pursue their high school studies? In other words, why work hard in high school if there is not a pathway in which those grades matter to be able to go to college? Are we seeing kind of reverberations back into high school in terms of the motivation of our students? And this, of course, would be very—may be a much harder issue to quantify, but it is kind of a huge impact on the future success of the next generation.

Ms. MCGHEE. There is good news there and there is bad news. First, the good news is that young people today are more determined to go to college than ever. They know how important it is to a middle-class life, and the vast majority of young people who graduate from high school do go on to some sort of college.

The bad news is that there are at least 100,000 young people who graduate from college who are well qualified—I am sorry, graduate from high school who are well qualified to go to college who do not go, who do not apply to school because simply of the cost.

More often what happens, though, is that young people do go on to college. They work 20 hours a week while they are in school. There is a lot of unmet costs for transportation and housing and in many cases child care. They end up having to take classes at community colleges where, because community college spending has actually been declining because of those State college investment cuts, they are actually trying to work very hard to get enough credits to finish, and they drop out of college. And the number one reason cited for dropping out of college is financial pressures. And we know that, according to a recent Economic Policy Institute study, nearly half of low-wage workers have some college.

So it is not that people are being dispirited. They are going to college in record numbers. It is that we as the American people have given up the sense that this is a public good and that it should be a shared contract. I think it is important, very important, to deal with the existing over $1 trillion in student loan debt, refinance it, open back up the doors to bankruptcy for a second chance for people with private student loans, and I would even say Federal loans. But most importantly, I think we should start with the assumption that the greatest middle class the world has ever known was made with debt-free college, and we should have to justify why this large, diverse generation should have to go into any debt at all from working in middle class to be—to get a higher education.

Senator MERKLEY. So here we are in a world knowledge economy where America's ability to thrive is going to depend on education, and we are making it far more expensive to get that education.

Ms. Viek, I wanted to turn to your thoughts about micro enterprise. One of the tools that some States have used—and there is some national policy around it—are individual development accounts. And these essentially are matching grant programs. A low-income family saves money, and they can earn matching grants to either buy a house, go to school, or to start a small business. And the reason for those three things is that those three things are the biggest levers or pathways for movement from poverty into the middle class. And so that third area, to start a business, is a tool of micro enterprise, if you will. I am just wondering if that is a tool that you have run into and have any particular thoughts about.

Ms. VIEK. Yes, thanks for asking, because actually at the same time that we are meeting is the Corporation for Enterprise Development Asset and Opportunities Conference I just came from, and one of the tax policies that is being promoted is that we should start savings at birth. And it relates to what you all were saying earlier about the lack of wealth and the lack of assets. So it is not just labor income; it is actually the lowering of assets.

So we need to address the issue of inequality when it comes to assets, and starting savings accounts for every child at birth is working in a pilot in Oklahoma. And as a result of those years of showing that it can work, it is now being picked up by Maine and other States.

So I wanted to bring that to your attention, and I think that this is something, again, that will contribute to college costs, buying a home, or starting a small business. And more and more—it is interesting. The two cohorts that are starting businesses or becoming self-employed: one are the over-55's, which you and I fall into——

Senator MERKLEY. Yes, we do.

Ms. VIEK. I am assuming.

Senator MERKLEY. Thank you for reminding me.

[Laughter.]

Ms. VIEK. You are on the young side, though. And the other is the millennials starting businesses at a faster rate.

So, yes, there is an interesting new report out by CFED called "From Upside Down to Right Side Up," and it really does deal with tax policies as they apply to savings accounts.

Senator MERKLEY. Thank you.

Another piece of the small business puzzle is access to traditional credit, and we have a story—I have a story that was sent to me by Albina Opportunities Corporation. It is a nonprofit small business lender in Portland who lends only to folks who cannot access traditional bank loans. And this is from a statement that we have now entered into the record, but Albina describes a typical client.

In 2010, an African American man who owns a trucking company for earth-moving purposes approached them to obtain a line of credit to expend his 10-person business, but a previous bankruptcy prevented a loan from a conventional lender. The Albina Opportunities Corporation underwrote a $100,000 loan, and he used it to hire more drivers, obtain larger contracts, and by 2013, the company now employs 26, the revenues have grown sixfold to $4.75 million, and is now a preferred subcontractor to major general contractors.

Now, the thing I really want to emphasize is Albina is a nonprofit community development organization that lends only when someone else will not. And in 6 years of operation, they have not lost a dollar of principal. And the point that they are making is our traditional banking does not seem to be reaching out in the same way that perhaps community banks might have done in the past, and that there is this gap of access to traditional credit that is constraining the entrepreneurial track from poverty into the middle class.

Any thoughts about that piece of the puzzle?

Mr. SUFI. Well, as you were telling your story, I was recalling one time—I teach MBA students, and I was telling them the foundational theories of banking involve a bank that goes in and carefully screens and monitors and tries to figure out whether this business person is credible, whether they have a good business plan. And one of them came up to me after class and said, "Banks do not do that." And I said, "What do you mean banks do not do that?" He said, "Maybe banks used to do that 20 years ago, but now banks just basically do trading. They try to make some profits, and if they run into problems with a borrower, they quickly try to get rid of the loan."

So there is some way in which banks are no longer doing the kind of small business lending that would be profitable for them, I think, and that could be because banks have become so big that they are just out of this market. It could be for a lot of reasons. But I would agree that there probably—it is telling that there are nonprofit institutions coming in and able to do such great lending in this segment of the market. We have a supposedly thriving private sector of banks that should be doing these loans, but they are not. And I think that tells you that there is something wrong with the banking system as it is operating today.

Senator MERKLEY. Anyone else?

Ms. VIEK. Yes. We have roughly 28 community development financial institutions like Albina Corporation in our membership, and while I am heartened by the use of technology and the growth, very fast growth in this segment, because the banks have basically ceded the under $200,000 loans to the nonprofit sector. But what we are really seeing, though—and it needs to be addressed—is the online lenders and some of the cash advance lenders that are not regulated. Some of them are transparent. Some of them are doing—like Lenders Club, but you have to have perfect credit to qualify for that. But it is addressing the market, and now the financial institutions are actually investing in Lending Club.

So I think that is a whole other hearing that we should have on the phenomenon, the emerging phenomenon of online lenders. I think it would be appropriate for the Banking Committee to take that on. It is something we are watching very carefully in California. We are concerned about it. But we also see some real hope for access to capital amongst those folks that have not had access.

Senator MERKLEY. So were you referring specifically to cash advance, payday loan-style online lending? Or were you speaking more broadly?

Ms. VIEK. The whole spectrum, from the cash advance, some of which are predatory, to there are some good cash advance groups. I mean, PayPal, Square, they are very transparent, low interest rates. But then we have others that end up layering on top. And then you have ones that have—are really working with the cream of the crop of the top credit scores.

Senator MERKLEY. When I was Speaker of the House in Oregon, we passed a law that limited the payday loan interest rates down to about 36 percent, which sounds like a lot, but they were charging well in excess of 500 percent. And I was struck a year later to visit a food bank and have the first thing that the director of the food bank said was, “We had a stream of families coming to us who had been bankrupted by payday loans,” because they started with a 2-week plan, and you end up—by the time you have rolled over a few times, the equity grew—at 500 percent, the loan multiplies fivefold in a year, 25 in 2 years, and pretty soon people are in a vortex of debt they cannot escape from. And she was noting how dramatically that source of bankruptcy had disappeared and how positive that was by passing that law in Oregon. Then she noted how the recession of 2008 had unfortunately knocked far more people off their economic foundation, and so that the demand on the food bank still had gone up.

But what we are seeing in Oregon are online payday lenders who are violating the State law because State law does not allow them to engage in these types of contracts, but they engage in them anyway, but they are operating from overseas or other places that cannot be reached, and they utilize the account number to simply reach in and pull money out of people’s accounts.

So this is a very huge predatory practice that as a society you would think that we would be able to get control over, but we do not have control over it yet.

Ms. VIEK. Well, you can see there is this huge market for these payday or faster forms of money. I mean, how do people—people have used them for generations for that reason.

I think there are alternatives, and I had mentioned in my testimony the fact that our regulators, the OCC, are looking at a small-dollar loan—promoting small-dollar loans in banks and giving banks extra CRA credit. I do not know how much of an incentive that will be, and we need to look at that. So I would just like to note that as something you may want to take a look at in a few months perhaps as it evolves down the line, because that could be another alternative, although I am not quite sure how the banks are going to deliver that because it is not exactly cost-effective to do it through the branches. It is going to have to be an online product.

Ms. MCGHEE. There is also something else that the Senate and the Banking Committee in particular can do. I commend you and the State of Oregon for making that reform to essentially eliminate the high-interest payday loan model. But the Senate Banking Committee—actually, I am sorry. It was not the Banking Committee, importantly. It was, I believe, the Armed Services Committee did pass a similar law for military families. I believe it was called the Military Readiness Act, I think, in 2006, if I recall correctly.

We could do that for the entire country. We could protect every single member of the American public from triple-digit interest rates on short payday loans whose model is repeating borrowing. And I think really the only reason that we do not do that and that that kind of reform cannot come through the Senate at this moment is the money in politics problem. I am sure you experience this in Oregon, but it happens, I think, every single day there is a very well organized payday loan lobby across the country that makes a lot of particularly State-level legislative campaign donations, and it becomes very, very difficult to regulate an industry that is financing so much of the campaigns at the State level.

Senator MERKLEY. Your point is absolutely right. This is a very good example of that type of economic clout, that influence, if you will.

I was very struck in Oregon how the industry's core argument was that clearly there is a demand for these loans; therefore, we should simply leave the system as it is and allow these 500-percent loans.

What we knew from other States, though, and from the military communities due to the 2006 law, was that ready equivalence did not disappear. The interest rates just came down dramatically. So you still had access to short-term lending, but you had it at a far lower rate.

Now, there should be a lot of doctorate theses exploring why it is competition did not have the effect of bringing this down. But it did not. It did not.

And so I can tell you there is absolutely no impulse in Oregon to restore us to where we were before we capped these loans. And we did it across the spectrum of consumer loans because we saw the migration in other States from payday loans to title loans to general consumer unsecured loans and so forth. And so it is only the folks who are online violating the law that are really the problem at this point.

But a major argument that we made was from the military community, because we had generals and admirals who were coming to Congress and saying these payday loans are destroying our military families and that is unacceptable. Why should it be acceptable for any family or community to be destroyed, not just our military families and our military communities, but any community to be destroyed? And, unfortunately, we have not completed the vision that was so well laid out through that 2006 Act.

Well, obviously there is a lot going on here, how we change the role of influence from money to shape policies that restore strategies that strengthen the middle class. What is absolutely clear is we are desperately off track right now in a rapidly changing world. And all of you are contributing significantly to the effort to illuminate strategies and possibilities for putting this back on track. And so I thank you very much for your participation and particularly for your ongoing work in your respective fields, and I look forward to learning additional insights from your work in the time ahead.

I will invite anyone who would like to submit any other information for the record to do so. We will be holding it open for a week, and that goes for my colleagues on the Committee who might want to submit questions. And if you get questions, certainly we look forward to your answers.

With that, we are going to conclude this hearing of the Subcommittee. Thank you.

[Whereupon, at 3:55 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

Dēmos

AN EQUAL SAY AND AN
EQUAL CHANCE FOR ALL

Testimony by Heather C. McGhee,
President, Dēmos
Prepared with Assistance by Amy Traub,
Senior Policy Analyst and Sean McElwee,
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U.S. Senate Committee on Banking,
Housing and Urban Affairs
Subcommittee on Economic Policy

Hon. Jeff Merkley, Chair
Hon. Dean Heller, Ranking Member

September 17, 2014

I. Introduction

America's economy has been an awesome engine of wealth creation over the past two generations, but the new prosperity has disproportionately gone to the wealthiest. Between 1979 and 2010, according to the Congressional Budget Office, American households in the richest one percent of the income distribution saw after-tax income gains of 202 percent[1]—while the 60 percent of the households in the middle saw their incomes grow by only 39 percent over this same period.[2] The CBO also finds that the share of after-tax income going to the richest one percent has increased from 7.4 percent in 1979 to 12.8 percent in 2010.[3] At the same time, the share going to least well-off 60 percent of Americans has declined, from 36.2 percent in 1979 to 32.5 percent in 2010.

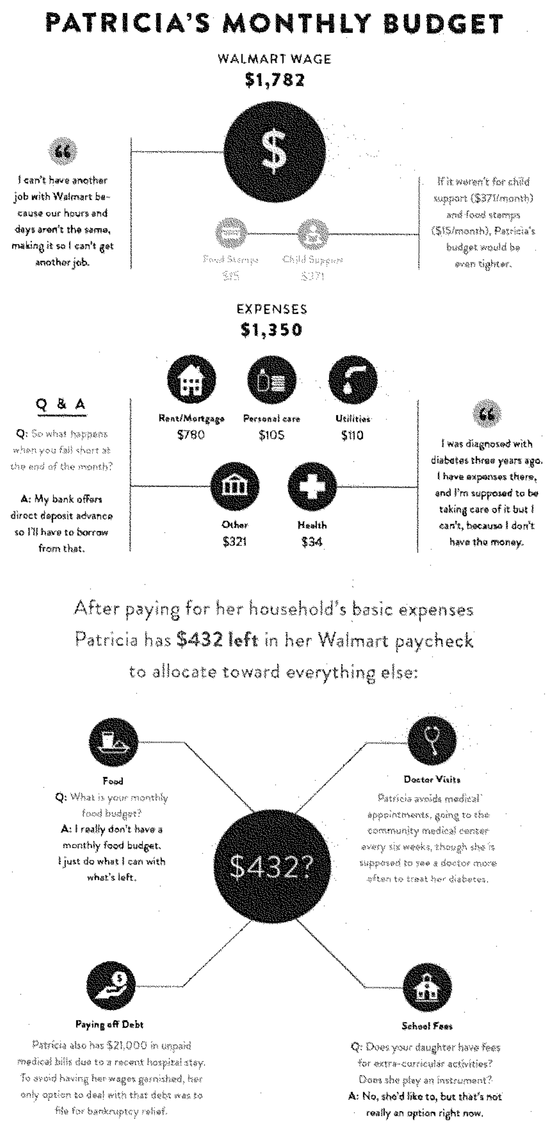
According to much research, social mobility—the very essence of the American idea—has remained stagnant for decades, and many of our global competitors are now performing far better on what we have long considered to be the American Dream.[4] For example, young men are earning ten cents per dollar less than their fathers did 30 years ago, according to research from Dēmos.[5] Princeton economist Alan Krueger observes that the economic data "challenge the notion that the United States is an exceptionally mobile society. If the United States stands out in comparison with other countries, it is in having a more static distribution of income across generations with fewer opportunities for advancement."[6]

The rising inequality of wealth and income that threaten shared prosperity and democracy long preceded the financial crash of 2008 and the downturn that followed. As a result of major economic and policy changes over the past three decades, the gap between the richest and the rest of America has become a chasm. Many jobs do not pay enough to cover basic living expenses, much less allow workers to save and build for the future. In fact, a quarter of full-time working-age adults are still not earning enough money to meet basic economic needs like housing, utilities, food, health care, and transportation for themselves or their families.[7]

A host of public policy choices have driven inequality and insecurity—including tax cuts that disproportionately benefitted the wealthy, state divestment in public higher education, financial deregulation, and the weakening of labor protections, to name only a few. Job growth on its own will not reverse inequality: the shift to a low-pay service economy has in fact accelerated during the economic recovery. Over the next two decades, the Department of Labor projects that the largest job growth will be in low-wage jobs offering little opportunity for advancement, few benefits, and not enough pay to allow workers to build wealth.[8] Meanwhile, most of the good jobs that are created will require a post-secondary education that is likely to remain out of reach for millions, as states continue to shift the cost of higher education onto students and families.

Even as inequality has worsened, national action has been lacking. Over recent decades, many political leaders have failed to reckon with a basic fact of the new economic era—for millions of Americans, no amount of individual effort or self-improvement or thrift can guarantee a secure middle-class life. The American social contract—a promise of opportunity and security for those willing to work hard—is fundamentally broken.

Dramatic new public policy initiatives are needed to accomplish two broad interrelated goals: to ensure that all Americans have a chance to move into the middle class and, second, to ensure greater security for those in the middle class. Such initiatives must move far beyond incremental measures, and be of sufficient scale to permanently address the economic insecurities of what is now a vast number of U.S. households.



Patricia Locks and Walmart: A Case Study in Inequality

To understand the impact of rapidly rising inequality on the American economy, there is no better place to look than the nation's largest private employer, the world's biggest public corporation, and a company whose customers and employees struggle on the opposite side of the economic divide from its owners. Many of Walmart's 1.3 million U.S. employees raise their families near the poverty line as they contribute to the company's $16 billion in annual profits. The primary beneficiaries of their efforts are the heirs of Sam Walton, who now hold more than 50 percent of the company's public shares. Walmart's business model has flourished over the past 20 years, with the growing economic insecurity leading to more price-conscious customers. However, in recent years, the company's economic performance has stumbled, as a growing number of its U.S. customers—like its own employees—lack the purchasing power needed for sales to flourish. A company that played a leading role in exacerbating American inequality by compensating its employees meagerly and squeezing suppliers and competitors is now being undermined by the very economy it helped to create. This story is emblematic of the larger state of the American economy. But it also has a very human face. Patricia Locks has worked at a

Seattle Walmart for 11 years and currently earns $13.10 an hour. Among Walmart's front-line employees, she is far from the bottom, due in part to Washington having a minimum wage 27 percent higher than the federal minimum.[9] A recent study from the National Bureau of Economic Research estimates that Walmart cashiers are paid an average $8.48 an hour, while the company has stated that its average wage is $11.81 for hourly workers.[10] Yet Patricia Locks struggles. As is increasingly the case with low-paid workers, her schedule is unpredictable[11] but she usually works about 34 hours each week. She struggles to support herself and her 14 year-old daughter, but her unstable schedule prevents her from taking on a second job. Her monthly wage is $1,782, which is supplemented by food stamps ($15 a month) and child support ($371 a month). Many low-paid workers must rely on public benefits because employers pay too little for them to support themselves.[12] Locks spends $780 a month on rent, $105 on personal care, $110 on utilities, $34 for health care and $321 for other expenses. That leaves her only $432 a month for everything else: school, paying off debt, food and doctor's visits. Locks has thousands of dollars in unpaid medical debt, as do millions of Americans—a recent study finds that medical debt was responsible for 62 percent of all bankruptcies in 2007.[13] She often has to skip doctor's visits even though she's been diagnosed with diabetes. Here too, her experience is common: a recent Gallup survey finds that three in ten Americans have forgone recommended medical treatment because of costs.[14] Locks' budget doesn't leave her with extra funds to supplement her daughter's education or let her participate in extracurricular activities. A recent study finds that the wealthy spend seven times more on enrichment for their children than the poor.[15] All of these sacrifices are still barely enough to keep Locks from falling further into debt, another new reality for most Americans.

Patricia's is not the only Walmart story, however. On the other side of the economic divide sit the six richest members of the Walton family, Christy, Jim, Alice, S. Robson, Ann, and Nancy, who have a net worth of $144.7 billion combined.[16] Their great wealth stems not just from money they inherited from company founder Sam Walton, but from the ongoing revenue stream that Walmart's operations (and workers like Patricia) generate. In the fiscal year ending in January 2014, the Walton heirs took home $3 billion in dividend payments from Walmart, enough to give a $2 an hour raise to the 825,000 company employees who make less than $25,000 a year.[17] In 2010, when the family's fortune was worth "just" $89.5 billion, it was already greater than the total financial assets of the least-wealthy 41.5 percent of American families combined.[18] That six people could have more wealth than nearly half of American households without working for it is extraordinary—but unearned wealth is increasingly a part of the American story of success: six of the ten wealthiest American are heirs, not entrepreneurs.[19] Recent data from Thomas Piketty finds that the wealthiest 0.1 percent make most of their income from capital ownership, not from labor.[20]

The picture of growing inequality between work and wealth epitomized by Walmart stands in stark contrast to the idea of America. Widely-shared prosperity is a signature promise of American society. It has made ours the most hopeful and dynamic country on earth and it is a foundation of strong democracy. Fortunately, in a democracy, Walmart's business practices are governed by laws, laws which, if changed, could reshape opportunity for people like Patricia and her family.

II. How Inequality is Experienced at the Household Level

The following sections describe the effect of inequality and the related rise of economic insecurity for most Americans at the household level.

A. Stagnating Real Incomes for All but the Richest

In the years after World War II, as economic growth and productivity increased, the workers contributing to that prosperity saw commensurate gains in wages, across the income spectrum. However, that connection has broken down over the last thirty years: while productivity increased 65 percent in the three decades between 1979 and 2013, the inflation-adjusted wages of the median worker grew just eight percent, and that growth occurred exclusively as a result of the strong economy of the late 1990s, according to analysis by the Economic Policy Institute.[21] Since 2000, the picture of earnings and income has become still more stark: despite a productivity increase of 22 percent between 2000 and 2012, inflation-adjusted median family income in the United States has ***declined*** seven percent, from $68,949 to $64,053, over the same period.[22]

Part of the story is the increasing economic returns to education, which left workers without a college degree lagging further behind in income and employment. For example, as chronicled in Dēmos' *State of Young America* report, in 1980, a young man with a bachelor's degree earned roughly $9,100 more than a young man with a high school degree. Today, he earns $20,000 more, and the trends are similar among women.[23] However, a college degree has not entirely protected workers from declining wages in the years since 2000. Between 2000 and 2014, the wages of young college graduates fell 7.7 percent, translating into a decline of more than $2,954 for full-time, full-year workers.[24] This suggests that boosting college attainment, while critical, will not be sufficient to reduce inequality[25] or re-establish the link between economic growth and productivity and wage growth.

A bigger part of the story has to do with the rising share of the nation's gross domestic product flowing to corporate profits rather than wages and the larger share of overall income going to the highest one percent of income earners. Until 1975, wages generally accounted for the majority of the nation's GDP, but by 2013 wages had declined to a record low of 42.2 percent.[26] Research from Northeastern University finds that in the first seven quarters after the end of the Great Recession, American corporations received an astonishing 92 percent of the growth in real national income, while aggregate workers' wages and salaries actually declined by $22 billion and contributed nothing to national income growth.[27]

Personal income has become far more concentrated among the richest, a trend that has also accelerated rapidly since the end of the Great Recession. Economist Emmanuel Saez finds that between 2009 and 2012, the incomes of the highest-paid one percent of Americans grew by 31.4 percent while the incomes of the rest of Americans grew by only .4 percent. In effect, the top one percent captured 95 percent of the income gains in the first two years of the recovery.[28] Over the full period studied (1993 – 2012), real income growth for the top one percent was 86.1 percent and growth for the bottom 99 percent was only 6.6 percent. In total, the one percent captured 68 percent of income growth.

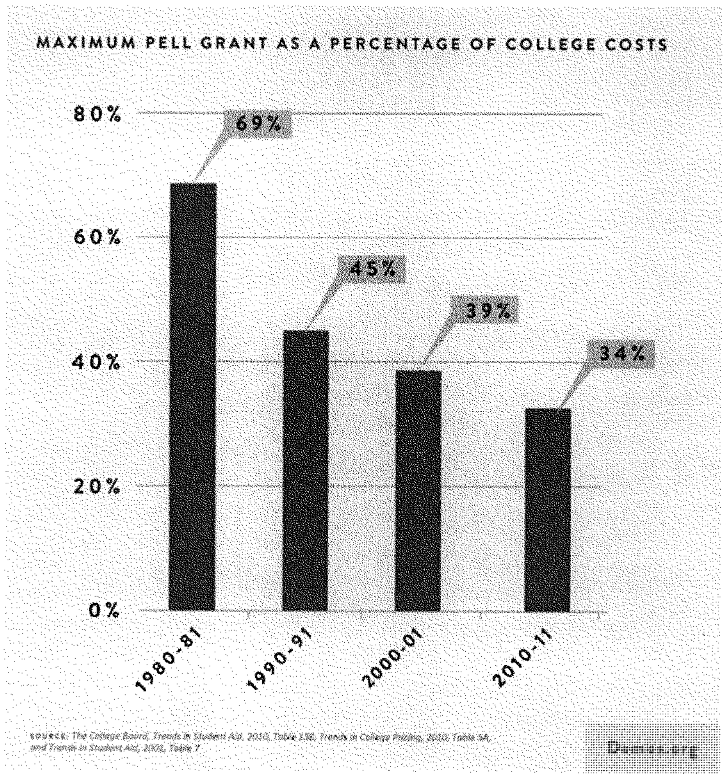
Finally, while the real wage data above is adjusted for inflation, this story does not fully account for the cost of health care, child care and higher education, which have seen their costs grow far more quickly than the Consumer Price Index. For example, the average annual employee contribution to health premiums has more than tripled since 1999, growing from $1,543 to $4,823 for family coverage and $318 to $1,081 for single coverage.[29] The national average cost for center-based child care in 2011 was $8,900 for full-time care for an infant and $7,150 for full-time care for a preschooler.[30] Center-based child care fees for two children (an infant and a four-year-old) exceeded annual median rent payments in all 50 states and the District of Columbia.[31] This is all the more troubling since according to the Center for Housing Policy, 22.1 percent of all working U.S. households (renters and owners combined) also experienced a severe housing cost burden in 2012, spending more than 50 percent of household income on housing costs, including utilities.[32] Meanwhile, at public four-year universities, average tuition has risen 117 percent (in real terms) since 1993.[33] The American middle class, and workers aspiring to a middle-class standard of living, are squeezed between stagnant and declining wages and higher costs for the fundamentals of a middle-class life. Aside from the major advances in health care coverage and affordability in the Affordable Care Act of 2009, policymakers have done little to address this new reality.

B. Priced Out of Upward Mobility

During the post-war industrial era, a post-secondary education was not required for a single breadwinner to support a family. For example, in 1970 male high school graduates earned a median income equivalent to $45,432 in today's dollars—32.5 percent more than they earn today.[34] However, just as automation, de-unionization and globalized manufacturing began to put downward pressure on the wages and job opportunities of non-college educated Americans, state and federal policymakers allowed college to become less affordable to non-affluent families. Tuition at public four-year schools has more than tripled in the past three decades, rising faster than either inflation or growth in family income.[35] The United States went from first in the world in degree-holders to 11th in the course of one generation. [36] The enrollment gap between low-income families and high-income families is as high as it was three decades ago. Many hardworking students are priced out of pursuing and completing higher education—a fundamental component to upward mobility and opportunity in American society. And those who do enroll are leaving college with unprecedented levels of debt, often without a degree in hand.

A major factor in the rise of public college costs is declining state support for higher education. Dēmos' report *The Great Cost Shift* finds that, despite appropriating $75.6 billion for higher education in 2010 (from $65.1 billion in 1990), states actually devoted less of their wealth to higher education than they did just 20 years ago. After controlling for inflation, states collectively invested $6.12 per $1,000 in personal income in 2010, down from $8.75 in 1990, despite the fact that personal income increased by 66.2 percent over that period. As a result, between the 1990 and 2009 academic years, the real funding per public full-time equivalent (FTE) student dropped by 26.1 percent, falling from $8,608 to $6,360. Funding levels are failing to keep pace with population growth, as the largest generation since the Baby Boomers has come of college age against the backdrop of a nationwide trend away from taxes and public investment. If states had provided the same level of funding as in 1990, total appropriations in 2009 would have equaled approximately $102 billion, an amount 35.3 percent greater than the actual one.[37]

Although increasingly large numbers of high school graduates enroll in some type of college, college completion has stagnated: today more than half of students who begin college never complete their degrees. Financial barriers are the primary reason why students do not finish college.[38] The high cost of college is particularly prohibitive for students from lower-income families, and shifts away from need-based aid are only exacerbating the challenge. In 2013, just 32 percent of all federal student aid was grant-based, down from 55 percent in 1980. Similarly, in 2003-2004, the maximum Pell grant covered 87 percent of the costs of a four-year public college, compared to just 63 percent in 2013-2014.[39]



Rising tuition and limited financial aid has more students than ever financing their college education with debt and at ever-increasing amounts. In addition, students are struggling to meet rising college costs by enrolling part-time and working long hours. Two-thirds of community college students and 46 percent of four-year college students work more than 20 hours a week while attending school, greatly increasing their risk of dropping out.[40]

C. The Debt-for-Diploma System

Student loan debt is another area of growing economic concern. Due to rising college costs and diminishing grant aid, students are increasingly reliant on interest-accruing loans to pay for college, a dramatic shift in norms over the course of a single generation. In 2012, 71 percent of college seniors (at public or non-profit schools) graduated with debt, with borrowers carrying an average burden of $29,400 (up from only 33 percent of students in 1992).[41] Graduates of for-profit schools are even deeper in debt: 88 percent graduated with debt and their average was $39,950 as of 2012.[42] All told, borrowers now owe more than $1.12 trillion in student loan debt, a $124 billion dollar increase from last year.[43] And there are increasing signs that student loan borrowers are becoming unable to repay this debt: 10.9 percent of all student debt is 90 or more days delinquent or in default (worth $122 billion).[44] Already student debt is causing young Americans to delay building the financial assets that are necessary to middle-class security, including purchasing homes and saving for retirement.[45] And the rising rate of defaults on student debt is impairing the credit of many Americans as well, making it more difficult to borrow or find employment among the nearly half of employers who now screen credit histories during hiring.[46]

The consequences of student loan debt can have a profound impact on the economy as a whole. According to Dēmos study, *At What Cost?*, $53,000 in education debt (the average amount held by a dual-headed college educated household) leads to a net worth nearly $208,000 lower than if the household had not been forced to service debt used to pay for their college education. Over time, the indebted household will end up with a net worth 17 percent lower than a similar non-indebted household. Over the economy as a whole, the $1 trillion in total outstanding student loan debt will lead to $4 trillion in lifetime lost assets for indebted households, not even accounting for the heavy impact of defaults.[47]

D. Wealth and Debt

Student debt is just one aspect of the overall divergence between compounding wealth for the rich and compounding debt for the average American. Wealth—home equity and savings nest eggs—provide a buffer against hard times and increase household economic stability, helping to fuel middle-class optimism and self-improvement. Household assets have a particularly powerful effect on how well children will do in their own independent lives.[48]

The wealthiest one percent have seen their share of American assets increase dramatically over the past three decades, and within that one percent, the top 0.1 percent has grown even more rapidly.[49] Thomas Piketty estimates that in the United States, the wealthiest one percent control 33.8 percent of the assets, and the wealthiest 0.1 percent control 14.7 percent.[50] In 1970, the similar figures were 28.2 percent and 11.5 percent. These estimates are likely to understate the wealth of the richest in our society, due to the increasing use of overseas wealth havens.[51] Recent research by Philip Vermeulen of the European Central Bank confirms this.[52] Vermeulen's estimates would put the share of wealth controlled by the wealthiest one percent at 37 percent of all wealth in the U.S.[53]

On the other side of the equation, most Americans are increasingly burdened by debt. In recent decades, financial deregulation and the aggressive marketing of toxic loans preyed on Americans' aspirations to build assets, fueling an unsustainable housing bubble that began to deflate in 2006. The bubble and the economic crash that followed decimated the wealth of American families, causing more than 2.7 million homeowners to lose their single largest asset to foreclosure and tens of millions of others to see their homes' value drop dramatically.[54] The crash hit those who had carefully saved and invested in their homes as well as speculators who gambled on a rising real estate market. Overall, the nation lost more than $6.5 trillion in home equity since the housing market peaked in 2006.[55] At the same time, the value of retirement savings collapsed as the stock market plummeted, destabilizing hopes for a secure retirement.

Not having enough money for retirement became Americans' biggest financial worry.[56] Even as Americans saw their assets diminished, the dramatic and long-lasting rise in unemployment and underemployment contributed to Americans' difficulty paying back their debts.

The prevalence of asset poverty in America is dramatic. The Federal Reserve, *Report on the Economic Well-Being of U.S. Households in 2013*, released in July 2014 details the depth of the problem.[57] Nearly half of survey respondents were not planning for retirement, and 31 percent reported having no retirement savings or a pension. Only 39 percent reported that they had a "rainy day fund" sufficient to pay for three months of expenses, and only half could pay a $400 bill without selling something or borrowing money. The Great Recession was a large factor; 57 percent of those who had savings before the recession said they had used up some or all of their saved money.

This degree of insecurity threatens to reverse one of the great policy victories of the 20th century: the creation of a middle-class senior citizen population. As a result of employers shifting from traditional defined benefit pensions to defined contribution plans, Americans' retirement security is now more at risk than any time since Social Security was created. Only half of workers currently have any kind of retirement savings accumulated outside of Social Security.[58] The vast majority of those who do are offered only the 401(k)-type plans that are an inadequate solution for retirement for multiple reasons. First, they are inordinately expensive. The fees charged by firms that manage 401(k) accounts can cost workers a quarter or more of their retirement savings. According to a widely-cited 2012 study by Dēmos, *The Retirement Savings Drain*, over a lifetime, these fees can add up to more than $155,000 in losses for the average household.[59] In addition, 401(k)s are a poor substitute for traditional pensions because they place the burden of investment risk exclusively on individual workers. After working throughout their lives, older Americans relying on individual retirement plans could lose their life's savings in a market crash, invest so conservatively that they ensure themselves weak returns, or outlive the funds they have been able to save. Pension-style plans, meanwhile, ensure security by spreading these risks among many plan participants over a long time horizon—no individual puts their entire retirement in danger. Yet in 2012, just 17 percent of private sector workers participated in a traditional pension as employers have opted for the low-cost 401(k) option instead.[60]

Instead of saving for the future, millions of working- and middle-class Americans are struggling just to service their debts. Dēmos has been chronicling the rapid rise in debt for nearly a decade: as wages stagnated and lagged behind the cost of living, Americans increasingly turned to borrowing—from credit card debt to loans against the value of their homes—to make ends meet and to try to get ahead.[61] The deregulation of consumer lending that began in the 1980s meant that many of these loans included deceptive and predatory terms that were highly profitable for lenders but led to record bankruptcies and debt-to-income ratios. Lenders aggressively marketed high-interest credit cards with hidden fees, exorbitant payday loans, and costly subprime mortgages (even to homebuyers who could have qualified for a better rate—particularly if they were African American or Latino).[62] While some of the worst practices unleashed by deregulation have been curbed by regulatory enforcement, the Credit CARD Act of 2009, and the Dodd-Frank Act of 2010, Americans remain vulnerable to the hangover of the deregulatory experiment: widespread servicer and debt collector abuse.[63]

Even today, as credit card debt has declined post-crash, 40 percent of among low- and middle-income households carrying credit card debt still rely on their cards to pay basic living expenses because they do not have enough money in their checking or savings accounts, according to Dēmos' own national household survey, *The Plastic Safety Net.*[64] Credit cards are also widely used to pay medical bills and cope with spells of unemployment, in effect a high-interest way to make up for gaps in the public safety net.[65]

Another problem arises from the prevalence of employment credit checks. Despite a lack of evidence that personal credit history predicts employee performance or likelihood to steal or commit fraud, nearly half of all employers now conduct credit checks as part of their hiring process.[66] As a result, job seekers with credit damaged as a result of medical debts, divorce, layoffs or identity theft are screened out of jobs they are otherwise qualified for. Employment credit checks disproportionately harm people of color because of damage done by predatory lending that continues to target communities of color, as well as the enduring impact of racial discrimination in employment, lending, education, and housing. The result is a vicious cycle: it's hard to pay your bills if you can't get a job, but unpaid bills may also prevent you from getting a job.[67]

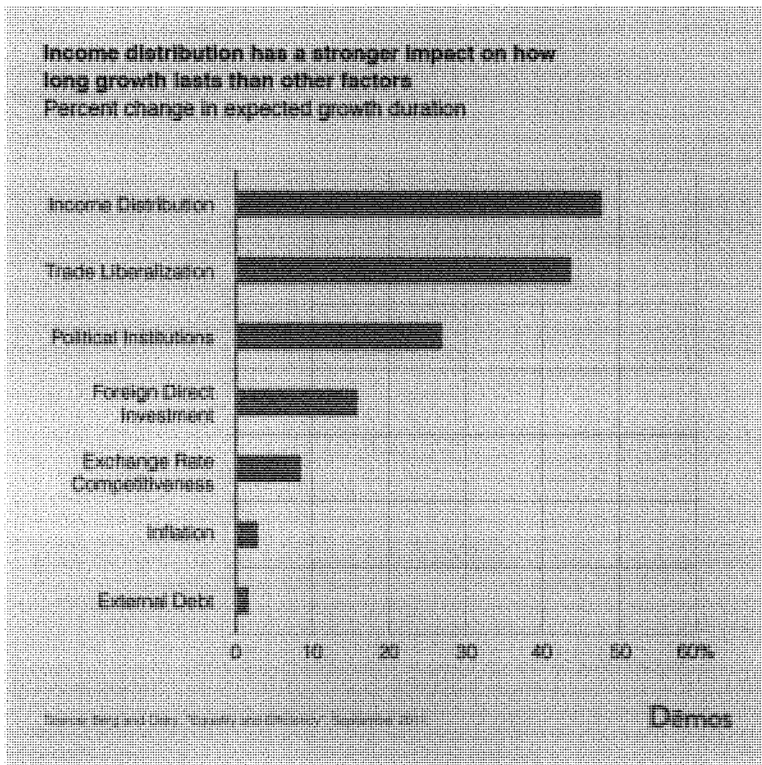
Fortunately for these borrowers, smart regulation has recently made credit cards a better, fairer financial product for American consumers. The Credit CARD Act of 2009 has benefited millions of households in ways that directly affect their monthly budgets. A recent study by Sumit Agarwal, Souphala Chomsisengphet, Neale Mahoney and Johannes Stroebel find that the CARD Act has saved U.S. consumers $12.6 billion each year.[68] Dēmos' national survey found that the Credit CARD Act has empowered Americans to take control of their finances by increasing the transparency of credit card statements and dramatically reducing excessive fees and penalties.[69] For example, the Act set new standards for clarity and disclosure in monthly billing statements. Credit card statements must now include information on how long it will take to pay off the current balance if consumers pay only the minimum payment amount each month. Ninety percent of households in our survey report they have noticed the change and one-third say they are responding to the new information included on credit card statements by paying their balances down faster. The CARD Act also offers consumers a reprieve from the assorted charges and fees that accompanied many accounts. In 2012, just 28 percent of households reported paying late fees—a significant decline from the one half of indebted households that accrued these fees in 2008. Of those who experienced late fees, only 29 percent saw interest rates go up on that card as a result, down from 53 percent in 2008, and only 14 percent experienced interest rate increases on their other credit cards. Finally, the Credit CARD Act virtually eliminated over-the-limit fees, previously one of the credit card industry's most abusive and profitable practices. Instead of denying transactions that exceeded a consumer's credit limit, credit card companies used to process them and then charge consumers a fee—whether the consumers wanted to go above their credit limit or not. The Credit CARD Act requires consumer authorization for exceeding limits, virtually eliminating these fees.

The following section describes the effects of inequality on three economic goals—economic growth, mobility, and opportunity.

III. The Impact of Inequality on Our Economy

A. Inequality and Growth

The previous sections have detailed inequality's effect on households, but it is worthwhile to note that evidence is mounting that inequality harms our nation's overall GDP growth rates as well. Standard and Poor's recently reduced its ten year U.S. growth forecast by 0.3 percentage points, citing "extreme" income inequality.[70] A 2011 International Monetary Fund (IMF) study by Andrew Berg and Jonathan Ostry finds that income distribution has a stronger impact on the duration of a country's growth than trade, external debt and political institutions.[71]

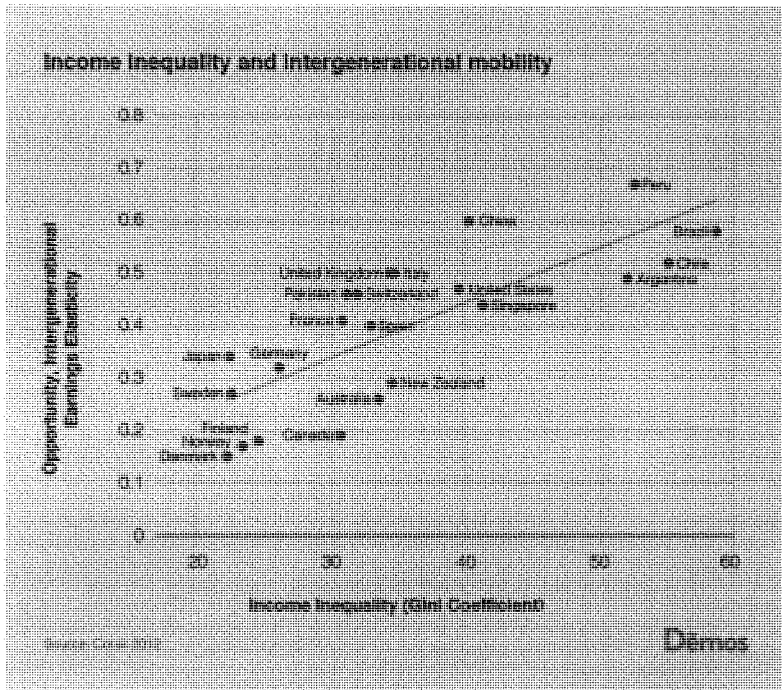


A 2014 IMF follow-up study finds that redistributing income doesn't have a large effect on growth, and therefore increasing redistribution can be pro-growth (since inequality stifles growth).[72] This supports a growing literature on the subject.[73]

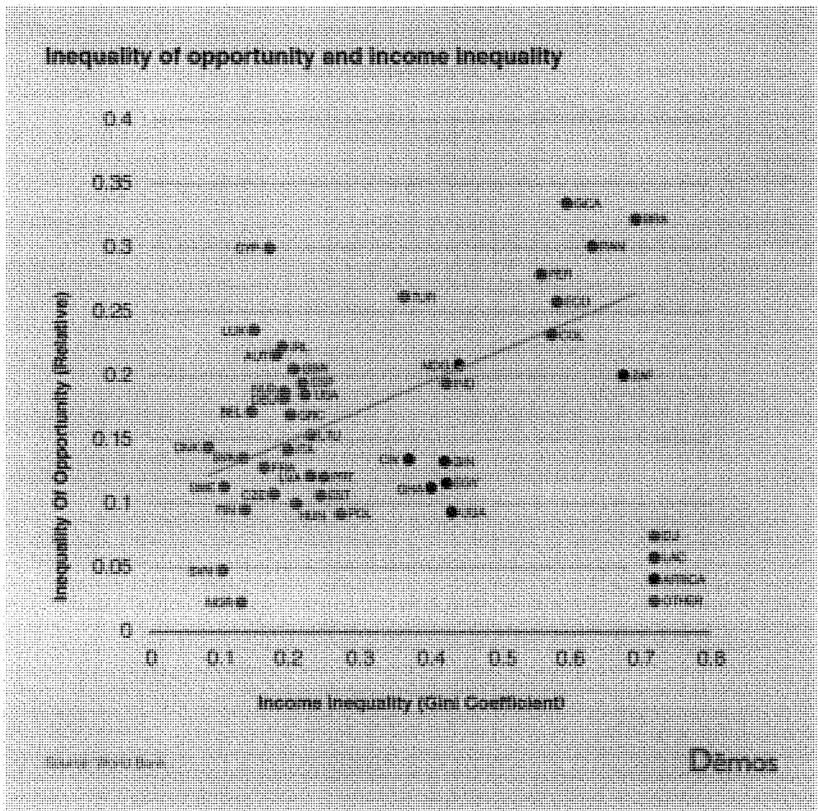
The literature shows that when consumers don't have money to spend, growth slows. Because the wealthy are more likely to save[74] than the poor and middle class, a higher concentration of wealth in their hands will stifle demand, cutting off the recovery. Even conservative Martin Feldstein, formerly the chief economic advisor to President Ronald Reagan, has recognized that economic growth has been stalled by inadequate demand.[75] Further, two studies have linked increasing debt, driven by inequality, to credit busts.[76] In their book, *House of Debt*, Atif Mian and Amir Sufi argue that rising debt has reduced consumer spending, weakening the recovery.[77] Growth also reduces the ability of poor and middle-class people to develop important human capital, further endangering growth.[78]

B. Inequality and Mobility

A large literature shows that inequality also reduces upward mobility. In both international comparisons and within the U.S., higher levels of inequality have been tied to lower levels of mobility.[79] Within the U.S., mobility varies widely by census tract, with the lowest levels of mobility in the south. [80] Raj Chetty, Nathaniel Hendren, Patrick Kline and Emmanuel Saez find that within the United States, "areas with more inequality as measured by Gini coefficients have less mobility."[81] Internationally, countries with higher levels of inequality have lower levels of upward mobility.[82] Miles Corak finds, "the United States stands out as being among the least generationally mobile among the rich countries, and in particular the overall degree of relative earnings mobility across the generations is almost three times greater in Canada, a country to which it might be most apt to make a comparison." His curve, below, shows that countries with higher levels of inequality have lower levels of upward mobility. Alan Krueger dubbed Corak's chart the "Great Gatsby Curve," saying, "The fortunes of one's parents seem to matter increasingly in American society."[83]



A 2013 World Bank study examining an even larger sample of countries and using a slightly different metric of opportunity finds that "countries with a higher degree of income inequality are also characterized by greater inequality of opportunity." [84]

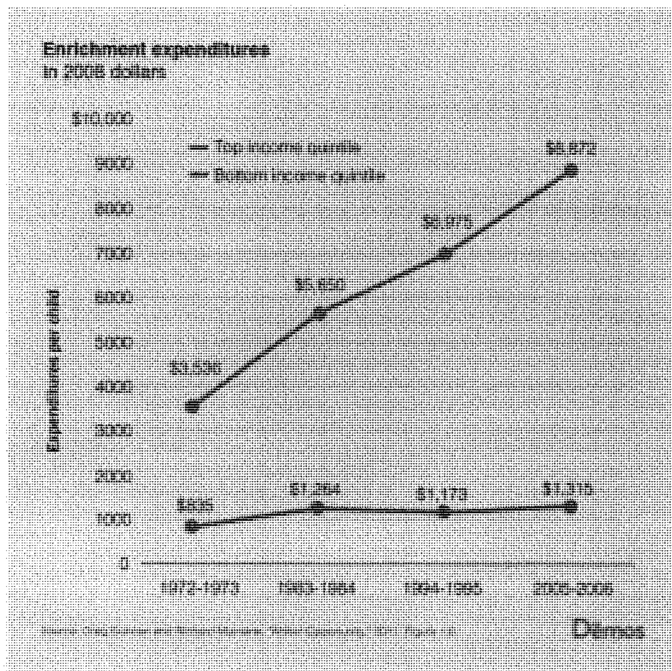


C. Inheriting Opportunity

Inequality hinders mobility in numerous ways. As Alan Kreuger notes,

> Children of wealthy parents already have much more access to opportunities to succeed than children of poor families, and this is likely to be increasingly the case in the future unless we take steps to ensure that all children have access to quality education, health care, a safe environment and other opportunities that are necessary to have a fair shot at economic success. [85]

There are myriad reasons why inequality reduces upward mobility. As inequality increases, the cost of falling behind becomes higher, leading parents to invest heavily in their children and possibly discourage public investment in other children through the public education system.[86] Higher income families spend far more money on enrichment (such as tutors, camps or private schools) for their children than can parents with fewer resources.[87] As inequality has increased in the United States, parents have spent an increasingly large share of their income on solidifying wealth.



Parents can also provide children with starter jobs, help pay off debts or support their children during an internship or low-paid starting position.[88] Martha Stinson and Christopher Wignall find that children in higher income deciles are far more likely to be employed by the same company that employs their father.[89] Nicolas Pistolesi finds that inequality of opportunity explains between 20 and 43 percent of earnings inequality in the United States.[90] In America, income distribution data show that it is now better to be born rich and not get a college degree than to be born poor and get one.[91] Additional evidence against the reality of meritocracy is provided by a study by Richard Reeves and Kimberly Howard finding that, "a sizable proportion (43 percent) of those who remain in a higher-income household are of modest skill, and would be expected on the basis of skill to fall."[92]

IV. Megatrends: How America Became So Unequal

The following sections lay out five megatrends contributing to inequality's rise: racial inequality, financialization, the loss of collective bargaining, underinvestment, and perhaps the most far-reaching factor: political inequality.

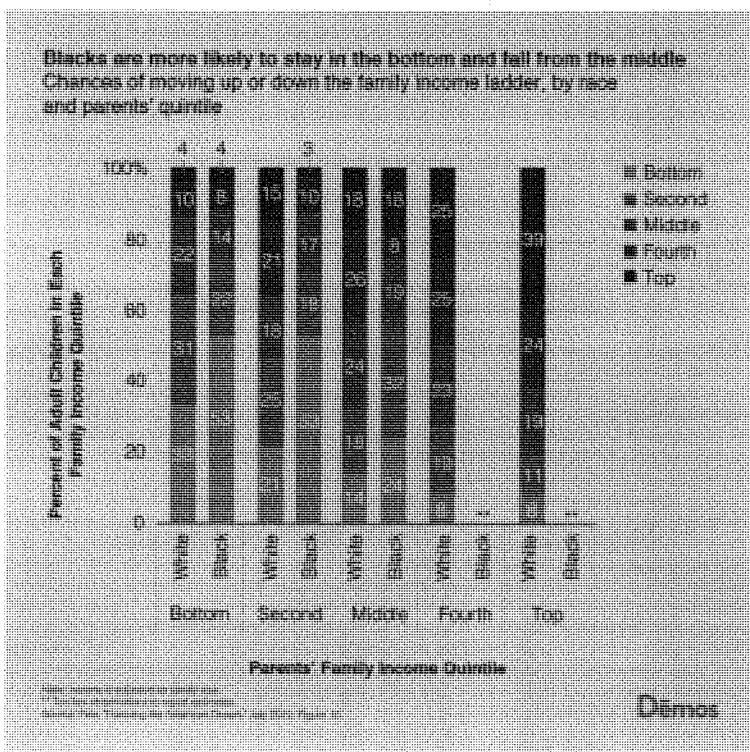
A. Increasing U.S. Diversity Without a Commitment to Equity

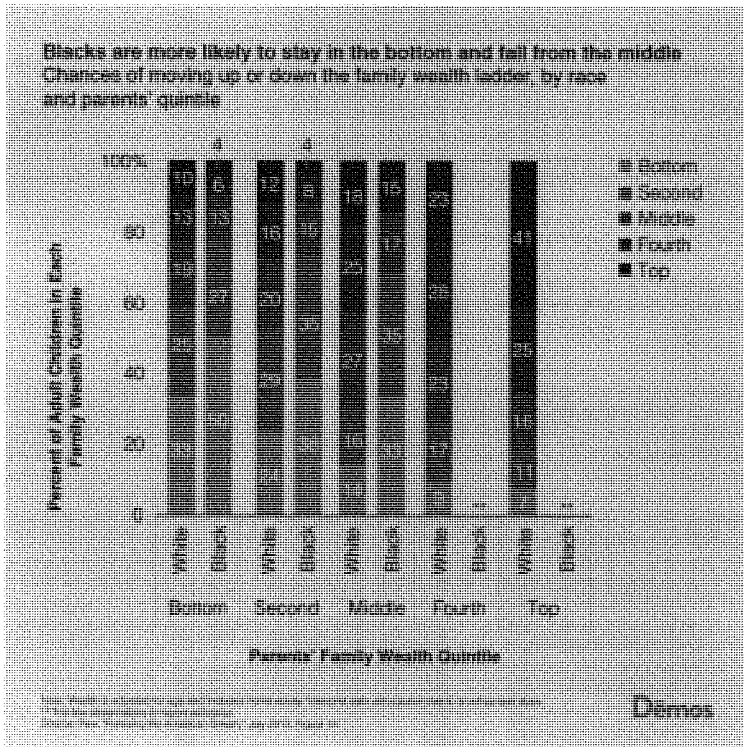
A major societal trend with implications for economic policy has been the rapid demographic change over the past four decades. After the Immigration Act of 1965 removed race-restrictive entry quotas, the share of immigrants from non-European countries climbed.[93] The white population was 83 percent in 1970 and 76 percent in 1990; it now stands at 64 percent.[94] By 2043, whites will no longer be a majority in the U.S.[95] Already, 46.6 percent of Americans under the age of 24 are not white.[96]

The country has only grown more diverse since the end of the Civil Rights Movement. American society has been experiencing rapid demographic change with only intermittent leadership attention to the challenges of coalescing a sense of common national purpose and identity out of a people with roots from every nation on the planet. While our discourse has recently embraced the idea that society can be color-blind, the facts belie the notion. In a 2011 Associated Press survey, 51 percent of all Americans expressed *explicit* anti-black attitudes, and 52 percent of non-Hispanic whites expressed explicit anti-Hispanic attitudes.[97] The incidence of *unconscious* prejudice, which can affect decision-making in ways that are hard to detect by the actors themselves, much less those who would enforce anti-discrimination laws in the courts, are even higher. For example, Harvard University's Implicit Association Test found that 88 percent of white people had a pro-white or anti-black implicit bias, and more than two-thirds of non-Arab, non-Muslim respondents displayed implicit biases against Arab Muslims.[98]

These implicit and explicit prejudices have real economic consequences for our diverse population. Approximately 3.7 million fair housing violations occur annually against African Americans, Latinos, Native Americans, and Asian Pacific Islanders as they seek to rent and purchase housing—yet HUD processed only 2,123 complaints in 2008.[99] In financial services, after decades of credit unavailability due to private and government redlining, the 1990s and 2000s saw communities of color experience a wealth-stripping phenomenon known as reverse redlining. Lenders and brokers targeted segregated neighborhoods with under-regulated financial products, particularly mortgages with features such as exploding adjustable rates, deceptive teaser rates, and balloon payments. Households of color were more than three times as likely as white households to end up with riskier loans.[100] Federal policymakers and regulators declined to protect these communities for years as foreclosures rose, even acting to pre-empt state anti-predatory lending efforts in the 2000s.[101] The resulting loss of wealth—66 percent average loss for Latino households, 53 percent for African Americans compared to just 16 percent for white households[102]—stands as a grave and lasting blight on the future of our diverse middle class. For every dollar in assets that the typical white family owns, the typical Latino family has just 12 cents, and the typical African American family has only ten cents.[103] African Americans are twice as likely as whites to have zero or negative net worth.[104]

A recent study[105] by Chetty, Raj, Nathaniel Hendren, Patrick Kline, and Emmanuel Saez find that, "income mobility is significantly lower in areas with large African-American populations."[106] They find that racial segregation predicts lower levels of upward mobility. In a recent study, Bhashkar Mazumber finds that for children born between the late 1950s and early 1980s, 50 percent of black children born into the bottom 20 percent of the income scale remained in the same position while only 26 percent of white children born into the bottom 20 percent of the income scale remained in the same position.[107] This finding is confirmed by a recent Pew study[108] finding that blacks had lower levels of upward mobility of both income and wealth. They also had higher levels of downward mobility.





Education in the United States is increasingly segregated by race. A 2014 study from the Civil Rights Project at UCLA finds that in 2011, only 23 percent of black students in the south attended majority white schools, down from a peak of 44 percent.[109] Although there was progress in the late 1970s and '80s after lower courts began enforcing the desegregation holding of *Brown v. Board of Education*, this progress has stalled in recent years (although not been completely erased[110]). Much of this slowdown in progress can be attributed to the courts removing oversight. A recent study finds that,

> Over 200 medium-sized and large districts were released from desegregation court orders from 1991 to 2009. We find that racial school segregation in these districts increased gradually following

> release from court order, relative to the trends in segregation in districts remaining under court order. These increases are more pronounced in the South, in elementary grades, and in districts where pre-release school segregation levels were low.[111]

The benefits of integration are well established. A seminal study by Rucker C. Johnson finds that desegregation "increased both educational and occupational attainments, college quality and adult earnings, reduced the probability of incarceration, and improved adult health status" for African American students.[112] Importantly, Johnson finds that the benefits primarily come from black students having access to the increased per pupil spending and smaller classrooms that white students enjoy. This is supported by previous studies on the subject, which link higher school spending to future student earnings.[113] The impact on earnings is particularly impressive; Johnson finds that five years in a court-desegregated school leads to a 15 percent increase in wages, an 11 percent decrease in the incidence of poverty and a $5,900 boost in annual family income. For white students, Genevieve Siegel-Hawley finds that diversity does not reduce educational outcomes for white students, but reduces intergroup prejudice and prepares students for a diverse workforce.[114]

A recent Department of Education report finds a large salary disparity for teachers with high proportions of students of color: "Nearly one in four districts with two or more high schools reports a teacher salary gap of more than $5,000 between high schools with the highest and the lowest black and Latino student enrollments."[115] Another study finds "schools with 90 percent or more students of color spend a full $733 less per student per year than schools with 90 percent or more white students."[116] These inequities are replicated at the college level. A recent report by Anthony Carnevale and Jeff Strohl find that college education in America consists of "a dual system of racially separate and unequal institutions despite the growing access of minorities to the postsecondary system."[117] They find that students of color are less likely to end up in the most selective schools than white students with the same qualifications.

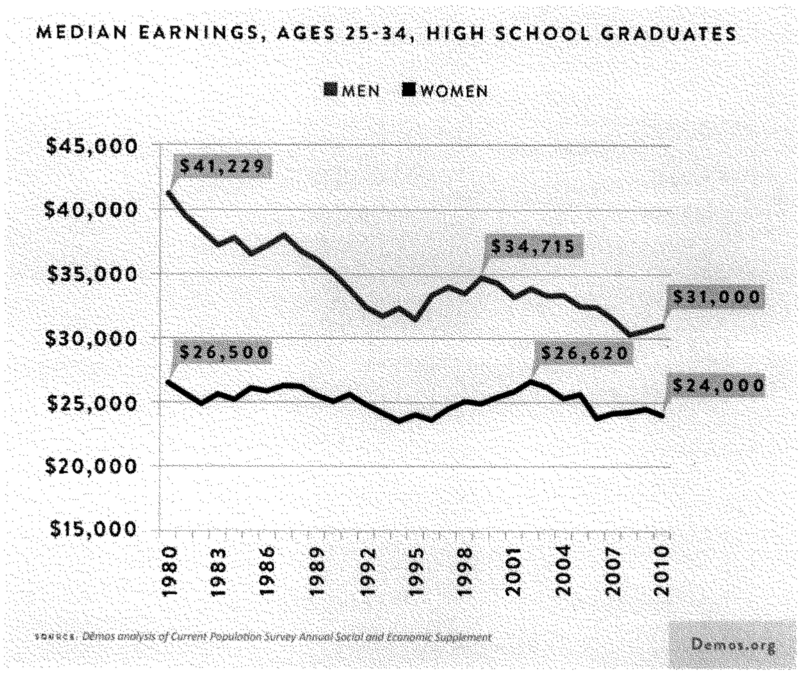
Finally, numerous studies[118] have shown that job discrimination plays a role in the higher incidence of unemployment among non-whites (while the seasonally-adjusted unemployment rate for whites is 5.3

percent, it is 11.4 percent for blacks and 7.8 percent for Hispanics).[119] As just one striking example of this literature, a 2005 Princeton University study revealed that employers were more likely to offer a callback to white job applicants with criminal records than to well-qualified African American job-seekers with no criminal history whatsoever.[120]

B. The Rules of Globalization

The way that policymakers have chosen to structure the rules of globalization has contributed significantly to increased inequality over the past three decades. Our trade policies have been written and enforced in ways that advantage multi-national firms seeking lower-cost labor, directly resulting in fewer and lower-paying jobs for the American middle class. Increasingly, white-collar jobs are also moving overseas as China, India, and other nations field more educated workers who can do the jobs now done by U.S. scientists, accountants, lawyers, and doctors. As a historic champion of a more open global economy, the United States has often failed to take a hard look at how this system puts U.S. living standards at risk and develop policies to balance the prerogatives of multi-national corporations and the American middle class. Worse, the U.S. has often done little as other countries, like China and Japan, have played by a different set of trading rules that put the U.S. at a disadvantage. And we have repeatedly been silent in the face of abuses of worker rights, even when these abuses are perpetrated by close trading partners who are bound by Free Trade Agreements to uphold basic labor standards.

Over the past few decades, increased trade with low-wage countries has been responsible for fully a third of the depression in wages of non-bachelors degree holders relative to degree-holders since 1979; tracking just since 1995 (one year after the North American Free Trade Agreement came into force), low-wage country trade accounts for over 90 percent of the wage depression.[121]

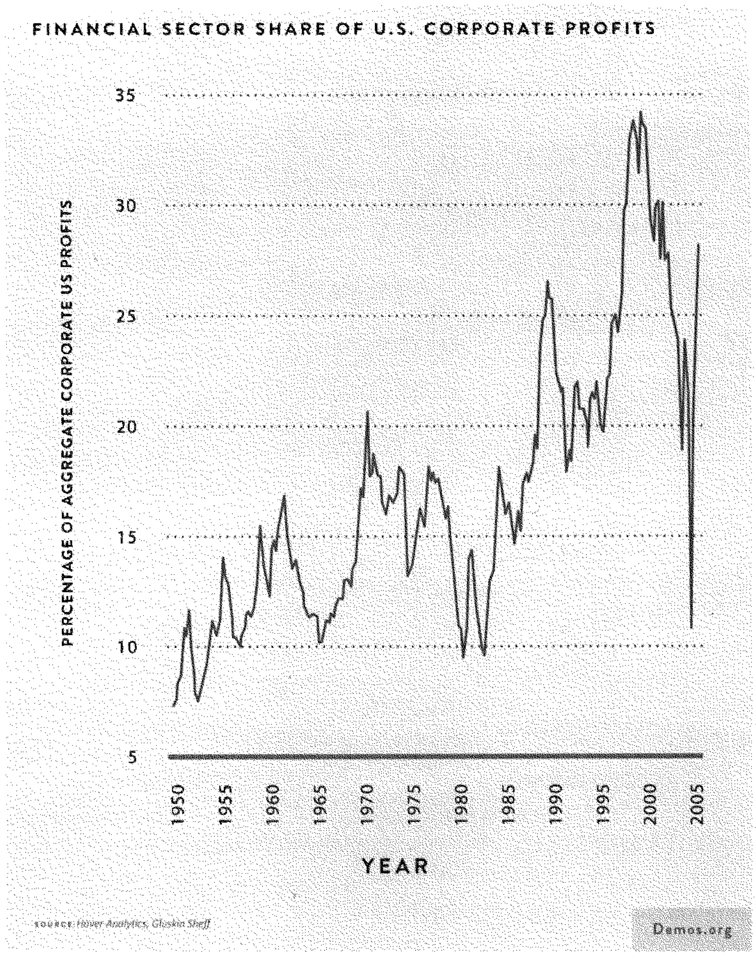


The downward pressure on wages affects not just workers who are directly competing with foreign production workers. When multi-national firms layoff American manufacturing workers in favor of less expensive employees in our trading partner countries, these laid-off workers compete for lower-paying jobs in non-offshorable sectors, such as landscaping or food service.[122] Thus the effect of our trade policy ripples throughout the working and middle class, beyond just those directly affected by plant closings.

The broader economic dynamic of high corporate profits amidst weak job growth and declining wages for most Americans is in large part a result of our global trade policies. The North American Free Trade Agreement turned a slight trade surplus with Mexico into the current almost $100 billion deficit, which has cost nearly 682,900 jobs.[123] The permanent normalization of trade relations with China has cost over two million American manufacturing jobs between 2001 and 2011.[124] Two recent studies suggest that globalization has been a major driver of inequality. David H. Autor, David Dorn and Gordon H. Hanson find that "labor markets whose initial industry composition exposes them to rising Chinese import competition experience significant falls in employment, particularly in manufacturing and among non-college workers."[125] Mike Elsby, Bart Hobijn and Aysegul Sahin find that, "offshoring of the labor-intensive component of the U.S. supply chain as a leading potential explanation of the decline in the U.S. labor share [of national income] over the past 25 years."[126]

C. The Financialization of the Economy

Another, less often-cited megatrend driving inequality has been the financialization of the American economy. The deregulatory movement that transformed consumer finance also revolutionized commercial and investment banking and trading in ways that have dramatically increased finance's share of the U.S. economy, from 3.8 percent to 8.2 percent of GDP.[127] Financial sector profits have also increased as a share of total corporate profits, with the non-financial business sector transferring increasing income to the financial sector. Research from New York University's Stern School of Business shows that, contrary to the claims that deregulation would lower costs, the cost of financial intermediation—the critical function of transferring capital from investors to productive uses in the economy—has actually *increased* since deregulation. This growth of the financial sector was not because of increased demand for financial services, which only grew by four percent in the last decade.[128] The reason appears to be an enormous increase in the sheer volume of trading.[129]


FINANCIAL SECTOR SHARE OF U.S. CORPORATE PROFITS
PERCENTAGE OF AGGREGATE CORPORATE US PROFITS
35
30
25
20
15
10
5
1950
1955
1960
1965
1970
1975
1980
1985
1990
1995
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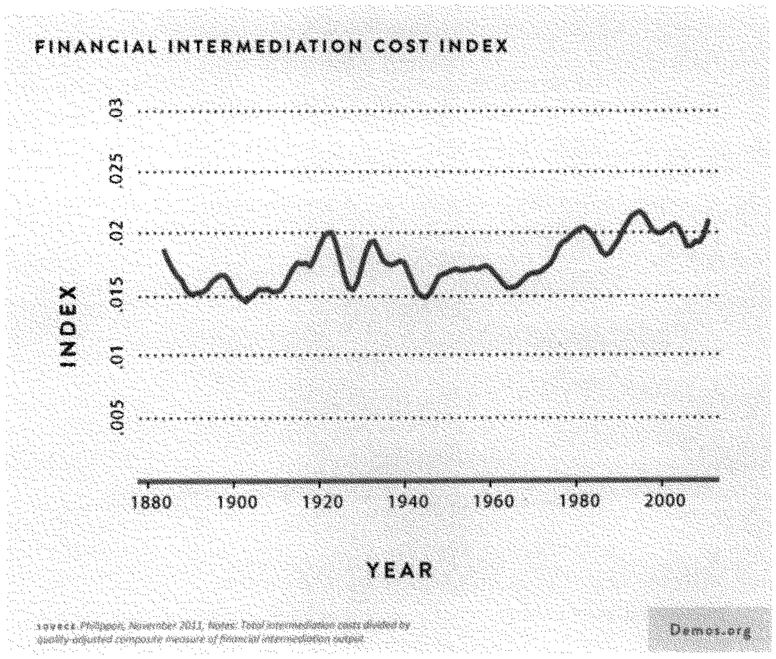
2005
YEAR
SOURCE: Haver Analytics, Gluskin Sheff
Demos.org

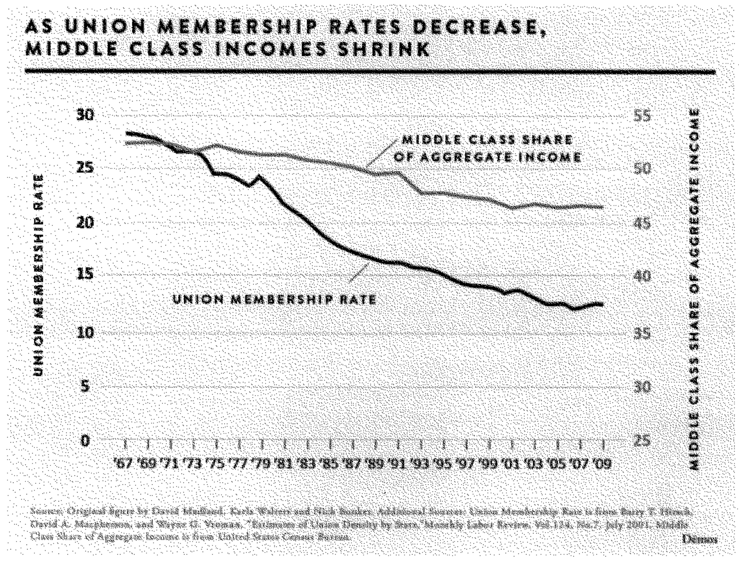


The relative growth of the financial sector is not necessarily a problem if the services provided by the sector add commensurate value to the overall economy. With the cost of intermediation rising despite technological advances that should be increasing efficiency—and with economic performance worsening, particularly as measured by the employment recovery time post-recessions—it is becoming apparent that value is being simply reallocated to the beneficial owners of financial firms. This drains resources that could be put to uses that would increase the productivity of the overall economy and create jobs and wealth. Dēmos Senior Fellow Wallace Turbeville estimates that the excessive wealth transfer to the financial sector is in the range of $635 billion per year.[130] Numerous studies confirm that financialization mainly serves as a rent-extracting activity, rather than a wealth-creating one.[131]

In fact, the growing financialization of the U.S. economy and its impact on publicly traded corporations has exacerbated inequality in a number of ways. A focus on "shareholder value" has trumped all other goals for the modern corporation since the 1980s—a shift that Wall Street helped usher in through a relentless search for profits that included leveraged buy-outs, mergers and acquisitions, and private equity deals, as well as a more aggressive quest for short-term trading gains. This narrow focus on the short-term bottom line has undermined American workers and the middle class by justifying any cost-cutting measures that can boost quarterly earnings, including layoffs, foreign outsourcing, eliminating benefits, and defeating union drives. Nearly all the forces typically blamed for rising inequality—globalization, new technologies, declining unionization—have had a more devastating impact on U.S. living standards thanks to Wall Street's imperative to put stock price above all else. Two University of Massachusetts at Amherst economists find that financialization accounts for more than half of the decline in the share of national income accruing to labor.[132] Other studies support this finding.[133]

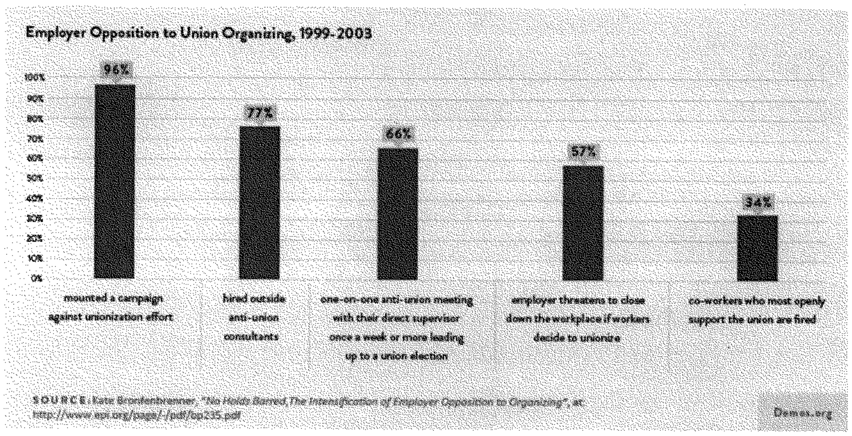
D. Increased Corporate Resistance to Employee Collective Bargaining

Organized labor has traditionally played a critical role in slowing the tide of rising inequality. Unions bargain collectively for better wages and benefits for their members. But unions also raise compensation for workers they do not represent: a recent study by Bruce Western and Jake Rosenfeld finds that unions substantially boost compensation for non-union employees in addition to their own members by influencing non-union employers to raise wages in order to avoid unionization; by promoting norms of fair pay, and by lobbying for public policies that raise wages.[134] David Jacobs finds that, "the role that union decline has played in growing income inequality may actually be larger than many of the favorite explanations offered by economists, such as the education gap in the United States."[135] In short, high unionization boosts the share of economic growth going to working people rather than to corporate profits or the very highest earners.



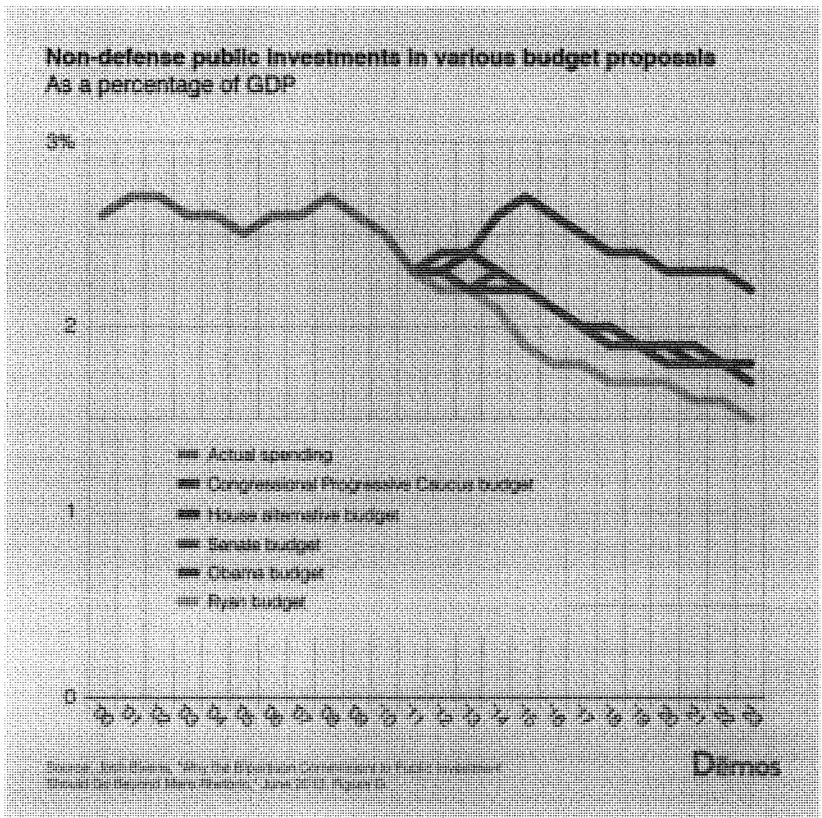
However, the percentage of Americans belonging to unions has declined steadily, falling by 44 percent between 1983 and 2012, so that today, just 6.6 percent of private sector workers belong to unions. Western and Rosenfeld estimate that the decline of unionization has contributed as much as third to the growth of income inequality among working men since 1973.[136]

Union decline can be attributed to the growth of corporate opposition to unionization and the weakening of laws intended to protect employees' right to organize. Today, the system meant to defend the rights of employees to form unions barely functions. Weak and slow-moving enforcement of labor rights allows employers to routinely violate the law by threatening and harassing employees who attempt to organize. An analysis of union elections from 1999 to 2003 revealed that when workers attempted to organize a union, 96 percent of employers mounted a campaign against their effort.[137] Three quarters of employers hired outside anti-union consultants. So while workers might wish to join unions, they often fail to persist in the effort after an intimidating one-on-one anti-union meeting with their direct supervisor once a week or more leading up to a union election (a tactic employers used in 66 percent of organizing campaigns), after their boss threatens to close down the workplace if workers decide to unionize (57 percent of organizing campaigns), or after those co-workers who most openly support the union are fired (34 percent of organizing campaigns).



E. Underinvestment in Infrastructure

As financialization has sapped resources from the real economy the government has pursued austerity policies that have further reduced national investment. Infrastructure spending has plummeted to levels not seen since World War II and is set to fall even further.[138] Because the poor and middle class rely more on public goods, they suffer the most from our increasingly inadequate infrastructure.



Public investment is crucial to future growth. The economic boom in the 1950s and 60s relied on government investments in education (for example, the G.I. Bill), infrastructure (for example, the National Highway System) and science (NASA, for example). Now, education spending is declining at the state level,[139] infrastructure across the nation is crumbling[140] and scientific researchers worry about the fate of their projects.[141]

Investments in science produce huge benefits, both in terms of well-being and economic growth. The Human Genome Project, for instance, cost $3.8 billion in public funding and has produced economic gains of $796 billion (that's a return of $140 to $1).[142] The Internet, too, was a product of government research and has produced trillions in increased economic output and growth.[143]

Our infrastructure is aging, and the American Society of Civil Engineers estimates that we will need to invest around $3.6 trillion by 2020 to move from a grade of D + to a B.[144] Numerous studies find that infrastructure investment brings about large economic returns.[145]

Public investment spending provides immediate stimulus and productivity growth in the future. A major Dēmos/Century Foundation/Economic Policy Institute fiscal analysis, *Investing in America's Economy: A Blueprint for Economic Recovery and Fiscal Responsibility*, estimates that if the U.S. had begun investing about $250 billion a year into infrastructure in 2011, GDP growth each year would be one percentage points higher in 2021 and five percentage points higher by 2025. By 2045, nominal GDP would be by 11.6 percent higher than baseline projections.[146]

V. Inequality Undermines Democracy

We have reviewed the data showing that inequality has detrimental effects on our society and how intentional policy shifts, not inevitable contingencies, are primarily responsible. Meanwhile, evidence abounds that the U.S. political system is increasingly dominated by wealthy interests, and strong, bi-partisan majorities of the public believe the deck is stacked against ordinary voters.[147] What is less understood, however, is the interplay between these two problems and how a growing chasm of income and wealth translates into diminished opportunities for most Americans.

As Dēmos outlines in our foundational report, *Stacked Deck: How the Dominance of Politics by the Affluent and Business Undermines Economic Mobility in America*, this tilting of political life toward those the well-connected and already-wealthy has served to undermine economic mobility as a whole. As private interests have come to wield more influence over public policy, with ever larger sums of money shaping elections and the policymaking process, our political system has become less responsive to those looking for a shot to improve their lives and move upward. This is in part because wealthy interests are keenly focused on concerns not shared by the rest of the American public and often oppose policies that would foster upward mobility among lower-income citizens, such as raising the minimum wage.

A. Different Incomes, Different Priorities

Significant differences between the wealthy and the general public exist in such areas as tax and budget, trade and globalization, regulation of business, labor, the social safety net, and the overall role of government. The general public is more open than the wealthy to a variety of policies designed to reduce inequality and strengthen economic opportunity, including: raising the minimum wage, increasing the Earned Income Tax Credit, providing generous unemployment benefits, and directly creating jobs. For example, as the table below reports, only 40 percent of the wealthy think the minimum wage should be high enough to prevent full-time workers from being in poverty, while 78 percent of the general public holds this view. Affluent voters are also less supportive of labor unions and less likely to support laws that make it easier for workers to join unions—even as research shows that unions are crucial to reducing inequality. Governors elected with strong support from affluent voters and business groups have prioritized tax cuts over funding for primary and secondary public education.[148]

Jobs & Income Policy Preferences of Affluent vs. General Public

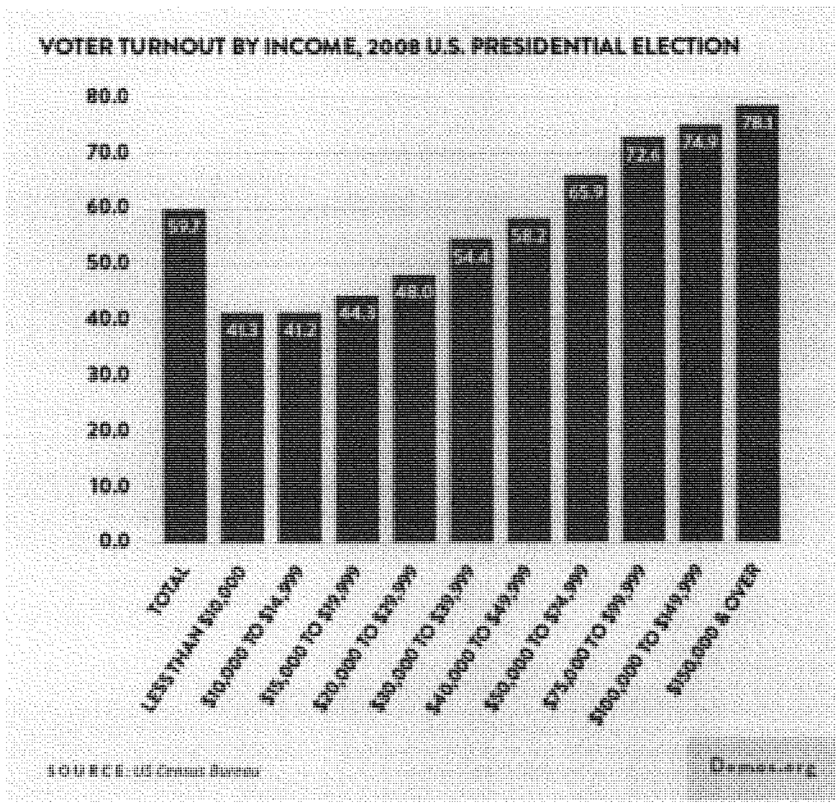
Policy	% Wealthy in Favor	% General Public in Favor
Government must see that no one is without food, clothing or shelter	43%	68%
Minimum wage high enough so that no family with a full-time worker falls below official poverty line	40%	78%
The government should provide a decent standard of living for the unemployed	23%	50%
The government in Washington ought to see to it that everyone who wants to work can find a job	19%	68%
The Earned Income Tax Credit (EITC) should be increased rather than decreased or kept the same	13%	49%
The federal government should provide jobs for everyone able and willing to work who cannot find a job in private employment	8%	53%

SOURCE: *Benjamin I. Page, Larry M. Bartels, and Jason Seawright, "Democracy and the Policy Preferences of Wealthy Americans," Perspectives on Politics, 11:1, pp. 51-73.*

Demos.org

B. Unequal Political Voice

These differences in policy preference by class create distortions in our policymaking precisely because the affluent are over-represented among both donors and voters (not to mention lobbyists, media influencers and other categories with outsized influence in our political system). Working and middle-class citizens are more susceptible to the disenfranchising effects of our needlessly bureaucratic system of voter registration, a system which leads to 51 million eligible Americans being unregistered to vote.



There is a large literature on the how low voter turnout influences policy outcomes. A recent study by William Franko, Nathan J. Kelly and Christopher Witko finds, "that where the poor exercise their voice more in the voting booth relative to higher income groups, inequality is lower."[149] Policies to increase low-income voter registration— whether through new laws, such as federal Same Day Registration,[150] or through basic enforcement of existing laws such as the National Voter Registration Act[151]—would help increase their voice in the political process. In a different study, Franko examined three policies: minimum wages, anti-predatory lending laws and SCHIP (State Children's Health Insurance Program).

Franko compared the adoption of these policies to voter participation rates across incomes and found that states with higher levels of inequality in turnout were less likely to pass legislation beneficial to the poor.[152] Kim Hill and Jan Leighley find that higher class bias in voter turnout reduces social spending.[153] Another study finds, "an enduring relationship between the degree of mobilization of lower-class voters and the generosity of welfare benefits."[154] These results are predictable: studies show that legislators respond more to voters than to non-voters.[155] A recent study finds that states with recent increases in turnout among voters of color were the most likely to have voter suppression laws proposed.[156] Research shows that these laws bias the electorate towards more upper-class turnout.[157] These findings indicate that voter ID laws are used strategically to reduce the turnout of low-income voters and voters of color.

Non-wealthy Americans are even less likely to contribute to political campaigns. Just 0.07 percent of the U.S. population made campaign donations of $2,500 or more in 2012, yet this group contributed a total of $1.4 billion to both presidential candidates.[158] In contrast, the total of contributions from a much larger pool of donors contributing between $200 and $2,500 was just $485.7 million.[159] The donor pool does not reflect the electorate's diversity. Over 90 percent of donations in the 2012 election came from majority white neighborhoods while only four, three and less than one percent came from Latino, African-American and Asian neighborhoods respectively.[160] Money buys access, and recent studies indicate that donors are far more likely to secure a meeting with a congressmember.[161] Access, in fact, is the main motivation of most political spending.[162] This unequal political voice distorts elected officials' representation of citizens' actual policy views, given how many non-affluent Americans favor policies to create new pathways to the middle class.

For example, despite the important role a strong minimum wage plays in economic mobility, Congress has allowed the wage to decline steadily in real terms over the past four decades. (Meanwhile, it has repeatedly lowered capital gains tax rates to benefit the wealthy, despite majority opposition to preferential treatment of wealth income over work income).[163] Even with the series of minimum wage increases, adjusting for inflation shows that the real value of the federal minimum wage fell roughly 30 percent since 1968. If the minimum wage increased at the same rate as inflation, it would be equal to $10.69 per hour, far above the current $7.25.[164]

This slide in the minimum wage should be no surprise when one takes a close look at the data on lobbying expenditures. The data suggests that low-wage workers have very few paid advocates in the corridors of Washington. Labor unions often speak up for these Americans, but otherwise, lobbying by groups that explicitly advocate for low-wage workers or non-elderly low-income people is so small that it doesn't even merit its own category in records compiled by the Center for Responsive Politics. This lobbying imbalance exacerbates the problem of elected officials being accountable to wealthy campaign contributors by ensuring that once in office, these officials are exposed to a constant flow of information supporting the donor class' views and positions.

The most important study in this area is by the political scientist Martin Gilens, *Affluence and Influence: Economic Inequality and Political Power in America.* By comparing the policy preferences of different income groups with actual policy outcomes, he was able to determine how much influence different groups have had over policy. In a recent update to his original study, Gilens writes with Benjamin Page, "Not only do ordinary citizens not have uniquely substantial power over policy decisions; they have little or no independent influence on policy at all...By contrast, economic elites are estimated to have a quite substantial, highly significant, independent impact on policy."[165]Their data suggests that the wealthy have 15 times the influence of the middle class. Larry Bartels, using data from the International Social Survey Programme (ISSP) finds that,

> In the other affluent democracies, net support for spending cuts was virtually constant across income groups, from the very poor to the very affluent. In the United States, however, poor people were only slightly more likely to favor than to oppose spending cuts, while affluent people

were vastly more likely to favor spending cuts. No other rich country even came close to matching this level of class polarization in budget-cutting preferences.[166]

Gilens shows that, in many cases, public policy outcomes would have been quite different if Congress and the president had been equally responsive to all income groups.

VI. Policy Recommendations

A. Strengthen Upward Mobility

Reversing the trend towards greater inequality in America and shoring up a middle class that fully reflects America's diversity will require policies that:

- *Invest in human capital and education.* Investing in education and human development, ensuring that future generations are well cared for and well educated, and that working people have the time they need to be caregivers to the people they love is a key starting point for moving millions of Americans into the middle class. For example, employees who need flexibility in their work lives to care for a child or other family member often face economic hardship. A system of family leave insurance—like the successful model in California—would help insure that the birth of a child no longer leads to poverty. The Schedules That Work Act would give workers the right to request a "flexible, predictable or stable" work schedule without retaliation. The bill stipulates that employers must detail upon employment the number of hours an employee can expect to work each week, and be given two-week notice before any scheduling change. Investing in affordable, high-quality child care and early education would reduce educational gaps and set the groundwork for success long after school. Finally, the nation's financial aid system should be revamped to ensure that every college-qualified student has access to higher education without taking on ruinous debt.

- *Increase employees' power in the workplace.* Since the 1970s, a growing share of national income has gone to corporate profits while the proportion going to labor compensation has decreased. This shift has greatly accelerated in the last decade. To reverse the trend, employees need more power in the workplace. The bottom of the labor market should be bolstered by raising the minimum wage, guaranteeing paid sick days to working people, and ensuring that worker protections are effective and apply to everyone. At the same time, weakened labor laws should be reconstituted so that Americans can exercise their right to organize unions and negotiate for pay and benefits that will allow them to enter the middle class. Finally, the U.S. should create a short-term public jobs program and long-term public investment plan to promote full employment.

- *Use tax policy to strengthen and expand the middle class.* Too often, the nation's tax policy bolsters the already wealthy rather than supporting Americans trying to work their way into the middle class. A more progressive tax system could increase economic mobility and reduce inequality. The Earned Income Tax Credit and the Child Tax Credit, which benefit low-income workers and their families, should be expanded. To ensure that the home mortgage tax credit helps middle-class families rather than subsidizing the super-wealthy, its value should be capped. Meanwhile, taxes on capital gains and dividends—income which disproportionately flows to the wealthiest Americans—should be increased, and corporate tax loopholes should be eliminated. To reduce the transfer of tremendous wealth from one generation to the next, estate taxes should be increased.

- *Enable Americans to build assets.* Owning assets—from a retirement account, to a home, to an emergency savings fund—is crucial to middle-class security. Yet American families have lost trillions of dollars in home equity as a result of the housing crash, and one in three say that if they lost their jobs, they could not make housing payments for more than a month.[167] To help distressed homeowners, a new public agency should be established to acquire and refinance under-water mortgages. To increase retirement security, Social Security should be safeguarded and supplemented with a system of voluntary annuitized pensions that guarantee a minimum rate of return. And to ensure that the predatory lending that drains pocketbooks is halted, federal usury limits should be established for all forms of lending and bankruptcy laws should be rewritten to provide greater relief to student borrowers and homeowners. To prevent debt from becoming a vicious cycle that shuts qualified job seekers out of employment, The Equal Employment for All Act, banning employment credit checks should also be enacted.

B. Limit the Economic Policy-Distorting Influence of Money in Politics

To achieve and preserve these reforms, we must also limit the influence of money in politics. One critical way to reduce the disproportionate influence of the wealthy on public policy is to create a system for financing election campaigns that lives up to the idea of one-person, one-vote by leveling the playing field between rich and poor and giving every American a strong voice. Such a system requires several key reforms:

- *Amend the U.S. Constitution to restore the ability of the people to enact common-sense, content-neutral restrictions on political contributions and spending to promote political equality.* Congress should propose an amendment or package of amendments to the U.S. Constitution to clarify that the First Amendment was never intended as a tool for use by corporations and the wealthy to dominate the political arena.

- *Enact strict limits on the amount that wealthy individuals and interests can contribute and spend on U.S. politics.* Millionaires, billionaires, and large corporations have no inherent right to drown out the voices of the rest of the population. After amending the Constitution or educating the next generation of Justices, Congress and states should sharply limit contributions and spending to level the playing field for all Americans.

- *Match small contributions with public resources to empower small donors and help grassroots candidates run viable campaigns.* Under a system of public financing (proposed in the House Government by the People Act or the Senate Fair Elections Now Act), candidates for Congress would be able to successfully run campaigns without relying on large donations. Low-dollar contributions would be matched with public funds. These measures would amplify the voices of non-wealthy citizens, encourage average Americans to participate in campaigns, change candidate incentives, and enable aspiring public servants without access to big-money networks to run viable campaigns for federal office.

- *Encourage small political contributions by providing vouchers or tax credits.* Encouraging millions of average-earning Americans to make small contributions can help counterbalance the influence of the wealthy few. Several states provide refunds or tax credits for small political contributions, and the federal tax code did the same between 1972 and 1986. Past experience suggests that a well-designed program can motivate more small donors to participate.[168] An ideal program would provide vouchers to citizens up front, eliminating disposable income as a factor in political giving.

- *Require greater transparency around political spending.* Congress should close existing loopholes in disclosure laws so that all money spent to influence U.S. elections (above a reasonable threshold) can be traced back to its original source. Allowing citizens to "follow the money" would help voters make informed choices and prevent wealthy interests from sponsoring nasty or misleading adds while insulated from public accountability.

- *Strengthen rules governing lobbying to reduce the influence of well-heeled special interests.* Congress should strengthen disclosure around lobbying and implement stronger revolving door limits that prevent former elected officials from approaching former colleagues for several years.

C. Address Class Gaps in Voting by Expanding the Freedom to Vote

A legitimate government "of the people, by the people, and for the people" must vigorously promote and protect the freedom to vote so that all eligible persons can participate in self-government. But today, too many bureaucratic barriers still block the ability of millions of eligible persons to register and vote, and too many politicians are actively seeking to shrink the electorate with unnecessary and discriminatory restrictions on political participation. Reversing this trend entails:

- *Removing barriers to registration and voting.* Voter registration is a particularly important target for reform, given that almost one of four eligible Americans was not registered to vote in the period leading up to the 2012 elections. In particular, the following should be adopted:

  - *Same-Day Registration:* Implementing Same Day Voter Registration, which allows eligible individuals to register and vote at the same time, is a proven method to increase participation and turnout among eligible voters.[169] States with Same Day Registration record consistently higher voter turnout and participation than states without it.[170] Same Day Registration has also been shown to reduce class gaps in turnout.[171]

  - *Expand agency registration and automate the registration process:* States should modernize the voter registration system to remove administrative burdens and costs by taking the initiative to place eligible voters on the registration rolls rather than leaving the burden on individual citizens to navigate the voter registration process. Motor Voter has also been linked to reductions in turnout inequality.[172]

- *Make registration permanent and portable:* Almost 36.5 million U.S. residents moved between 2011 and 2012.[173] Low-income individuals are twice as likely to move as those above the poverty line. Voter registration should become portable and permanent for persons who move within a state, by automatically updating registration records as citizens change their addresses.

- *Protections against intimidation and wrongful challenges:* States should put measures in place to protect voters from intimidation tactics, including clear rules and procedures to protect voters from improper removal from voting rolls, intimidating behavior at polls, and deceptive practices that discourage voting.

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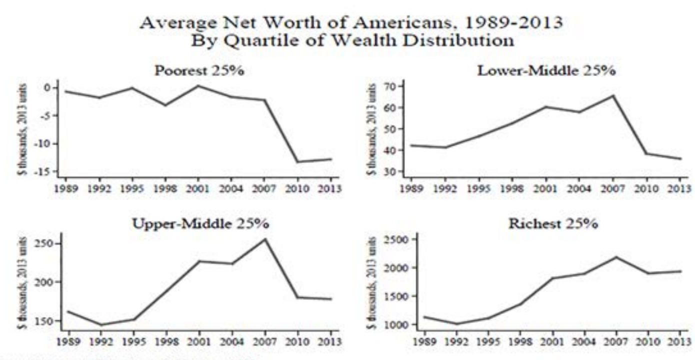
There is something wrong with the U.S. economy. We all know that the Great Recession was the most severe economic downturn since the Great Depression of the 1930s. What is perhaps less well understood is that the recovery since 2009 has been dismal. From the end of recession through 2014, real economic growth has been 2.1 percent per year, much lower than the 3.5 percent average annual growth the U.S. economy generated from 1947 to 2007. The decline in the unemployment rate over the past 2 years should not be a cause for celebration—it is driven primarily by households leaving the labor force. Only 76 percent of Americans aged 25 to 54 currently have jobs, compared to 80 percent in 2006 and 82 percent in 1999. Put differently, there are currently 4 million fewer Americans aged 25–54 working today compared to 2006.[1]

How did we get into this mess? And why is it taking so long to recover? My research with Atif Mian at Princeton University suggests that the culprit is the devastation of wealth suffered by middle and lower-income American households during the Great Recession.[2] The weak recovery is due in part to the lack of any rebound in wealth among these households since the end of the recession.

Americans below the top 25th percentile of the wealth distribution have lower net worth in real terms in 2013 than they did 15 years ago. For Americans below the median of the wealth distribution, it has been a disaster. For example, those in the lower-middle quartile of the wealth distribution have seen their net worth plummet from $65 thousand in 2007 to $40 thousand in 2010, with a further decline to $38 thousand in 2013. This puts their wealth in 2013 below the 1989 level—the Great Recession wiped out 25 years of wealth accumulation. The chart below shows how bad the Great Recession was for the bottom 75 percent of the wealth distribution.



The disproportionate negative impact of the Great Recession on the net worth of lower wealth Americans may at first seem surprising, but it makes perfect sense with an understanding of how the financial system operates. Richer Americans save a much higher fraction of their income, ultimately holding most of the financial assets in the economy: stocks, bonds, money-market funds, and deposits. These savings are lent by banks to middle and lower-income Americans, primarily through mortgages.

There is nothing sinister about the rich financing the home purchases of the poor. But it is crucial to note that the borrowing takes the form of *debt contracts* which leave the borrower with the first losses in case house prices fall. Here is a simple example to illustrate. Imagine a homeowner in 2007 who had a $100 thousand home, a $60 thousand mortgage, and therefore $40 thousand of home equity. When

[1] This is based on active population of United States aged 25 to 54 of 101 million as of 2013, and a 4 percentage point difference between the employment to population ratio in 2006 versus 2013.

[2] This research, published in economics and finance academic journals, is summarized in my book with Atif Mian: *House of Debt: How They (and You) Caused the Great Recession and How We Can Prevent It From Happening Again,* University of Chicago Press: Chicago, 2014.

house prices fell by 40 percent from 2007 to 2010, the house plummeted in value to $60 thousand. The mortgage in 2010 was still worth $60 thousand, but the $40 thousand of home equity vanished. The homeowner lost 100 percent of their home equity, even though house prices fell only 40 percent.

This is the effect of debt. The use of mortgage debt within the financial system gives the holders of financial assets protection against a fall in house prices. In the example above, the mortgage did not decline in value.[3] But it provides this insurance by concentrating the brunt of economic downturns on borrowers. The standard mortgage contract is *inflexible*—the same amount is owed even if house prices and the economy collapse. Given that 85 percent of the financial assets in the U.S. economy are held by the top 20 percent of the wealth distribution, the financial system's reliance on inflexible debt contracts means it insures the rich while placing an inordinate amount of risk on middle and lower net worth households.

As we illustrate in our research, it was the massive pullback in spending by indebted households that triggered the Great Recession. The financial system concentrated the collapse in home values on exactly the households that were prone to cutting spending most dramatically in response. Further, the lack of any increase in the net worth of lower- and middle-income Americans helps explain why the recovery in household spending has been so weak.

Going forward, there are two important lessons from the framework we outline in our research. First, encouraging borrowing by lower- and middle-income Americans may temporarily boost spending, but it is not a path to sustainable economic growth. Instead, stronger income growth for the lower and middle part of the income distribution is necessary for a balanced growth path. Second, the financial system in its present form concentrates risk on lower wealth households who are least able to bear it. The current policy and regulatory framework encourages such a system, even though it has disastrous effects for the economy. We must re-think how the financial system allocates risk. I explain these two lessons in more detail below.

Credit Growth Without Income Growth: A Recipe for Disaster

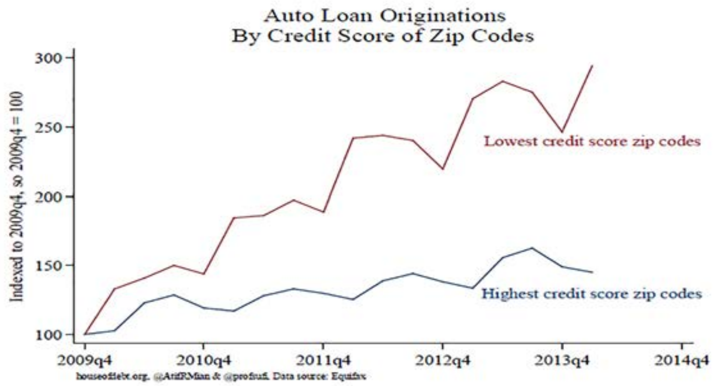
A tempting solution to our current troubles is to encourage even more borrowing by lower- and middle-income Americans. This group of Americans is likely to spend out of additional credit, which would provide a temporary boost to consumption. But unless borrowing is predicated on higher-income growth, we risk falling into the same trap that led to economic catastrophe.

In the past 3 years, there has been an aggressive expansion in credit to lower credit score borrowers. While credit scores and income are not the same, they are closely related; lower-income Americans tend to have lower credit scores. More data are available that track consumers by credit score, and so the statistics I show below focus on credit scores.

In contrast to the expansion of subprime *mortgage* credit during the 2002 to 2006 housing boom, the current expansion has been concentrated in *auto* lending and to a lesser degree *credit card* lending. For example, from 2009 to the first quarter of 2014, auto loan originations grew by 300 percent among consumers with a credit score below 620, which is deep subprime territory.[4] The growth has been much smaller among prime consumers with a credit score above 700: less than 50 percent. The chart below shows this pattern. The tremendous growth in auto loans to subprime borrowers may help explain why auto spending has been a bright spot for retail spending since the end of the Great Recession. Credit card lending to low credit score consumers has also accelerated, but the increase has been more modest and more recent. From 2011 to 2013, credit card originations grew by 30 percent among consumers with a credit score below 620, compared to 3 percent for consumers with a credit score above 700.

[3] Of course if the home value declines by even more, it will also reduce the value of the mortgage, which is what happened during the Great Recession. But the losses will be more severe on home equity because by definition the mortgage only falls in value after the equity is wiped out.

[4] A credit score below 660 is considered subprime.



Such rapid growth in credit to lower credit score households may not be a cause for alarm—after all, credit to lower credit score households all but disappeared during the recession, and we would therefore expect some growth from 2009 to 2014. But the key question is whether income growth among lower credit score individuals justifies the expansion in auto lending. Are lenders willing to lend more because they believe borrowers have better income prospects?

The answer to this question is worrisome: income growth among lower credit score and lower-income Americans has been flat or even negative during this same timeframe. A variety of data sets show this pattern. Analysis by the Economic Policy Institute based on Current Population Survey data shows that real income was between 2 and 3 percent *lower* in 2012 than in 2007 for the bottom 60 percent of the income distribution.[5] The grand majority of Americans have not seen real income growth from 2007 to 2012. The recently released 2013 Survey of Consumer Finances of the Federal Reserve shows the same result from 2010 to 2013.[6] During these 3 years, income has fallen for all but the top 10 percent of the income distribution.

The evidence from the 2013 SCF is especially alarming, and worth discussing in more detail. From 2010 to 2013, real income fell by 4 to 7 percent for households in the bottom 60 percent of the income distribution. These losses were registered *after* the Great Recession. For the 60th to 90th percentile of the income distribution, real income fell by 2 to 3 percent. Real income grew by 2 percent for the top 10 percent of the population. These statistics contradict the notion of a recovery since 2010 for the grand majority of American households.

Different data sets tell one consistent story: as in the subprime mortgage credit boom, credit is once again expanding to households that have declining real incomes. The magnitude of the credit expansion is smaller given that auto and credit card debt are smaller markets than mortgages. But something has to give. Income growth needs to improve, or lenders will eventually shut off the credit spigot.

Relying on lender willingness to provide credit is not a sustainable way of generating economic growth. We desperately need higher-income growth for middle and lower-income Americans. The best way of generating income growth in the long run is by improving the productivity of workers. Better education and strong life skill development at a young age can help achieve higher productivity. Unfortunately, such a boost in worker productivity takes time.

In the short run, policymakers should investigate whether there are policies that can boost wage and income growth among lower- and middle-income Americans without reducing economic efficiency. Some potential policies include expanding the Earned Income Tax Credit, or identifying public works projects that can boost aggregate productivity. Such public investment could potentially pay for itself in the longer run while boosting earnings in the short run. I do not know for certain whether such policies would help. But I know for certain that stagnating income growth for the majority of American households is a serious economic threat.

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[5] Gould, Elise, 2014. "Why America's Workers Need Faster Wage Growth—and What We Can Do About It," *EPI Briefing Paper,* August 27th.

[6] See Bricker, Jesse, Lisa Dettling, Alice Henriques, Joanne Hsu, Kevin Moore, John Sabelhous, Jeffrey Thomson, and Richard Windle, 2014. "Changed in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin,* 100:4, September.

Financial Reform: Making the Financial System Work for Americans

Another pressing matter is reform of the financial system, which as currently constructed does not work for the majority of Americans. Let's start with a basic indisputable point: the economy is a risky place. House prices go up and down, as do the returns to business capital. Human capital is risky—the wages one earns could potentially collapse if the economy falls into recession.

This risk must be borne by someone, and the financial system should help Americans *share* this risk with one another. Those that bear the most risk should be those who have the capacity to bear losses in case the economy crashes. In general those with a large amount of wealth have exactly such capacity. And of course, those that bear the most risk should be compensated for bearing that risk—earning high returns when the economy is strong. Investors should look to the financial system to take risk and earn a return as a result.

But how does the financial system currently operate? Does it encourage those with wealth to bear risk by compensating them for it? The answer is no. Instead, the financial system relies almost exclusively on *inflexible debt contracts,* which force borrowers to bear risk instead of investors.

Student debt offers a simple example. When the college class of 2009 entered college in 2005, many of them took on debt to pay tuition. This was a sensible decision—the income premium to a college degree is high, and students were willing to borrow in the short-run to get the benefit of higher wages in the future. But of course, no one in the college class of 2009 understood in 2005 that the U.S. economy was about to get whacked with the worst recession since the Great Depression. The unemployment rate for recent college graduates skyrocketed from 9 percent to 18 percent from 2007 to 2009. Further, wages for those that were able to find jobs collapsed. The consequences for the class of 2009 will likely persist into the future: Research shows that there are long-run, persistent negative effects of graduating from college in the midst of a severe recession.[7]

Did the financial system help share the risk borne by the college class of 2009? No. In fact, the student debt burden and interest payments remained exactly the same for the students, even though their employment prospects collapsed. The financial system, with its reliance on inflexible student debt contracts, forced young Americans to bear risk that they were poorly equipped to bear. They are young with almost no assets—why should they bear the costs of an economic downturn?

A more sensible financial system would share the risk by having the principal and interest payments on student debt automatically adjust downward when recessions hit. The lenders should share some of the downside risk, and they should be compensated if the economy ends up being stronger than expected. A simple adjustment would be a debt contract with a higher average interest payment if the unemployment rate facing recent college graduates remained low, but automatic debt forgiveness if the unemployment rate facing college graduates increased substantially. In this way lenders would be paid a higher interest payment if the job market were strong, but would have to accept lower payments if the job market ends up being very weak.

This example applies more broadly to financial contracts in the economy. The reliance on inflexible debt contracts forces lower-income and younger Americans to bear too much economic risk. Debt contracts require the same payment regardless of what happens in the economy. As mentioned above, there is risk in the economy. That is unavoidable. But the current bias of the current financial system is to force the most vulnerable to bear the risk.

We need policies that would help move the financial system away from its current reliance on inflexible debt contracts. One such policy the Government could implement in the short-run would be to lower student debt owed to the Government for those who graduated in the midst of the Great Recession. The college class of 2009 should not be forced to bear the costs of the downturn with no assistance: it is not their fault they were born in 1987, 22 years before the worst recession in 80 years. This could be done with outright debt forgiveness, or by allowing borrowers to refinance into current market interest rates. Going forward, student debt provided by the Government could be indexed to the unemployment rate facing college students, so that debt burdens are automatically reduced if the economy enters another recession.

More broadly, the current bias of policy encourages the financial system to use inflexible debt contracts, even though they have potentially disastrous effects for the economy. We tolerate the issuance of fragile short-term debt by financial institutions

[7] Kahn, Lisa, 2010. "The long-term Labor Market Consequences of Graduating from College in a Bad Economy." *Labour Economics,* 17:2, 303–316.

that enjoy some level of Government backing, and we allow them to do so while holding very little capital. Banks then either choose or are told by regulators to take very little risk on the asset side of their balance sheets, which results in borrowers bearing the risk. We force insurance companies to hold highly rated assets, which can only be produced by debt contracts to borrowers. We encourage inflexible mortgage contracts by declaring them as "conforming" mortgages that the Government-sponsored entities can buy and securitize. More equity-like mortgages where the principal adjusts downward if house prices fall do not qualify, and the private sector therefore has little incentive to provide them. Further, we give a mortgage interest deduction for inflexible debt contracts, which encourages households to use them.

Removing the strong policy bias toward inflexible debt contracts will not be easy, and it cannot be done overnight. However, I want to encourage policymakers to think in a big-picture manner about the current financial system, what it is supposed to do, and what Government can do to make it work better for Americans. We have a tendency to accept the financial system as it is, and make minor changes to help insulate it from risk. But the risk is not going away—it must be borne by somebody. A properly functioning financial system would encourage those with wealth—that is, those with risk-bearing capacity—to bear risk and earn a return for doing so. It would help those with little wealth attend college or buy a home without bearing an inordinate amount of economic risk. It may take time, but moving toward such a financial system would improve the welfare of all Americans.

PREPARED STATEMENT OF CLAUDIA VIEK

CEO, CAMEO—California Association for Micro Enterprise Opportunity

September 17, 2014

Chairman Jeff Merkley, Ranking Member Dean Heller, and Members of the Committee, thank you for the opportunity to submit testimony about an issue of crucial importance to the American business community and economy.

CAMEO's mission is to grow a healthy, vibrant, thriving environment for all entrepreneurs and startup businesses in California. We are the largest Statewide network of nonprofits that provided training, coaching and loans to 18,000 businesses last year, businesses that created 32,000 jobs. We are also a member of the American Sustainable Business Council, which collectively represents over 250,000 businesses, many of which are small businesses that create jobs across the country.

Let me illustrate with a brief story: Johneric Concordia is a young man who was laid off as a baggage handler for United Airlines. He loved to barbeque in his neighborhood in Filipinotown in Los Angeles. He and his uncles would compete to see who made the best sauce. When he lost his job, he sought business counseling from the Asian Pacific Islander Small Business Program to start his own barbeque catering business. He raised $8,000 for a truck-mounted barbeque rig through Facebook, and a year later opened Parks Finest restaurant in Echo Park. He has hired nine of his friends to work for him and is ready for a larger loan from a local nonprofit lender.

Parks Finest is not a one-off—I have many, many similar stories from members like the National Asian American Coalition, the Los Angeles Latino Chamber, and the other 85 CAMEO members who serve entrepreneurs with small dollar loans and coaching. Johneric and others have the desire and ability to contribute to our economy by being their own boss, and go on to employ others—they are exactly the kind of people we should invest in!

If we are serious about addressing income inequality, then we need to support entrepreneurship and starting a business as a real pathway to closing the wealth gap and generating new jobs.

There are 26 million small businesses in the United States, most of which are self-employed. If just 1 in 3 such businesses created one job, we could have full employment! "This would address the 50 percent unemployment rate among black and Latino youth," said Reverend Mark Whitlock, Corporate Relations Chair for the 5,000 member national AME Church.

For example, a minimum of a million new jobs a year could be created through bank investment in lending and technical assistance programs.

Why business ownership? The Congressional Budget Office found that the cause of the rise in income inequality between 1979 and 2007 derives mostly from disparities in business income. If we get to the heart of the problem of inequality, the answer can be simple. Instead of handouts and promises of trickle-down job creation, help people create their own businesses and have them close the income inequality gap themselves.

The wealth gap in the United States is large and growing: the median net worth of Caucasians was $110,500 compared to $7,683 for Latinos and $6,314 for African Americans. The wealth gap hinders their ability to create, maintain and grow their small firms, which impacts all of us.

Eighty-eight percent of minority business owners finance their small businesses from home equity, compared to about a quarter overall. Thus, the loss of home equity disproportionately affects minority-owned businesses. In California, almost 2 million homeowners are still under water; also true in Nevada, Senator Heller's State. We can assume that minority-owned businesses have not been able to recover fully from the downturn.

Business ownership is an effective strategy to reduce income inequality: the median net worth of business owners is two and a half times greater than for all non-business owners, and for African Americans the difference is eight times higher for business owners compared to nonbusiness owners.

Households headed by women who own a microbusiness generate up to $13,000 more in annual household income than similar households without a microbusiness owner. This may not sound like much, but this amount can be the difference that sends one's child to college or buys a home. And, research shows that the children in families with a microbusiness owner do better in terms of education and social mobility (Source: AEO Report, "Bigger than You Think", 2014).

Self-employment, business ownership and entrepreneurship are key ways for lower-income people to become middle income. Therefore, Government should increase support to programs that help start and grow small and microbusinesses. Instead we have seen a 40 percent drop in funding over past 3 years and fewer businesses benefiting.

This is the case within the U.S. Small Business Administration (SBA), U.S. Department of Agriculture (USDA), and Housing of Urban Development (HUD), all of which fund microbusiness development. Furthermore, women are starting businesses at three times the rate of men and African American women at four times the rate, but women receive $1 of capital for every $23 men receive. We are fortunate that Maria Contreras-Sweet, SBA's new Administrator, is addressing this inequity, as is the proposed Women's Equity Bill introduced last month by Senator Maria Cantwell.

Self-employment is *the* labor market trend—by 2017, 50 percent of our workforce will be, or have been, self-employed! Research on the independent workforce reveals that young millennials and those over 55 are the most likely to choose self-employment.

We know that when businesses get training and coaching help, 80 percent are in business after 5 years, compared to 50 percent of those that did not get such help. (Source: Aspen Institute, FIELD). Also, businesses that received capital and services from a nonprofit organization have 30 percent higher median annual revenue growth than those that did not. And when microbusinesses succeed, they create on average another two jobs. (Source: AEO Report, "Bigger than You Think", 2014.)

These statistics are borne out by my personal experience of more than 25 years running entrepreneurship training and business incubation programs. Again, small business ownership will help close the income inequality and wealth gap and bring low-income families into the middle class. So why don't we invest more in them?

For example, the U.S. Department of Labor (DOL) could recognize self-employment as a job. DOL does not provide funding or have performance measures for self-employment. This keeps many young, lower income, and people of color from starting their own businesses because local Workforce boards will not allow them to pursue entrepreneurship training, but will pay for training in expensive institutions that don't place them in a job. And the SBA only budgets $12 million nationwide for helping women business owners, most of whom are low or moderate income.

Currently our bank regulators are proposing giving extra Community Reinvestment Act credit to banks that provide small dollar microloans in low- and moderate-income communities. This policy could have a major impact on new self-employment and job growth in communities that have not recovered from the Great Recession.

So, I urge you to target our economic policies to very small businesses in and around low- and moderate-income communities, those that have not recovered from the downturn, that have not regained equity in their homes and businesses. In this way we can create more opportunities everyone, especially for young, unemployed people of color.

If there is one thing you remember from my testimony, let it be how small business creation and entrepreneurship can reduce income inequality and bring hope to our communities with so much untapped entrepreneurial potential. Thank you for this opportunity to address the Committee.

PREPARED STATEMENT OF ADAM S. HERSH, PH.D.

SENIOR ECONOMIST, CENTER FOR AMERICAN PROGRESS

SEPTEMBER 17, 2014

Thank you Chairman Merkley, Ranking Member Heller, for inviting me to testify today. My name is Adam Hersh and I'm a Senior Economist at the Center for American Progress Action Fund.

There is an increasingly broad consensus among professional economists that high levels of inequality are extremely detrimental not only to current economic growth, but to future growth as well. This is the case because when we talk about the economy, we are talking about what's happening to people and how people are faring in their lives. An economy with broadly shared income gains creates the financially secure families who can:

- Invest in the human capital—health and education—that creates a productive, innovative labor force
- Provide stable, strong consumer demand that entices business investment
- Provide a fertile environment for entrepreneurship to develop

Research also indicates that economies with lower inequality and stronger middle classes have more stable financial systems, higher investments in public goods, better quality of governance and public institutions, broader civic participation, lower crime, and less political polarization.[1]

Taken as a whole, inequality is the central thread that runs through essentially all the factors that economists identify as important for economic growth. In other words, a vibrant U.S. economy does not trickle down from the super wealthy, but rather springs forth from a thriving middle class.

International trade and investment are critical parts of the U.S. economy—they always have been and always will be—but they create complicated economic policy issues because trade is simultaneously a cause of inequality and of the innovation and investment that leads to growth.

Trade is one among several factors that have contributed to the rise in U.S. income and wealth inequality since the late 1970s—declines in unionization and the real minimum wage, decreasing tax progressivity, increased short-termism and focus on financial profits over real investments in the business sector, and shifting technologies have all played roles. But economists don't really debate whether trade has distributional impacts on incomes and wealth; we debate how big is the impact of trade, among the multiple causes. And across a variety of studies, economists estimate that increased trade accounts for between 10 percent to 52 percent of the overall increase in U.S. wage inequality since the 1980s.[2]

Trade also has positive effects on living standards in the United States by incentivizing innovation and providing access to a broader variety of goods and services at lower prices. While certainly yielding substantial gains from cheap imports, we account for this when measuring inflation—adjusted real wages and family incomes, which, respectively, have stagnated and declined. Median family income, for example, today is more than $5,400 below its level in 2000 and back down to its levels before the 1990s economic boom.[3]

Trade's impact on inequality comes both through direct channels—the dislocation of workers when domestic production shrinks or moves overseas—as well as from indirect effects that can saddle regions in localized economic depressions. The losses to local economies render large swathes of capital stock—factories, office buildings, infrastructure—unproductive. It is equivalent to having a Hurricane Katrina or Hurricane Sandy, but that capacity won't be rebuilt.

Economist Andrew B. Bernard and co-authors found that the more manufacturing plants were exposed to low-wage-country imports, the slower they grew and the

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[1] Heather Boushey and Adam Hersh, "The American Middle Class, Income Inequality, and the Strength of Our Economy: New Evidence in Economics," (Washington, DC: Center for American Progress, 2012), available at *http://cdn.americanprogress.org/wp-content/uploads/issues/2012/05/pdf/middleclass_growth.pdf.*

[2] Paul Krugman, "Trade and Wages Reconsidered," *Brookings Papers on Economic Activity, available at http://www.brookings.edu/~/media/Projects/BPEA/Spring%202008/2008a_bpea_krugman.pdf.*

[3] Author's analysis of U.S. Census "Family Income: Table F–7. Type of Family, All Races by Median and Mean Income: 1947 to 2012," available at *http://www.census.gov/hhes/www/income/data/historical/families/.*

more likely they were to exit the market—close their doors.[4] Similarly, economist Avi Ebenstein and co-authors find that wages grow more slowly in occupations more exposed to import penetration and to U.S. multinational companies ability to move production offshore.[5]

Recent research from economists at the Federal Reserve Bank of San Francisco shows that these dislocation and wage impacts are concentrated in industries most exposed to offshore competition—primarily manufacturing industries, and rising increasingly up the advanced technology ladder. Their analysis shows it is precisely here where the impact on the distribution of wages and capital income within firms have been felt most strongly.[6]

Other recent research, from MIT economist David Autor and co-authors show that the economic impacts of trade competition and dislocation are not limited just to affected factories or companies.[7] The spillover effects can essentially create regional economic depressions, with broadly elevated unemployment rates, public safety net expenditures for things like unemployment, disability, and Medicaid benefits—even while the total U.S. economy steams ahead.

Much has and still is changing in the global competitive environment facing U.S. workers and businesses—and binding together their futures with those of people and businesses around the world. Whereas most of the postwar period saw global trade concentrated among the United States, Europe, and latecomers like Japan, the gravity of economic growth and international trade in the world is shifting to the East, and to the South—that is, to developing countries in Asia, Latin America, and elsewhere that now account for half of global economic growth, a share that is likely to continue rising for the foreseeable future. Not only will U.S. businesses compete increasingly with businesses based in these countries in United States and world markets, but U.S. workers at all skill levels will increasingly compete for a share of the work across a growing range of industries and occupations.

In the past, trade tended to occur at arms-length between independent firms, but today globally integrated production and corporate governance systems comprise the core of international trade. In 2013, fully half of U.S. imported goods were traded by companies within the same corporate families—what the Census Bureau calls related-party trade.[8] This means that a foreign affiliate of a U.S.-based company transacted with another related affiliate or the parent company in the United States.

This practice of offshoring, moving production to foreign locales while continuing to sell goods to the U.S. market, is now a deeply entrenched and a pervasive feature of the U.S. economy impacting inequality and growth in several ways. The work that would otherwise be conducted in the United States would go elsewhere, causing direct disemployment, with expected multiplier effects on output and employment.

Adjustment to these trade shocks need not be too disruptive if displaced workers and capital investments can be smoothly segued into other productive uses, and if the shock to aggregate demand can be offset by growth elsewhere in the economy. However, because of the widespread trend toward such global production arrangements, and the sharp fiscal contraction we've seen in the past 4 years, the quality and quantity of jobs being created in the United States. Three-fifths of the jobs lost in the United States since the start of the Great Recession earned middle class incomes, but three-fifths of the jobs created since the labor market recovery began in 2010 are in low-wage industries and occupations. The pace of growth is not adequate to move us back toward full employment—a critical factor for growing market wages—or to create jobs that generate opportunities to secure a rising middle class standard of living.[9]

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4 Bernard, Jensen, Redding, and Schott, "Firms in International Trade," *Journal of Economic Perspectives,* Vol. 21, no. 3, pp. 105–130.

5 Avi Ebenstein, *et al.,* "Estimating the Impact of Trade and Offshoring on American Workers Using the Current Population Surveys," *Review of Economics and Statistics,* available at *http://pluto.huji.ac.il/~ebenstein/Ebenstein_Harrison_McMillan_Phillips_August2012.pdf.*

6 Michael Elsby, Bart Hobjin, and Aysegul Sahin, "The Decline of the U.S. Labor Share," *Brookings Papers on Economic Activity,* 2013, available at *http://www.frbsf.org/economic-research/files/wp2013-27.pdf.*

7 David Autor, David Dorn, and Gordon Hanson, "The China Syndrome: Local Labor Market Effects of Import Competition in the United States," *American Economic Review,* Vol. 103, no. 6, pp. 2121–68.

8 Adam Hersh, "Offshoring Work is Taking a Toll on the U.S. Economy," (Washington, DC: Center for American Progress, 2014), available at *http://www.americanprogress.org/issues/economy/news/2014/07/30/94864/offshoring-work-is-taking-a-toll-on-the-u-s-economy/.*

9 Adam Hersh, "New Jobs Growth Underscore Stable Recovery Although Wages Have Yet to Budge," (Washington, DC: Center for American Progress, 2014), available at *http://www.americanprogress.org/issues/economy/news/2014/08/01/95027/new-jobs-data-underscore-stable-recovery-although-wages-have-yet-to-budge/.*

The questions before lawmakers are:

(1) How should the United States engage trading partners in an increasingly open and competitive world in order to grow the economy from the middle out?

(2) What should the United States do to make sure that workers and businesses in the United States can thrive in this environment?

The United States and its trading partners across the globe need to find a way to set a high road path to trade in an increasingly open and competitive world. Our national strength, and indeed our mutual social and environmental future depend on this. And doing so will require us to rethink our approach to the means and goals of economic growth well beyond just trade policy.

Though the global competitive landscape has evolved much faster than U.S. economic policies and institutions, there are clear steps we can take to set this high road path toward sustained, broadly inclusive economic growth.

First, the U.S. trade negotiators must be pressed to establish strong, enforceable standards for fair and open competition in the global economy. Capitalizing on U.S. economic potential for trade and getting better outcomes for people in the United States and in trading partner countries begins with negotiating better international agreements. Unfortunately, many rules of the international trading system that the United States has painstakingly built through the post-WWII era are still lacking in key respects and need to evolve to keep pace with a changing world economy.

Currency manipulation for trade advantage is prohibited both by IMF and WTO Articles of Agreement and should be dealt with in conjunction with other trade issues in bilateral and multilateral trade agreements—not through separate dialogs—and I believe that legislation to treat currency manipulation as a countervailable duty would strengthen that position.[10] A week's worth of appreciation of an undervalued exchange rate would do more to expand U.S. manufacturing and agriculture exports than years of Trans-Pacific Partnership negotiations.

Setting a high enforceable standard of conduct also applies to the areas of labor rights and conditions at work, incentivizing responsible stewardship of environmental assets in our economies, and ensuring an environment of open competition in international commerce.[11] The May 10th agreement on labor and environmental standards are a start, but fall far short of what is needed: policies with real teeth to sanction real, egregious labor practices and conditions that make all workers around the world worse off. National labor markets are not segmented along export and domestic lines, and therefore labor standards should apply economy-wide. Requiring countries to sign on to a handful of multilateral environmental agreements is a win, but does little to address the costs of environmental externalities built into current consumer-driven global supply chain—both due to lax pollution controls abroad and the environmental footprint from physically trading goods.

And though trading partners should be free to choose their path to development, the United States should insist on establishing international norms of transparency and corporate to ensure competitive neutrality where developing countries pursue initiatives to build their global economic niches through State ownership. It is imperative that we establish through our international trade relations standards for financial reporting disclosures and independent third-party auditing that can establish companies compete with out the undue and impermissible forms of State support and privilege—public bodies operating in the commercial sphere should conform to the OECD Guidelines on Corporate Governance of SOEs or face withdrawal of reciprocal trade preferences.

High standard agreements should also set a high standard for public health and safety. Intellectual property rights aspects of trade agreements, particularly where they pertain to life-saving drugs and medical devices must strike a balance between the social welfare and private incentives to innovate. Granting "ever-greening" patent protections creates a monopoly rent, not an incentive to innovate. Nor should high standard agreements impede public health policies from using their purchasing power to negotiate fiscally responsible procurement for health care goods and services.

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[10] IMF Articles of Agreement, Article VIII, Section 2(a), available at *http://www.imf.org/External/Pubs/FT/AA/#a8s2;* WTO Articles of Agreement, Article XV available at *http://www.wto.org/english/res_e/booksp_e/gatt_ai_e/art15_e.pdf.*

[11] Adam Hersh and Jennifer Erickson, "Progressive Pro-Growth Principles for Trade and Competitiveness," (Washington, DC: Center for American Progress, 2014), available at *http://www.americanprogress.org/issues/economy/report/2014/03/11/85639/progressive-pro-growth-principles-for-trade-and-competitiveness/.*

Second, Congress should increase commitments to enforce the hard-fought rules of trade agreements. Trade agreements aren't worth the paper they are printed on if agreed upon rules are routinely flaunted. Making sure rules aren't violated takes resources to monitor, investigate, and enforce. Our Interagency Trade Enforcement Center, or ITEC, is basically an under-resourced public defenders office. As a start, Congress should double funding to ITEC to $50 million per year. Congress can also instruct the USTR to increase transparency, accountability, and action of trade enforcement by instituting a more effective National Trade Barriers Report, a new National Trade Compliance Data base, and expanded statistical reporting to better identify where trade violations are occurring and what we're doing about them.[12]

Third, the most important things the United States can do to improve America's trade competitiveness is to substantially *expand investments in the sources of U.S. competitiveness in:*

- broadly available quality education to build a workforce that can compete and fuel innovation as well as the family friendly workplace environment that allow parents to build a career while raising their kids;
- modernized infrastructure that can move people, goods, and ideas around more efficiently, lowering costs and making people and businesses more productive;
- scientific research and development, and supporting the innovation ecosystems that link together research with workforce development and commercialization;
- replacing outdated trade adjustment assistance programs, or TAA, with a new universal dislocated worker program that integrates public and private efforts to help workers knocked down by the shock of job dislocation—anywhere in the economy, not just in the tradable sector—by helping them climb the next rung on their job ladder in finding new work and helping smooth aggregate demand for the overall economy.

Trade is an essential part of the U.S. economy, and it is essential that the United States get its trade and economic policies on the right track so that we can set a high road path for the global economy.

[12] Adam Hersh and Jennifer Erickson, "Progressive Pro-Growth Principles for Trade and Competitiveness," (Washington, DC: Center for American Progress, 2014), available at *http://www.americanprogress.org/issues/economy/report/2014/03/11/85639/progressive-pro-growth-principles-for-trade-and-competitiveness/*.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

NAAC
National Asian American Coalition

September 8, 2014

Chairman Tim Johnson
Ranking Member Mike Crapo
Senator Richard Shelby
Senator Jack Reed
Senator Jeff Merkley

U.S. Senate Committee on Banking,
Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510
SENT VIA EMAIL

Asian Americans are an Entrepreneurial Force that Should Be Unleashed and Supported

Dear Chairman Johnson, Ranking Member Crapo and Senators Shelby, Reed, Merkley and Other Members of this Committee,

The National Asian American Coalition is our nation's largest pan Asian American advocacy group that meets regularly with all the banking regulators and most of the banks doing business in California, including the "too big to fail" banks, large banks, such as Union Bank and Bank of the West, medium sized banks, such as East West Bank and First Republic, and community banks, such as Banc of California and Royal Business Bank. We are also an active member of CAMEO.

As many members of this committee have recognized, the Asian American entrepreneurial spirit is alive and active. Nationally, there are over one million Asian American-owned businesses. But, I fear our new immigrant spirit that has created many of our Asian American-owned businesses will not be present within the second and third generations of Asian Americans.

It is why our organization strongly supports CAMEO's efforts to develop new incentives for our successful young people to start new businesses, rather than work for the government or a large corporation. To do so, however, we need the encouragement of government and support from Corporate America, including the highly successful high tech companies in our home state of California.

I will personally be in Washington, D.C. for meetings with key government leaders, including Secretary of Labor Perez, during the week of November 10th to further express the pan Asian American perspective on entrepreneurship, particularly for young people and the second and third generations of Asian Americans. During this time period, I would be pleased to meet with any senators who are in town after the election.

NAAC
National Asian American Coalition

Thank you for considering the Asian American perspective.

Most sincerely,

Faith Bautista

Faith Bautista
President & CEO
National Asian American Coalition

los **angeles**
latino chamber of commerce

September 8, 2014

Chairman Tim Johnson
Ranking Member Mike Crapo
Senator Richard Shelby
Senator Jack Reed
Senator Jeff Merkley

U.S. Senate Committee on Banking,
Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510
SENT VIA EMAIL

Doubling the Number of Latino-Owned Businesses

Dear Chairman Johnson, Ranking Member Crapo and Senators Shelby, Reed, Merkley and Other Members of this Committee,

The Los Angeles Latino Chamber of Commerce serves almost 300,000 Latino-owned businesses in the L.A. region. And, we are an active participant with other Latino chambers across the nation in representing 3.2 million Latino-owned businesses. These businesses increasingly serve not only our nation's almost 60 million Latinos, but a broad cross-section of America.

We are an active participant and member of CAMEO and we would like to add a brief comment regarding the potential of Latino-owned businesses. Although we are presently 3.2 million strong, we can easily increase the number by 1 million to 1.5 million if we focused on the entrepreneurial spirit and talent of young Latinos who will soon be the future of America.

Latino businesses have often prospered despite a lack of specific government assistance and often in the face of onerous regulatory headwinds. We have asked CAMEO to work with us to reduce the regulatory headwinds and to help us develop partnerships with Corporate America that will provide for appropriate training, beginning as early as middle school, for our future Latino entrepreneurs.

With the right regulatory climate, some government and corporate technical assistance and the guidance of CAMEO, it is our hope that over the next five years, 1.5 million additional Latino-owned businesses will be created and successful.

los angeles
latino chamber of commerce

Most sincerely,

/s/ Gilbert Vasquez

Chair, Los Angeles Latino Chamber of Commerce
Serving 250,000 Latino Businesses
Founder of the Largest Latino CPA firm in the Nation

634 S. Spring Street, Suite 600, Los Angeles, CA 90014 | info@laicc.org | www.laicc.org

Reverend Mark E. Whitlock, II
Senior Minister

September 8, 2014

Chairman Tim Johnson
Ranking Member Mike Crapo
Senator Richard Shelby
Senator Jack Reed
Senator Jeff Merkley

U.S. Senate Committee on Banking,
Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510
SENT VIA EMAIL

Millions of Black Youth Prefer Entrepreneurship Over Government Handouts or Jobs

Dear Chairman Johnson, Ranking Member Crapo and Senators Shelby, Reed, Merkley and Other Members of this Committee,

Black unemployment rates are more than twice the rates for Whites and the real unemployment rate exceeds 30% in many areas of the country, including 50% or more unemployment among our youth.

As Chairman of Corporate Partnerships for our nation's 5,000 African Methodist Episcopal churches, I would urge a strong no handout policy. Instead, I urge that we focus on creating small business opportunities for the large segment of our Black youth who are entrepreneurs.

From the first days after the Civil War ended, Frederick Douglass and the Black communities sought "40 acres and a mule" in order to be entrepreneurs. As a partner with CAMEO, our Black churches look forward to working with all members of this committee on entrepreneurial solutions that do not depend on government jobs or handouts.

Most sincerely,

46 Maxwell, Irvine, CA 92618 | Office (949) 955-0014 | Fax (949) 955-0021

Reverend Mark E. Whitlock, II
Senior Minister

/s/ Mark Whitlock
Senior Minister, COR AME Church, Irvine, CA
Chairman of Corporate Partnerships, 5,000
African Methodist Episcopal Churches
Executive Director, Cecil Murray Center for
Community Engagement
Executive Director, Ecumenical Center for Black
Church Studies
Chair, Orange County Interdenominational
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Albina
OPPORTUNITIES
CORPORATION

Honorable Jeff Merkley
United States Senate
Committee on Banking
Washington, D.C.

September 11, 2014

Dear Senator Merkley,

Thank you for the opportunity to submit a statement for the record in connection with the hearing "Who is the Economy Working For? The Impact of Rising Inequality on the American Economy" in the Economic Policy Subcommittee of the Senate Banking Committee. We believe this is a timely and very relevant hearing for American families and their communities.

Our experience in dealing with small businesses seeking capital for expansion in the Portland Metropolitan Area, Oregon market area over the last 6 years has led us to the following conclusions which are relevant to this hearing:

1. There are numerous small, family-owned businesses that are credit-worthy who have increasing demand for their products or services, and want to expand, and increase their employment, but are prevented from doing so because traditional business lenders do not make sufficient loans to small businesses.
2. There is particular demand for lines of credit, under $350,000, but in the Portland Metro Area there are virtually *no* lenders making available lines of credit of less than $350,000 other than a few lenders giving lines of credit based on high credit scores or home equity.
3. The need for capital is especially acute among minority and women-owned small businesses.
4. Lack of access to capital inhibits employment substantially. with a disproportionately negative impact on lower income communities.
5. Many small businesses denied credit by traditional lenders are, in-fact, credit-worthy and financial institutions can make reasonable profitable returns providing credit to such businesses at reasonable interest rates.
6. Non-traditional lenders, such as Albina Opportunities Corporation, are only able, given limited resources, to meet a small part of for credit by small, credit-worthy businesses.
7. Lack of access to capital contributes significantly to income inequality and wealth disparity.

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Albina Opportunities Corporation ["AOC"] was formed in 2008 by a group of successful Portland business and professional individuals who, based on their experience in the sector, believed that the Portland and Oregon community could benefit greatly from a non-profit, non-bank lender to small family-owned businesses in Portland's underserved communities. Backed by those individuals, and by grants and loans from several leading Oregon foundations, AOC has made loans of between $30,000 and $200,000 to small businesses seeking to expand, and hire more employees, but that cannot obtain needed funds from other sources. AOC also provides business advisory and technical assistance free to its clients. As a mission-driven lender, AOC is certified by the US Treasury as a Community Development Financial Institution ["CDFI"]. During its nearly six years of operation, AOC has made 55 commercial term and lines-of-credit loans, averaging approximately $80,000 in size, with interest rates of 8.25% to 9.75% annually. As loans are repaid, AOC re-loans its funds to others.

With its loan and advisory services, AOC creates opportunity for its clients to help themselves and their communities; AOC does not make grants or hand-outs.

Most businesses are small businesses and are the backbone to building stable families and sustainable communities. Over 90% of businesses in Oregon, and a majority of businesses nationwide, are small businesses with less than 500 employees, most of those with less than 50 employees. Small businesses are locally owned by families. If those businesses become strong, the owners and their families have security and stability, and our overall communities are strengthened. Local businesses hire local people, buy local materials, use local business services, and invest profits locally.

If those small, family-owned businesses are not able to expand because they do not have access to capital, their owners are obviously not able to create or increase their wealth, and thus income and wealth inequality grows.

Most employees are hired by small businesses and access to credit creates jobs. Over 65% of Oregon employees, and a majority of employees nationwide, are employed by small businesses. A recent study, reported from data on YourEconomy.org, showed that very small businesses grew employment greater than any other segment of the Oregon business community.

Between 2009 and 2014 AOC made loans to 50 businesses who employed just over 320 people at the time of the loans; "tracking" reports demonstrate that as a result of AOC's loans at least 470 new jobs were created, more than double the number previously employed. For every $8000 loaned, a new job was created. As these are loans, not grants, our lending is re-cycled into additional loan funds once they are repaid, and even more jobs are created.

Small businesses are credit-worthy. In nearly 6 years of operation, and despite lending to small businesses who could not obtain credit through other channels and who operate in low and moderate income communities, *AOC has not lost $1 in principal.*

Approximately 30% of all AOC loans have been pre-paid before they were due as a result of the wealth borrowers have created obtaining credit from AOC.

There is huge demand from established and credit-worthy small businesses for commercial loans. AOC does not make loans to "start-up" businesses, but only to small businesses with proven track records. AOC has not undertaken any advertising or marketing campaign because it has found there is far more demand for its loans than it can make. To be eligible for a loan from AOC, a client must be able to demonstrate that he/she was not able to get the funding from a traditional lender [e.g., a bank]. Although AOC has now only approximately $2.5 million in assets, it has had a pipeline at any particular moment of about $1 million of qualified borrowers seeking loans from AOC. AOC believes that this state of affairs is not unique to it, and that the demand for credit-worthy small business lending is enormous and unfulfilled.

Lines of credit are particularly important, but challenging to obtain. In part, this is because the lender must put aside funds greater than those actually being borrowed in case the borrower decides to more fully utilize its line of credit. Lines of credit also require more ongoing servicing costs, as a result of irregular and continual increases and decreases in utilization. Yet, lines of credit are extremely important to small businesses, particularly to small but expanding contractors, who, for example, may have lucrative contracts that pay off in 90 to120 days after work is done, but who will have to meet payrolls every two weeks in the interim.

Small businesses cannot obtain adequate credit from banks. As a consequence of the 2008 Financial Crisis, there is increased consolidation and concentration of banking. For example, it is reported that now five banks have over 50% of all bank deposits nationally, whereas prior to 2008 the five largest banks had 30% of deposits. Large banks have highly structured loan qualifications and decision-making is in distant locations, with little flexibility locally. Smaller banks were particularly hard hit by the Financial Crisis. As the economy has picked up, smaller community banks have increased their lending, but not commensurate with the growing financial needs of expanding small businesses.

Underwriting, origination and servicing costs of loans favor making larger loans, especially for the larger banks. National or regional borrowers are frequently viewed by lenders as more prestigious, with more credit-worthy collateral, and national or regional audited sales and earnings data, than a small family-owned business, whose collateral is local, and whose sales and other data is usually unaudited. The disinclination to make a loan may especially be true if the potential borrower is owned by a member of a sub-culture in America different from a loan officer.

AOC's borrowers must demonstrate they have not been able to obtain the requested loan from a traditional bank in order to be eligible for a loan from AOC. While some large national banks are now making "cookie-cutter" $50,000 term loans, term commercial loans between that amount and up to $1 million are very difficult to find in the Portland Metro area, and there are virtually no lines of credit up to $350,000 being issued for businesses in Portland unless the borrower has a high credit score and/or real estate equity as collateral.

This contrasts with traditional business lending which considers the small business' cash flow, accounts receivable, and overall business in deciding whether to extend credit and not simply look to real estate as collateral.

As the economy has turned a corner, small business lending has increased somewhat, but the largest increase has been in the *size* of *individual* small business loans: for instance, the recent Oregon Capital Scan disclosed that between 2012 and2013 the *number* of SBA 7(a) individual loans made in Oregon increased about 10% [and SBA 504 loans actually decreased 20%] but the *size* of the average 7(a) loan increased about *30%* to an average loan of $397,508. There are very few SBA-guaranteed commercial loans less than $200,000, and without an SBA guarantee, there are even fewer.

As a non-profit lender, our goal is not to compete with banks, but simply to support the communities in which we operate. We would be pleased to see banks do more small business lending, which has traditionally been the bread and butter of traditional banking. Indeed, the insurance provided by the FDIC for bank deposits was meant to support banks' ability to lend, especially to small businesses. We believe that more needs to be done to ensure that banks of all sizes are ready, able, and willing to do the hard work of making quality loans to credit-worthy small businesses. And, if not, more needs to be done to support non-bank lenders to fill that space.

Small business access to capital reduces income inequality. We would like to give you a glimpse of a typical client of AOC. An African-American who owns a trucking and earth moving company that needed a line of credit in 2010 to expand his business. A previous bankruptcy prevented a loan from a conventional lender. AOC agreed to provide a secured $100,000 credit line, allowing the business to obtain larger contracts and hire more drivers. In the last year prior to his loan in 2010, the client had total revenues of about $750,000 and had 10 employees. By 2013, the company employed 26, revenues had increased *six*-fold to $4.75 million and the owner's equity and wealth had nearly tripled. That company is now a preferred subcontractor to several of the major general contractors in Oregon.

As you can see from the story of AOC, access to capital is one of the most powerful ways to combat income inequality and create middle class job opportunities. We appreciate your interest in the topic of income inequality and hope that more attention can be paid to the pressing need to increase opportunity through access to capital for small businesses.

Sincerely,

N. Robert Stoll
Co-Founder, and Chair of AOC Capital Committee

Terry L. Brandt
Executive Director

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