TESTIMONY OF
BRADLEY R. SCHILLER
JOINT ECONOMIC COMMITTEE
FEBRUARY 28, 2007
WASHINGTON, D.C.

I come before you today to praise income instability not to bury it. The United States would have a far less vibrant economy if incomes were stable. We'd look and behave more like the French than like the entrepreneurs of Silicon Valley.

Members of Congress and academic faculties are fearful of income instability. We both occupy positions with effective lifetime tenure. Members of Congress have a 96 percent re-election rate and so, implicit lifetime tenure. University professors have explicit tenured positions. This gives us both a lot of license. Members of Congress can take bribes, evade taxes, and even commit manslaughter without losing their job, their income, or their pensions. University professors can do pretty much the same thing. That's one of the virtues of income and job stability.

There's a downside to income stability too, though. Job security often dulls efficiency, innovation, and entrepreneurship. People in secure positions—with guaranteed incomes and benefits—don't have to be as responsive to their customers or their constituents. They are also less likely to take chances on new ideas, new products, or new technologies. A

“stable” income, after all, implies not only little risk of income loss, but also little prospect for income gain. So why pursue a new idea if there’s no payoff? Just stay put, follow the established order and you can count on job stability and income security.

Lets look outside the halls of Congress and the University to see how the rest of America grapples—and prospers from— income instability.

Job Flows

Wal-Mart hires dozens of new workers every day. Maybe you’re not a fan of the Wal-Mart employment model. Well, then, how about Google? They hired over 2000 new workers last year alone. Genetech also hired 2000 workers last year. XM and Sirius Satellite have taken on over 1000 workers in the last couple of years. The healthcare industry as created 3.5 million new jobs in the last 10 years; schools and colleges have added another 2 million jobs.

So who filled all these jobs? A couple of million workers enter the labor force every year. But most of these labor-market entrants are teenagers and immigrants. They might get some of those jobs at Wal-Mart, but they probably didn’t fill many of those jobs at Google, Genentech or

XM Satellite. Those companies want employees with experience, demonstrable skills, and employment references.

So where do growing firms and industries get the workers they need? For the most part, from firms and industries that aren't doing so well. Workers have lost thousands of telephone company jobs in the last ten years. The auto industry is now shedding tens of thousands of workers. With the downturn in housing, a lot of real-estate brokers and mortgage lenders are re-thinking their career choices.

Is all this job mobility good for the economy? Absolutely. Consumer tastes, production technologies, product innovation, and global competition are always changing. To respond to those changes, we've got to be fast on our feet. Specifically, we've got to be able to move capital and workers out of one set of industries and into another set of industries. That resource mobility is a prerequisite for productivity advance and output growth. Without such mobility, our incomes might be more stable, but they'd also be lower.

Fear of Falling

I know you've worried about the individuals who are part of this process—the workers who lose their jobs as a result of plant closings and job

layoffs. That's a legitimate concern for public policy. But we should keep our eye on the big picture even as we reach out to help displaced, dislocated, and otherwise unemployed workers. For the most part, the workers who move from one industry to another end up better off in the long run. Holding onto a job in a declining industry isn't the path to prosperity. Far better to get a toehold in an industry where jobs and wages are growing. As we seek to provide a safety net for unemployed workers we've got to be sure we're not discouraging workers—or their employers—from grasping that toehold.

Remember the French riots of last Spring? French workers have always had something akin to job tenure. Even new entrants into a firm are pretty much guaranteed a lifetime package of income growth, fringe benefits, and a generous pension. What sparked the riots in Paris and its suburbs last year was a proposal for more resource mobility. Specifically, the proposed law would have given French employers the legal right to fire newly hired workers under age 26 for any reason within the first two years of employment. French youth viewed this as a threat to their income security—and took to the streets. A good many of them have stayed in the streets, since French employers are reluctant to shoulder the upfront cost of hiring young workers. Youth unemployment in France hovers around 24

percent, more than twice U.S. levels. The French economy is growing half as fast as the U.S. economy, with average incomes 25 percent below American levels. How many Americans would trade American income prosperity for French income stability?

Upward Mobility

Income instability sounds pejorative. But we mustn't forget that instability includes both upward movement and downward movement. Winning a Powerball jackpot generates an enormous amount of income instability—and an ocean of envy. The high school dropout who advances from a minimum-wage job at McDonalds to a better job at UPS also experiences welcome income instability. So does the welfare mom who becomes a sales clerk at Wal-Mart.

So the concern over "income instability" isn't really about instability per se, but instead about the single dimension of income losses, i.e., downward instability. The issue boils down to the adequacy and efficiency of the social safety net that is intended to cushion income falls.

Time-Limited Aid

For the most part, the U.S. social safety net is woven from time-limited income transfer programs. Regular, unemployment insurance benefits are available for a maximum of 26 weeks. TANF welfare benefits are available for a lifetime maximum of five years. By putting time limits on such benefits we are implicitly recognizing the importance of keeping people in the job market, where the best chances for upward mobility reside. Providing wage insurance, unemployment benefits, trade adjustment assistance, or welfare for longer periods reduces incentives for seeking new opportunities in the labor market. Such extended benefits are an important explanation for the higher unemployment and lower average incomes in France and most of Europe. Our shorter time limits and lower benefits strike a more dynamic balance between equity (safety net features) and efficiency (economic incentives).

Business Income Instability

If we're going to worry about income instability, we ought to look also at the dynamics of business instability. Over 50,000 new businesses are started each year in the United States. These start-ups are the wellspring of some of our greatest innovations, new products, and technological advance.

Most of these start-ups are little more than the inspirations of a lone entrepreneur or the aspirations of an ambitious household. A good many of these upstarts will fail, often with devastating financial results for their owners and investors. Should we be extending “profit insurance” to entrepreneurs? Probably not. Collectively, we seem comfortable with the notion of business income instability. We even seem to regard that income instability as a productive source of innovation and growth.

Middle Class Dynamics

Much of the concern for income instability originates in perceptions of middle-class stagnation. The media ceaselessly depicts a “disappearing middle class,” the result of a surge in inequality that leaves America a divided nation of rich and poor. The “rich get richer while everyone else gets poorer” is a popular mantra. That perception is not entirely consistent with the facts, however.

If you look only at median household incomes, its easy to see why people get the wrong impression about the middle class. According to the Census Bureau, the inflation-adjusted median income for U.S. households was

$46,326 in 2005

47,599 in 2000

43,366 in 1990

39,739 in 1980

These numbers suggest that middle class incomes have fallen over the last 5 years and risen by only 0.5-0.6 percent annually over the last 15-25 years.

There is no dispute about the Census statistics themselves. What is controversial is what the numbers tell us about the typical household. Is the typical U.S. household just barely clinging to its middle class existence? Or are there other forces at work here?

Population Dynamics

One force that helps explain the income statistics is population growth. Just since 2000, the U.S. population has increased by over 18 million people. Nearly half of that growth comes from immigrants, both legal and illegal. According to the U.S. Labor Department, nearly half of the growth in the U.S. labor force has come from foreign born workers, most of whom take low-wage jobs. What this means is that the flow of new households is heavily concentrated in the lower end of the income

distribution. This "bottom-heavy" population growth puts a damper on the level of <u>median</u> household income.

As a result of this bottom-heavy population growth a stagnant <u>median</u> income need not imply stagnant or falling individual incomes. Think of the people lined up for concert or baseball tickets. Individuals move up the line as tickets are purchased. But new people keep coming. So the line never gets shorter, even though individuals are advancing.

Something similar happens with the distribution of income: People keep entering the distribution line from the bottom. Even though individuals are moving up the line, the middle of the line never seems to move. Hence, an unchanged—or even receding—median marker could co-exist with individual advancement. The people who <u>were</u> at the middle marker before have moved up the distribution line.

The same thing happens at colleges that open their doors wider. As enrollments grow, the median SAT score may decline, even though no student is less accomplished than he or she was before. The same thing happens when a Harvard student transfers to American University and the average SAT score rises at both schools. The change in the median tells us nothing about changes in individual performance.

Changing Household Composition

Another factor distorting our collective view of income dynamics is the changing composition of American households. The Census Bureau defines a household as one or more persons living under the same roof and sharing kitchen facilities. In 1980, 74 percent of all households were actually families of two or more persons. Today, only 59 percent are families. Economic growth over the last 25 years has enabled GenXers to move out of the family home and establish their own household. Rising incomes and employment opportunities for women have also encouraged delayed childbirth, fewer children, and single-parent households. Senior citizens too, have used rising income and asset values to establish their own residences. These residence shifts depress median incomes. But those same shifts are a symptom of affluence, not of income deterioration.

These demographic changes suggest that even an actual decline in median or average household income need not signify lower living standards. When you look at the big picture—the really big picture—it is apparent that living standards are rising. Just since 2000, real GDP has risen by 18 percent while the population has grown by 6 percent. So per capita incomes have clearly been rising.

Some people would have you believe that all of this added income was funneled to the rich. But the math doesn't work out. The increase in nominal GDP since 2000 amounts to nearly $4 trillion. If you assume that all that money went to the wealthiest 10 percent of U.S. households, that bonanza would come to a whopping $350,000 per household. Yet, according to the Census Bureau, the top 10 percent of households has an average income of only $200,000 or so. Where is the "extra" $350,000 they allegedly got? The implied bonanza is so absurd that the notion that only the rich have gained from the economic growth can be dismissed out of hand! Clearly, there is a lot of economic advancement across a broad swath of the population.

Rising Consumption

That broad swath of economic advancement shows up in personal consumption. According to the Labor Department personal consumption spending has risen by $2.5 trillion since 2000. More Americans own new cars and homes today than ever before, despite modest slowdowns in both industries. Ipods, camera phones, and flat-panel TVs are fast becoming necessities rather than luxury items.

The point of all these observations is that the average American household is doing pretty well. Certainly well enough to reject the notion of income stagnation across the vast middle class and also well enough to appreciate the phenomenon of upward income instability.

I don't mean to suggest here that everything is coming up roses for every American household. Inequality and income deprivation are still very real problems for millions of American households. But it's better to approach these problems from a factual perspective than the hyperbole of middle-class stagnation.

Poverty Dynamics

We should shed the same factual light on the hyperbole concerning America's poverty population. Here again, the facts do not match popular perceptions. The notion that "the poor are getting poorer" seems etched into the media's internal processor.

The foundation for that perception is Census data that reveal a shrinking income share for low-income households. The bottom 20 percent of households got

4.2 % of total income in 1980

3.8% in 1990

3.6% in 2000

3.4% in 2005

Evidence on the shrinking incoming share of the poor should not be confused with receding income levels. Even if one accepts the Census data at face value, they do not depict worsening deprivation. Although their percentage share of the pie may be shrinking, the size of the slice received by the poor keeps getting larger. In 1980, 4.2 percent of America's $5.16 trillion output (in constant dollars of 2000) amounted to $217 billion. In 2005, the smaller 3.4 percent share amounted to $375 billion. So the absolute size of the low-income slice grew by 73 percent. Over the same period, the population of the lowest quintile grew by only 30 percent. Here again, the math is compelling: living standards have risen substantially among low-income households, despite increases in income inequality. So we must reject the notion that the poor are getting poorer.

Income Mobility

The economic situation among low-income households is not adequately conveyed by this increase in statistical averages. A much more meaningful picture emerges from the observed mobility—income instability, if you will---of individual families.

The same kind of population dynamics that affect measured median incomes also impact poverty statistics. In fact, the impact may be greater. Think about the families that were counted as "poor" in 1980. Where are they now? Most of the elderly poor from that year are now dead. The younger families of that year have changed as well. The children have grown up and established their own households. The teenage moms of 1980 are now middle-aged, with few if any children to care for. Life goes on. In the process, the composition of the poor population changes.

Just because the same number of people are poor each year doesn't mean the same people are poor every year. The poverty statistics are similar to emergency room statistics. Every time you visit the emergency room you'll see people bleeding. But that doesn't mean the same people are bleeding continuously. People move in and out of emergency rooms just as households move in and out of poverty.

Even over very short periods of time there is tremendous turnover in the poverty population. Census data reveal that 1 out of 6 Americans will experience poverty for at least two consecutive months over a four-year period. But fewer than 1 out of 50 Americans will stay in poverty for as long as four years. Hence, persistent poverty is by far the exception rather than the rule. Close to half the people in poverty in a given year won't be

poor in any of the following three years. Thankfully, most of the patients bleeding in the emergency room don't come back.

If households are exiting from the poverty population with such frequency, how come the poverty rolls don't shrink? Census data show that the official poverty population has been in the narrow range of 32-37 million people for the past 25 years. So the number of people entering poverty must roughly match the number exiting from poverty each year. Where are they coming from?

We've got a constant flow of immigrants, for starters. Well over a million immigrants – both legal and illegal – enter the country each year. Most come in at the lowest rungs of the economic ladder, working for the minimum wage or less. The household poverty rates among immigrants are twice as high as those of non-immigrants.

Then we've got 3 million or so low-achieving kids dropping out of high school each year. And more than a million births a year to single moms, about a third of whom are teenagers. On top of that, add more than a million divorces every year that often devastate someone's finances. Then there are the persistent scourges of death, disability and illness – all of which throw families into poverty, often without warning. Finally, there's the economy, in which constantly shifting demands, costs and technology create

a continuous profusion of winners and losers. So there's always a flow of new faces into the poverty ranks.

The reality of our poverty population is constant churn. Sure, this reflects a lot of income instability. But the net change is positive – that is to say, there is net movement out of poverty and up the income ladder. This has to be regarded as a good thing. Moreover, unless we learn how to control all of life's vicissitudes – births, illnesses, divorces, job layoffs, etc. – such income instability is also inevitable.

Minimum Wage Workers

Perhaps no group manifests the virtues of income instability better than minimum-wage workers. Most minimum-wage workers are young people taking their first paid job. New immigrants also gravitate toward minimum-wage jobs. But neither group stays at minimum-wage jobs very long. Minimum-wage jobs have two salient characteristics. The first, and most obvious characteristic, is low wages. Wages so low that they can't possibly support a family. But there a second characteristic that is relevant here – turnover. Ask any fast-food manager or other low-wage employer what their greatest labor problem is and the answer is always the same: turnover. Once minimum-wage workers accumulate some job experience

(including a resume and employer references), they move on to better jobs. It's the emergency-room phenomenon again. We may have a constant stock of minimum-wage jobs, but a stream of different workers keeps flowing through them.

Research shows how brief most minimum-wage experiences are. One out of three minimum-wage entrants moves entirely into higher-wage strata within the first year. Sixty percent surpass minimum-wage thresholds within two years. Only 1 out of 6 minimum-wage entrants still have <u>any</u> minimum-wage experience after three years. Here again, upward mobility is pervasive – and welcome.

Policy Implications

These observations about the middle class, the poor, and minimum-wage workers all have a common theme – namely, that income instability is a common phenomenon <u>and</u> that it might not be as devastating as presumed. For the most part, the economic deprivation that can result from income instability tends to be a relatively brief experience. Moreover, the patchwork of safety-net programs now in place appear appropriately targeted to those time-limited problems. No, we haven't solved all our poverty and inequality problems. But before anyone jumps on the "income instability"

bandwagon, we should exercise some caution. In particular, we should ask whether any new policy responses to income instability might impose unintended costs. Of special concern are programs or policies that raise hiring costs for employers or reduce work incentives for workers. Either phenomenon may increase income stability but reduce income levels.