



# The Middle-Class Squeeze

A Picture of Stagnant Incomes, Rising Costs, and What We Can Do to Strengthen America's Middle Class

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Edited by Jennifer Erickson September 2014



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Chapter 1

# Introduction and summary



# Introduction and summary

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## Why the middle-class squeeze matters

The American middle class is in trouble.

The middle-class share of national income has fallen, middle-class wages are stagnant, and the middle class in the United States is no longer the world's wealthiest.<sup>1</sup>

But income is only one side of the story. The cost of being in the middle class—and of maintaining a middle-class standard of living—is rising fast too. For fundamental needs such as child care and health care, costs have risen dramatically over the past few decades, taking up larger shares of family budgets. The reality is that the middle class is being squeezed. As this report will show, for a married couple with two children, the costs of key elements of middle-class security—child care, higher education, health care, housing, and retirement—rose by more than \$10,000 in the 12 years from 2000 to 2012, at a time when this family's income was stagnant.

As sharp as this squeeze can be, the pain does not stop at one family, or even at millions of families. Because of the critical role that middle-class consumers play in creating aggregate demand, the American economy is in trouble when the American middle class is in trouble.<sup>2</sup> And the long-term health of the U.S. economy is at risk if financially squeezed families cannot afford—and smart public policies do not support—developing the next generation of America's workforce. It is this workforce that will lead the United States in an increasingly open and competitive global economy.

This report provides a snapshot of the American middle class and those struggling to become a part of it. It focuses on six key pillars that can help define security for households: jobs, early childhood programs, higher education, health care, housing, and retirement. Each chapter is both descriptive and prescriptive—detailing both how the middle class is doing and what policies can help it do better.

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## Defining the middle class

Statistically, when we talk about the middle class, we generally mean the middle three quintiles of American households by income—those making between the 20th and 80th percentiles of the income distribution. In reality, however, being middle class in America is at its core about economic security. As Sen. Tom Harkin (D-IA) wrote in the 2011 report “Saving the American Dream,” “Most of us don’t expect to be rich or famous, but we do expect a living wage and good American benefits for a hard day’s work.”<sup>3</sup>

At the Center for American Progress, our work has focused on the importance of both strengthening and growing America’s middle class. So while the middle three quintiles will always be just that, it is our goal to ensure that as many Americans as possible have the cornerstones of the American Dream, including access to education, health care, housing, and the ability to retire.

So even as this report measures what has been happening to the middle class, we articulate our hopes for all Americans. To be clear, having more than 46 million Americans in poverty is both contrary to our national character and to our economic aspirations.<sup>4</sup> So too is having millions of young people unemployed and underemployed<sup>5</sup> and 11 million aspiring Americans living in the country without legal status.<sup>6</sup>

Having more workers in good jobs—who have access to good education; affordable child care, health care, and housing; and the ability to retire with dignity—is our clear objective. The closer we get to this reality, the better it will be for all of our families and the sustainable growth of our economy.

What’s more, we know that areas with larger middle classes and less inequality also have more economic mobility.<sup>7</sup> And opportunity is what America is about: 97 percent of Americans believe that every person should have an equal opportunity to get ahead in life.<sup>8</sup> We all have an interest in a strong and growing middle class.

## Squeeze part I: A snapshot of incomes

When we think about the golden age of the American middle class, we often think of the decades following World War II. To be sure, the mid-20th century legislated unequal treatment and therefore limited opportunities for many Americans, but even with that marked and deep-rooted inequality, the economic statistics from that period tell a story of growing wealth and security for America's middle class.

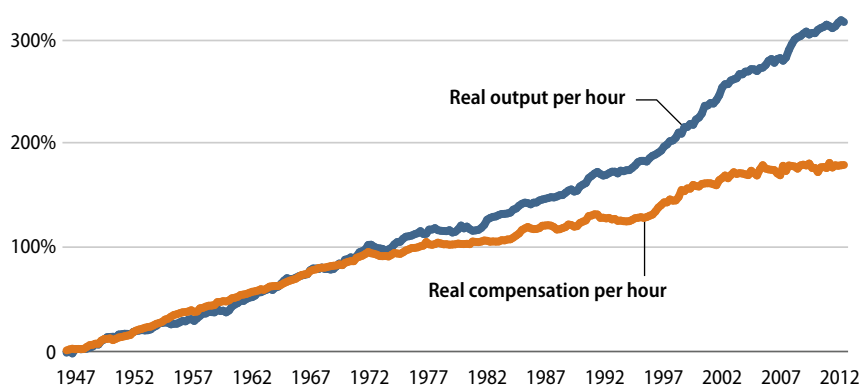
From 1948 to 1973, America experienced a period in which growing compensation tracked growing worker productivity: A worker in 1973 was almost twice as productive as a worker in 1948 and earned nearly twice as much.<sup>9</sup> This golden age built the middle class as prosperity was increasingly shared. The economy grew by an average of 3.9 percent from 1948 to 1973,<sup>10</sup> and the bottom 90 percent of families reaped 68 percent of the gains.<sup>11</sup>

However, around 1973, American productivity growth slowed, increasing about half as quickly between 1973 and the early 1990s as it had during the previous 25 years.<sup>12</sup> Furthermore, compensation started to decouple from productivity, growing about one-third as quickly as before.

FIGURE 1.1

### The decoupling of employee compensation and productivity

Cumulative change in compensation and productivity per hour



Source: Bureau of Labor Statistics, "Real Output per Hour", available at <http://research.stlouisfed.org/fred2/series/OPHPBS>, (last accessed July 2014); and Bureau of Labor Statistics "Real Compensation per Hour," available at <http://research.stlouisfed.org/fred2/series/COM-PRNFB> (last accessed July 2014)



As the 1990s tech boom progressed and the economy heated up, productivity accelerated again: Productivity growth from 1991 to 2012 averaged 2.2 percent per year, yet compensation growth only averaged 1 percent per year.<sup>13</sup> A worker today is almost 60 percent more productive than a worker in 1991 but has seen only half of that productivity growth translate into higher compensation. And the vast majority of this wage growth took place toward the end of the 1990s tech boom, as real wages and benefits jumped about 16 percent between 1995 and 2001.<sup>14</sup>

Real compensation growth has slowed further since the start of the 21st century. What's worse, health insurance premiums over this period ate into even modest compensation gains.<sup>15</sup> Therefore, many Americans saw stagnant or declining take-home pay even as productivity continued to rise.

In other words, American workers have been squeezed for decades when it comes to take-home pay, even before 2007 and the Great Recession. The financial crisis and the Great Recession itself then took a catastrophic toll on millions of Americans, as unemployment skyrocketed and trillions of dollars in household wealth vanished. And while the economy has picked up since bottoming out in 2009, and private-sector job growth began to bounce back in 2010, the gains from this postcrash period have been strikingly unequal. Ninety-five percent of all income gains since the start of the recovery have accrued to the top 1 percent of U.S. households.<sup>16</sup>

The trends in rising inequality are also striking when measured by wealth. Among the top 20 percent of families by net worth, average wealth increased by 120 percent between 1983 and 2010, while the middle 20 percent of families only saw their wealth increase by 13 percent, and the bottom fifth of families, on average, saw debt exceed assets—in other words, negative net worth.<sup>17</sup> Families of color have fallen further behind white families in building wealth: A survey that tracked white and African American families between 1984 and 2009 found that the wealth gap between them nearly tripled, from \$85,000 to \$236,500.<sup>18</sup> Homeowners in the bottom quintile of wealth lost an astounding 94 percent of their wealth between 2007 and 2010.<sup>19</sup>

## The importance of the middle class to economic growth

Rising inequality is not simply a question of distribution; it also poses real questions for how our economy operates. The increasing resources available to the wealthiest Americans have created demand for such luxuries as private jets—which creates jobs building those jets—but the declining purchasing power of middle-class Americans means that there is less demand for goods and services more broadly in the economy. A recent analysis showed that giving \$1 to a low-income household produces three times as much consumption as giving \$1 to a high-income household.<sup>20</sup> And it is certainly true that increasing the concentration of wealth means more jobs managing finances and fewer jobs making the goods that middle-class consumers once bought in numbers that drove much of our economic growth.

CAP outlined the economic importance of a strong and growing middle class—and the concerns for our economy from growing inequality—in a 2012 report, “The American Middle Class, Income Inequality, and the Strength of the Economy.” The report details the importance of the middle class to human capital, stable demand, entrepreneurship, and support for institutions.<sup>21</sup>

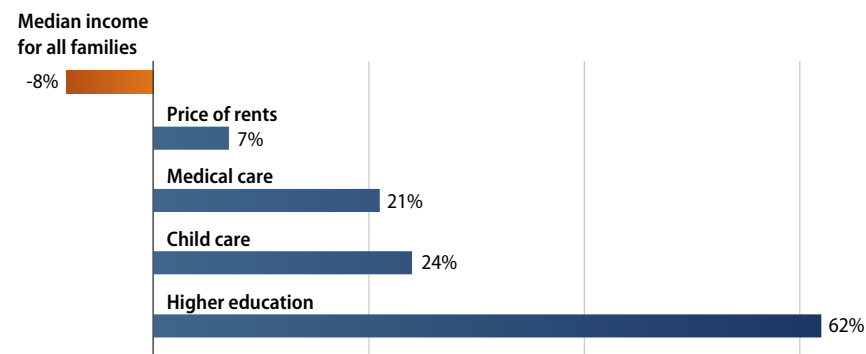
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### Squeeze part II: A snapshot of rising costs

While real incomes have been stagnant or declining in recent years, the other side of the story is the increase in the costs of various items that define a middle-class standard of living. Not only have families’ costs for things from higher education to health care increased rapidly relative to overall consumer inflation, but these costs are also consuming a growing share of family budgets, leaving less and less room for discretionary spending and saving.

When looking at the changes in consumer price indices for core elements of middle-class security, it is painfully easy to see the squeeze in action; prices for many cornerstones of middle-class security have risen dramatically at the same time that real incomes have fallen.

**FIGURE 1.2**  
**Change in median household income and real price of selected goods and services, 2000–2012**



Note: Percentage change in CPI price index for individual components, deflated by CPI-U-RS, from 2000–2013. Income is change in median quintile incomes from 2000–2012 deflated by CPI-U-RS.

Source: Author's calculations based on Federal Reserve Bank of St. Louis, "Economic Research" available at <http://www.research.st-louisfed.org/> (last accessed July 2014); and Bureau of the Census, "American Social and Economic Supplement" (U.S. Department of Commerce, 2000–2012), available at <http://www.census.gov/hhes/www/income/data/historical/household/>.

As stark as the data appear when comparing stagnant or falling incomes to rising prices, they are even worse than the Consumer Price Index above might suggest.

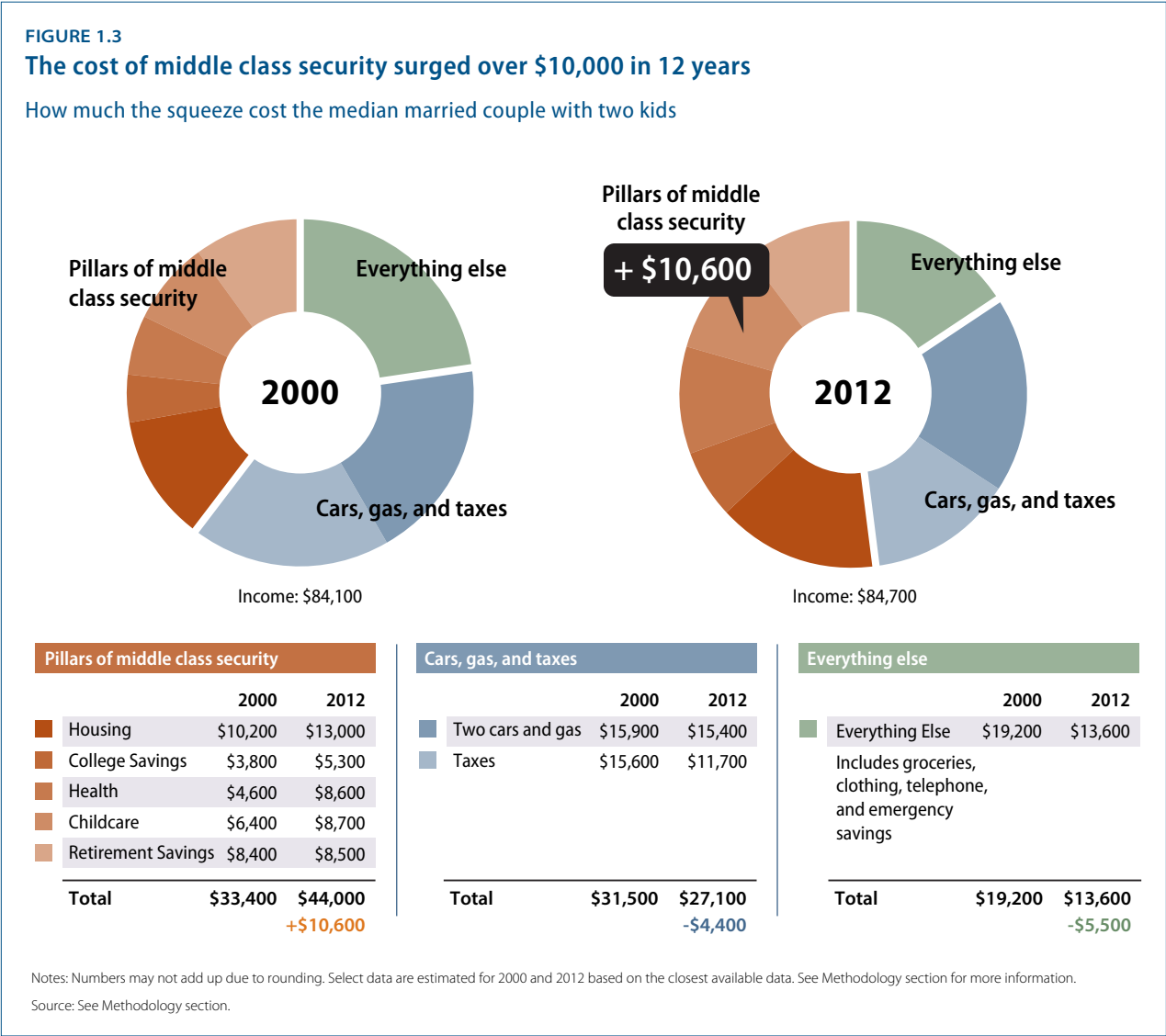
Let's consider what has happened to the finances of a typical middle-class family since 2000.

The median family saw its income fall by 8 percent between 2000 and 2012.<sup>22</sup> Even when we look at just married couples with two children—a type of family that tends to have higher incomes—median income was virtually frozen between 2000 and 2012.<sup>23</sup>

At the same time, this type of family also faced a severe middle-class squeeze as the costs of key elements of security rose dramatically, including child care costs—which grew by 37 percent—and health care costs—both employee premiums and out-of-pocket costs—which grew by 85 percent.

In fact, investing in the basic pillars of middle-class security—child care, housing, and health care, as well as setting aside modest savings for retirement and college—cost an alarming \$10,600 more in 2012 than it did in 2000.

Put another way, in 12 years, this household's income was stagnant—rising by less than 1 percent—while basic pillars of middle-class security rose by more than 30 percent. As the cost of basic elements of middle-class security rose, the money available for everything else—from groceries to clothing to emergency savings—fell by \$5,500. And while for the purposes of this example we have assumed this household kept retirement savings constant, data about worryingly low savings confirm that for millions of families, their retirement funds are bearing much of the pain of the squeeze.



The data paint a clear picture: The middle class is being squeezed. So it should come as no surprise that in a 2014 Pew Research Center survey, 57 percent of Americans responded that they think their incomes are falling behind the growing cost of living, up from 47 percent in 2006.<sup>24</sup> In fact, the percentage of Americans who identify themselves as middle class has fallen to 44 percent, down from 53 percent in 2008.

# Policies to alleviate the squeeze

Understanding that middle-class families are clearly squeezed—with adverse effects on our entire economy—we must craft policies to alleviate the squeeze. This requires two things: growing incomes and containing costs.

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## Jobs

Given that the majority of middle-class families derive their incomes from jobs—as opposed to investments—improving our lackluster jobs picture is the first task to address the middle-class squeeze. To do this, we need to invest in a dynamic economy powered by skilled workers who operate in an environment that lets them and their businesses compete at home and abroad. Doing so will require myriad policies outlined in depth in CAP’s long-term growth strategy, *300 Million Engines of Growth: A Middle-Out Plan for Jobs, Business, and a Growing Economy*.<sup>25</sup> Five areas that would directly help the jobs and income pictures in the shorter term include policies to:

- **Boost aggregate demand**, including through extending federal unemployment insurance; raising the federal minimum wage to \$10.10 per hour; strengthening the Earned Income Tax Credit by expanding it for workers without children and lowering the eligibility age from 25 to 21; and making long-term investments in our economic growth that will also pay dividends now in the form of expanding high-quality early childhood education and infrastructure
- **Foster inclusive capitalism that will see more gains shared with workers**, including through expanding tax incentives that transfer ownership or at least a share of profits from capital ownership to employees; offering grants to regional inclusive capitalism centers; stopping policies that inhibit the growth of sharing programs; and promoting existing best practices through an Office of Inclusive Capitalism

- **Ensure basic workplace protections to maximize workforce participation,** including through developing a federal paid family and medical leave program to ensure working families have access to wage replacement when they need it most, via the Family and Medical Insurance Leave Act, or the FAMILY Act, as well as establishing a national paid sick days standard via the Healthy Families Act
- **Strengthen unions,** including by modernizing the union election process; ensuring that all workers, regardless of their occupation or location, have the right to join a union if they so desire; better protecting workers who choose to unionize by making the right to join a union a civil right; and establishing more meaningful penalties and remedies for workers who are fired or discriminated against for exercising their right to organize
- **Improve education and workforce-development programs,** including a dramatic expansion of apprenticeship programs in high-growth sectors, by creating a \$1,000 federal tax credit for each apprentice hired; establishing competitive grants to support promising apprenticeship partnerships in new high-wage, high-growth occupations; improving apprenticeship marketing to businesses; leveraging the federal workforce and federal contracting to support apprenticeships; and improving the portability of apprenticeships by offering grants for employers to come together to write national guideline standards for apprenticeships in key high-growth occupations

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## Early childhood programs

High-quality early childhood programs—including both child care and preschool programs—are critical for workers with young children who hope to remain in the workforce. Research shows that these programs are also critical educational investments in the children themselves. So with two generations relying on the existence and affordability of high-quality programs, it is critical to address the high cost of child care, which rose dramatically from 2000 to 2012. To do so, we recommend policies that would:

- **Provide high-quality preschool to all 3- and 4-year-olds** through a partnership between the federal and state governments
- **Expand and reform the child care subsidy system,** which is currently insufficient to reach even a majority of low-income working parents, let alone those

struggling to stay in the middle class, by both providing additional resources to help families access high-quality child care and ensuring that child care assistance declines gradually as parents earn more money, rather than cutting off abruptly

- **Reform the Child and Dependent Care Tax Credit** by making it refundable and raising the amount that can be claimed to cover more of the actual cost of child care
- **Expand Early Head Start-Child Care Partnerships** building on the initial investment already made and reaching additional children

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## Higher education

Increases in higher-education costs are a huge part of the middle-class squeeze. These costs affect what parents can do to help their children pay for college and what students can bear in terms of debt as they enter an uncertain job market. What's more, the real and perceived costs of higher-education affect who applies for and who goes to college—representing a real constraint on economic mobility, which carries a cost for individuals and for the economy. To help alleviate the middle-class squeeze in higher education, we propose policies that would:

- **Promote consumer choice** by establishing a student-record system that can be used to create improved consumer-choice tools that highlight outcomes such as graduation rates and labor-market outcomes, and by creating a federal accountability system with institutions placed in broad categories, rather than rankings, which indicate their performance across key metrics
- **Restore public investment in higher education**, including through increasing funding for the Pell Grant program to help low- and lower-middle-income students; creating a competitive federal grant program to support public institutions—matched with state funds—to support state policies that promote on-time completion and that significantly lower the cost of postsecondary education
- **Innovate to bring down costs and improve quality** through increasing support for the First in the World Fund; using experimental site authority to give institutions flexibility from existing federal requirements in exchange for a commitment to implement innovative programs that reduce costs for students; creating an alternative to accreditation where institutions could choose to focus exclusively on improving the learning outcomes of their students; and increasing



investment in research and development.

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## Health care

Access to affordable health care is critical for all American households, and the rising costs of health care in recent decades have kept a basic underpinning of middle-class security out of reach for too many. While the Affordable Care Act, or ACA, has already made a difference for millions of Americans—from the ability of children under age 26 to remain on their parents’ health insurance plans to a prohibition on exclusion from coverage based on pre-existing conditions—more needs to be done to bend the cost curve and to ensure that people have access to high-quality coverage. A single health event should not wipe out a person’s savings. To help lower costs, we therefore propose policies to:

- **Accelerate the use of alternatives to fee-for-service payment** to reduce costs and improve care coordination, with Medicare leading the way by encouraging private payers to participate in alternative payment methods, especially bundled payments
- **Leverage insurance exchanges** to improve access to lower-cost, high-quality insurance products, including through state marketplace officials using their broad authority to exclude low-value plans and reward plans that offer more value to consumers
- **Increase transparency** to allow consumers to choose high-quality, lower-cost providers and services via the Department of Health Human Services, ensuring that the ACA’s requirement to provide cost-sharing information is implemented in a consumer-friendly way. Congress should also modify the ACA’s cost-sharing disclosure requirements so that the plan’s quoted costs for episodes of care are guaranteed
- **Reform restrictive state scope-of-practice laws** to maximize use of nonphysician providers, with the federal government providing bonus payments to states that meet scope-of-practice standards delineated by the Institute of Medicine
- **Address cost shifting to employees** by encouraging employers to share health care savings with employees via more transparency, with employers providing annual notices about how much the employer expects to pay, on average, for

health care benefits per employee, as well as how much the employer expects the employee will spend, on average, for health care during the upcoming year

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## Housing

Having an affordable place to call home is out of reach for far too many families, putting the most basic piece of middle-class security in doubt. New mortgages are at their lowest level in 17 years, millions of Americans still owe more than their homes are worth, and half of all renters spend more than 30 percent of their income on housing. The federal government has a huge role to play in steering the country out of the housing crisis and building a stronger and more equitable housing-finance system. To do so, we suggest policies that would:

- **Require Fannie Mae and Freddie Mac to support a healthier and more equitable housing market** by increasing access to and affordability of mortgages, providing struggling borrowers with better loan modifications that include principal reductions, and capitalizing the National Housing Trust Fund and Capital Magnet Fund
- **Reform the housing-finance system to realign incentives**, enable broader access to affordable and sustainable mortgages, and support the creation of more affordable rental housing
- **Track cash investor activity in the single-family rental market** and monitor its potential impact on tenants, rents, neighborhoods, and homeownership opportunities

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## Retirement

Among the top concerns of middle-class Americans is whether they will be able to afford to retire. Unfortunately for many, saving for retirement has become much more difficult in recent decades as families have struggled to find money to save and as the workplace-retirement-plan environment has fundamentally changed. As incomes have stagnated and as employers have shifted away from pensions to 401(k)-style plans, employees have been forced to shoulder far more risk and to invest what little they can set aside in savings vehicles that are often designed to

take advantage of their lack of investment experience. With approximately half of all American households in danger of having insufficient savings for retirement, we propose policies that would:

- **Encourage the adoption of hybrid retirement plans** such as CAP's Safe, Accessible, Flexible, and Efficient, or SAFE, Retirement Plan at both the state and national levels
- **Increase access to existing alternative savings options** such as the low-cost Thrift Savings Plan which—by allowing all workers the ability to join—would not only give many a chance to save through a workplace plan but also would provide them with access to one of the best 401(k) plans available<sup>26</sup>
- **Require 401(k) and IRA plans to be more transparent about fees and investment practices** through the adoption of a retirement label on all qualified plan options that informs consumers about the high risks of fees and lets them know how the fees in a given plan compare with fees in other plans of the same type<sup>27</sup>
- **Make tax incentives for saving simpler and fairer** by replacing the complex web of tax deductions that disproportionately benefit the wealthy with a Universal Savings Credit that would turn all existing deductions into a single, streamlined credit, as well as by potentially introducing a progressive match for low-income savers' contributions<sup>28</sup>

# Conclusion

To have a strong and growing economy, we need a strong and growing middle class. The longer the middle-class squeeze continues unabated, the more these trends will continue to affect both families across the country and our economic prospects as a nation.

We know what policies would help reverse the middle-class squeeze. Now, we just need to act.

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Chapter 2

# Jobs



## Jobs

### The middle-class squeeze on jobs is real

- 15.5 million people are still out of work as the country struggles to return to full employment following the Great Recession.<sup>1</sup>
- Productivity and wages have decoupled since the 1970s. While wages tracked productivity almost one for one until 1973, since then, wages have increased less than 10 percent while productivity has increased by about 75 percent.<sup>2</sup>
- Middle-class incomes have been stagnant—a situation that is all the more troubling because mothers are working 2.6 times as many hours as they were in 1979, meaning households are working many more hours to essentially maintain their standard of living.<sup>3</sup>



For the median-income married couple with two children, incomes were stagnant from 2000 to 2012. See figure 1.3

### Understanding how we got here

No issue is more central to middle-class security than jobs. Unlike the wealthy—who have more savings, wealth, and investment income—the middle class counts on work to provide income and stability. Yet work doesn't pay like it used to; labor's share of income fell dramatically in the 2000s.<sup>4</sup> The middle 60 percent of Americans' share of aggregate income fell from about 53 percent in the late 1960s to just 46 percent today.<sup>5</sup> It's not that workers have become less productive, it's that they are not seeing the gains from that productivity passed on to them, leading to record corporate profits while workers' wages are often stagnant.

The problems of unemployment are particularly acute for the 5.5 million unemployed Millennials starting their working careers and the 47 percent of new retirees who involuntarily dropped out of the workforce in 2013, retiring years sooner than they might have otherwise due to decreased opportunities.<sup>6</sup>



Depressed incomes—either from stagnant wages or lack of employment—are only part of the story when it comes to the middle-class squeeze. While a dollar goes much further today than it did a generation ago for consumer goods such as big-screen TVs and cell phones, a middle-class lifestyle has always been more about the ability to afford security than the ability to simply buy things, and the cost of security has risen dramatically. Many of these costs of security—from housing to health care—are explored elsewhere in this report. But if the jobs data tell us anything about incomes and unemployment, it is that for millions of Americans, the income side of the ledger is not keeping up with the expenses side. And the income squeeze leads to a retirement squeeze as people are able to save less and less.

## Policy recommendations

Creating and maintaining good, middle-class jobs will require a suite of policies to both invest in our nation's human capital and ensure that the United States is as competitive as possible in a global context; these policies are explored in detail in the Center for American Progress report, *300 Million Engines of Growth*.<sup>7</sup>

In the immediate term, however, there are five things we can do today to support good middle-class jobs and address the middle-class squeeze:

- Increase aggregate demand to stimulate the economy.
- Foster inclusive capitalism so that more gains are shared with workers.
- Ensure basic workplace protections to maximize workforce participation.
- Strengthen unions and empower workers.
- Improve education and workforce development programs, including a dramatic expansion of apprenticeship programs in high-growth sectors.



# Jobs

Since most middle-class workers derive the vast majority of their income from their job—and since too few Americans have incomes that can support the rising costs of basic necessities such as child care and health care—increasing the number of jobs that pay a fair wage is a critical step toward tackling the middle-class squeeze.

This chapter offers a snapshot of the current jobs picture, outlines the implications for America’s middle class, and highlights policies that can help improve the jobs situation—and subsequently, improve the income side of the middle-class squeeze.

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## Current jobs picture

With millions of Americans still out of work, job creation is still a top national priority more than five years after the end of the Great Recession in June 2009.<sup>8</sup> The picture is even more worrying when we consider that on top of the 9.7 million unemployed Americans, millions more have dropped out of the labor force entirely, leaving our labor market with distressingly low labor-force participation rates.<sup>9</sup>

While millions of Americans—particularly the 3.2 million long-term unemployed<sup>10</sup>—are eager to find any kind of job, our standard of what it means to be middle class is broader than just being employed.

After all, 3.3 million Americans earned the minimum wage of \$7.25 an hour or less in 2013,<sup>11</sup> a wage that is already more than 30 percent lower than it was at its inflation-adjusted peak of \$10.69 an hour in 1968.<sup>12</sup> There are also more than 7 million people working part time for economic reasons<sup>13</sup>—meaning they want to work more hours, but employers are not willing to give them more—as well as 7 million multiple-job holders,<sup>14</sup> many of whom are just trying to make basic ends meet.

While the economy has added 9.7 million private-sector jobs since hiring picked up in early 2010, many of the jobs that have come back during the most recent expansion are at lower wage levels than the jobs that were lost.<sup>15</sup> National Employment Law Project analysis shows that nearly 40 percent of the job losses in recent years were in middle-income jobs. In fact, middle-wage jobs have made up only one-quarter of the employment growth, while low-wage industries, such as food services and retail, have shown the strongest employment growth, at 44 percent. All told, there are 1 million fewer good middle-class jobs today than at the start of the recession.<sup>16</sup>

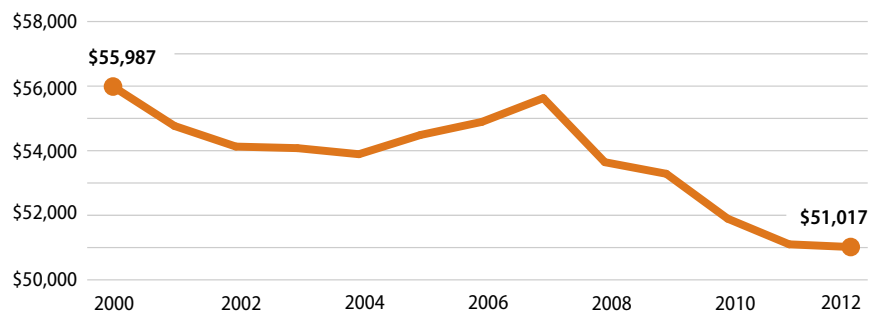
This is part of a longer-term trend that has seen median household income decline in real terms since 2000.<sup>17</sup> So while American workers are more productive,<sup>18</sup> real median incomes have still fallen.

How do we ensure  
that more people  
in the labor force  
are getting good,  
middle-class jobs?

**FIGURE 2.1**

**Median household income has declined over past decade**

Real median household income in the United States, 2000–2012



Bureau of the Census, "American Social and Economic Supplement," (2001–2012), available at <http://www.census.gov/hhes/www/income/data/historical/household/>.

So the basic employment challenge for the 21st century economy is how do we ensure that more people in the labor force are getting good, middle-class jobs?

## The labor-market situation for key groups

In addition to understanding top-line numbers about the current U.S. jobs market, it is also critical to understand how the effects of the Great Recession—plus decades of changes from technology to globalization—have affected different communities. What follows is a list of key facts that paint a picture of what is happening in the jobs market for young people, older workers, women, and communities of color.

### Young people

- There are more than 3.6 million Americans under the age of 25 who are unable to find work, and millions more face the struggle of being underemployed.<sup>19</sup>
- Today's recent high school graduates are unemployed at a rate of 23 percent and underemployed at a rate of 42 percent. Both of these rates have nearly doubled since 2000. Recent college graduates are unemployed at a rate of 9 percent and underemployed at a rate of 17 percent—up from 5 percent and 10 percent in 2000.<sup>20</sup>
- About half of all mothers have their first child before the age of 25,<sup>21</sup> but young workers are much less likely than their older counterparts to have a job that can support a family.<sup>22</sup> Consider that workers under the age of 25 constitute only about one-fifth of hourly paid workers, but they make up about half of those paid the federal minimum wage or less,<sup>23</sup> meaning this low-wage reality affects families across the country.<sup>24</sup>

### Older workers

- Unemployed workers between the ages of 50 and 61 are one-third less likely than younger workers to find a job within 12 months.<sup>25</sup> Workers older than 62 years old are half as likely.
- When older unemployed workers find a new job, they often take a steep pay cut: The median wage for the new jobs of formerly unemployed 50- to 61-year-old men is 20 percent lower than their previous jobs<sup>26</sup>
- Many older workers are having a difficult time staying in the workforce; 47 percent of retirees in 2013 retired earlier than planned.<sup>27</sup>

## Women

- Maternal labor-force participation is falling in the United States relative to other advanced economies, and more than one-quarter of this is due to a lack of family friendly policies.<sup>28</sup>
- The gender wage gap has not seen any improvement during the recovery and the ratio of women's annual earnings to men's annual earnings actually fell from 2008 to 2012.<sup>29</sup> Much of our failure to make progress on closing the gap results from our failure to enact 21st century work-family policies: 10.5 percent of the gender wage gap comes from women's shorter job tenures, at least partially attributable to their greater likelihood of taking time off to provide family care.<sup>30</sup>
- Sixty percent of women's jobs gains in the post-2009 recovery have been in the 10 largest low-wage job categories, compared to 20 percent of men's job gains.<sup>31</sup>

## Communities of color

- African Americans and Latinos persistently suffer from disproportionately high unemployment rates across all different worker characteristics. The unemployment rate of African Americans is typically twice as high as that of whites, while the Latino unemployment rate is about one-third greater than the rate of whites.<sup>32</sup>
- Communities of color—black, Hispanic, and Asian communities—represented 42 percent of minimum-wage earners in 2013 despite the fact that they made up just 32 percent of the workforce.<sup>33</sup>
- Household incomes have fallen drastically for African Americans since the Great Recession. Inflation-adjusted median incomes for African Americans fell by 7.1 percent from 2007 to 2009, faster than for any other population group. Furthermore, inflation-adjusted median household incomes dropped another 4.68 percent from 2010 to 2012, which was faster than comparable income drops for any other population group.<sup>34</sup>

Ensuring that more people—from all communities—have access to good middle-class jobs is key not only to alleviating the economic pressures faced by individual households, but also to improving our economic prospects as a nation. If we had eliminated the racial and ethnic disparities that drive these inequalities, average incomes for everyone would have been \$3,201—or 8.1 percent—higher in 2011, and our GDP would have grown by \$1.2 trillion.<sup>35</sup> Eradicating the gender wage gap would raise working women's incomes by an average of \$6,250, cutting the poverty rate in half and raising GDP by 2.9 percent, or nearly \$450 billion.<sup>36</sup>

# Policies to improve the jobs picture and help alleviate the middle-class squeeze

Good jobs are not created in a vacuum. In fact, we know that one of the key requirements for the creation and maintenance of good jobs is healthy demand. And we also know that a vibrant middle class is key to healthy demand.<sup>37</sup>

If the United States is going to have a healthier economy and grow the largest, most complex, dynamic economy the world has ever seen, we are going to have to do a lot of things right. CAP laid out its long-term growth strategy in *300 Million Engines of Growth*,<sup>38</sup> outlining policies that will help build human capital and also create a more dynamic economic environment. Some of these policies that also relate to the middle-class squeeze—such as access to high-quality preschool education and affordable housing—are addressed in this report. Many more policies that will affect our ability to set the stage for good middle-class jobs in both the short and long term—from enforcing trade rules<sup>39</sup> to comprehensive immigration reform<sup>40</sup>—are dealt with as well in other CAP reports.

This report recommends five key things we can do to support good middle-class jobs today:

- Increase aggregate demand to stimulate the economy.
- Foster inclusive capitalism so that more gains are shared with workers.
- Ensure basic workplace protections to maximize workforce participation.
- Strengthen unions and empower workers.
- Improve education and workforce development programs, including a dramatic expansion of apprenticeship programs in high-growth sectors.



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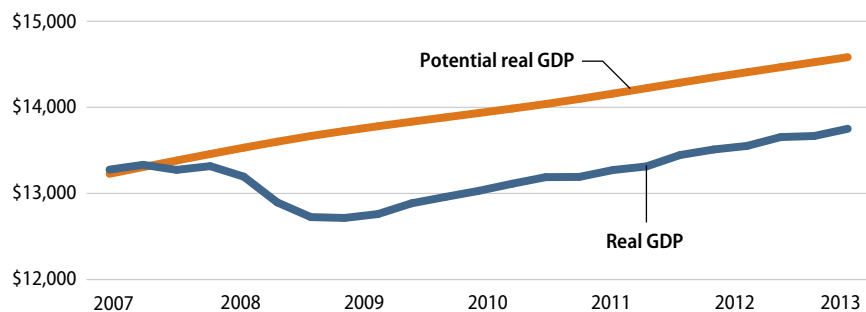
## Boost aggregate demand

Raising aggregate demand may sound a bit technical, but it's quite straightforward: Our economy has the ability to be more productive. Right now, factories are sitting idle and millions of workers are devoting effort to dropping off resumes rather than producing goods. But without enough demand for goods and services, businesses are understandably hesitant to invest. As a result, the country has seen a persistent output gap in recent years that represents lost opportunity for the U.S. economy and American jobs.

FIGURE 2.2

### The GDP gap since the beginning of the Great Recession

Real GDP and potential real GDP, in billions



Source: Lawrence Mishel and others, "The State of Working America, 12th Edition" (Washington: Economic Policy Institute, 2012), updated April 2013, available at <http://www.stateofworkingamerica.org/charts/output-gap-real-gdp-compared-to-potential-gdp-2000-11/>

There are a range of simple, concrete steps the government can take to raise aggregate demand by making smart investments that will create more good jobs for workers while at the same time boosting productivity and America's long-term competitiveness. The following three steps could have immediate effect in boosting aggregate demand.

- **Extending federal unemployment insurance.** The labor market remains depressed, and unemployment not only provides a lifeline to workers as they search for more work, but it is also extremely effective at generating demand in the economy. In fact, the Congressional Budget Office estimated that extending federal unemployment benefits would have created 200,000 jobs in 2014.<sup>41</sup>

- **Raising the federal minimum wage.** Gradually raising the federal minimum wage to \$10.10 an hour from 2014 through 2016 would put \$35 billion into the pockets of 28 million workers. What's more, according to an open letter signed by 600 economists in support of increasing the minimum wage, "the weight of evidence now show[s] that increases in the minimum wage have had little or no negative effect on the employment of minimum-wage workers, even during times of weakness in the labor market."<sup>42</sup>
- **Strengthening the earned income tax credit, or EITC.** In 2013, more than 27 million taxpayers claimed more than \$63 billion in EITC funds.<sup>43</sup> That year, EITC benefits lifted more than 6 million people out of poverty.<sup>44</sup> Strengthening the EITC would be both a powerful signal that Americans value work and a means to increase demand and generate additional jobs while millions of Americans are still looking for work. To do so, we should expand it for workers without children, whose average credit is only one-tenth of what workers with children receive,<sup>45</sup> and also lower the eligibility age from 25 to 21 so that young adult workers can qualify.<sup>46</sup>

Congress should also recognize that there has never been a better time to make long-term investments in America's aging infrastructure, as well as its human capital—the sources of stronger future economic growth. At precisely the time when demand in the economy was low, Congress was cutting nondefense discretionary spending, which is the part of the federal budget that supports many of our most important public economic investments, such as scientific research, education, and infrastructure. Those cuts both hurt demand in the short term, as well as our competitiveness over the long-term. In fiscal year 2014, nondefense discretionary spending was cut by 16 percent from FY 2010 levels, once inflation is taken into account.<sup>47</sup> With the automatic sequestration cuts scheduled to return in full starting in fiscal year 2016, nondefense discretionary spending is on track to fall to its lowest level ever as a share of the economy since 1962—when tracking of this category started.<sup>48</sup> To make the investments our economy needs, Congress must allocate more funding to the nondefense discretionary budget.

These investments work just like any others, we spend money up front—boosting demand in the process—in order to reap gains in the future. For example, we could:

- **Invest in our future workforce.** Some of the most productive investments we can make are in our people. While a record number of children are now in the U.S. school system,<sup>49</sup> we have actually cut teacher numbers by 300,000 since the

Great Recession began, making investment in education all the more critical.<sup>50</sup> Increasing access to high-quality early childhood programs—discussed later in this report—would be a particularly effective investment.

- **Invest in our infrastructure.** U.S. infrastructure currently has a D+ grade from the American Society of Engineers<sup>51</sup> and approximately 800,000 construction workers are looking for work, making this a timely investment. Given that every \$1 billion in infrastructure spending supports between 9,000 to 15,000 direct and indirect jobs, infrastructure investment would help boost demand now while improving future competitiveness.<sup>52</sup> Once the immediate job creation has receded, infrastructure investments continue to provide substantial benefits to the economy for decades to come. Infrastructure projects improve efficiency, reduce unpredictable service disruptions that harm businesses and raise production costs, and provide seamless and timely access to global markets at competitive prices. For example, more than 15,000 trains a year move through the Alameda Corridor rail tunnel, which was completed in 2002 and connects the Ports of Los Angeles and Long Beach with the national rail network; it has allowed for substantial freight and job growth in Southern California.<sup>53</sup>

There are more opportunities for a wide range of infrastructure investments across the country, including for the busiest 59 ports in the United States. These ports support jobs that rely on the continuous and predictable movement of freight. Due to a lack of harbor maintenance, however, the channels reach full depth less than 35 percent of the time, limiting the size and timing of ships that can access certain ports; this limits trade and adds uncertainty to supply chains.<sup>54</sup>

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## Foster inclusive capitalism that will share more gains with workers

When workers share an ownership stake in the companies they work for, research shows that this type of inclusive capitalism leads to positive outcomes for both the firms and the workers.<sup>55</sup> From employee stock ownership plans to profit sharing and broad-based stock options, this can yield measurable dividends. For workers, inclusive capitalism is associated with higher pay, greater long-term wealth accumulation, and greater job stability. For businesses, it often translates to increased productivity, profitability, and lower worker turnover.<sup>56</sup>

In fact, empirical studies have shown that firms that switch to inclusive capitalism arrangements immediately see increased productivity relative to peers; and productivity increases continue for years after implementing the system. Survey evidence suggests that giving workers a voice and tying pay to the success of the firm empowers and motivates workers to share information and suggest improvements, further increasing productivity.<sup>57</sup>

Inclusive capitalism is by no means a new or rare phenomenon in the United States. Today, almost half of all U.S. workers receive some sort of inclusive capitalism compensation—although its use is quite limited in most firms. Companies practicing broad-based inclusive capitalism range from unionized American steel manufacturers to air carriers, leading technology firms to socially minded companies.

Inclusive capitalism has not only been embraced by a wide array of businesses, it can also draw broad political support. A bipartisan list of lawmakers—ranging from Sen. Bernie Sanders (I-VT) and Rep. Chaka Fattah (D-PA) to Sen. Kelly Ayotte (R-NH) and Rep. Dana Rohrabacher (R-CA)—have introduced legislation to expand government support for inclusive capitalism.<sup>58</sup> Historically, President Ronald Reagan called it “people’s capitalism” that “can serve the nation well.” Then-Sen. Hubert Humphrey called profit sharing “one of the twin pillars of our economy.”

It is a particularly important time to promote employee participation in firm ownership, as 70 percent of U.S. business owners are over the age of 45.<sup>59</sup> In other words, with the right information and incentives, there is the potential for a multi-trillion dollar transfer of wealth over the next 20 years. While not all of these companies are necessarily suitable for employee ownership, there is an opportunity to dramatically improve the balance of wealth in the United States by enhancing incentives for owners, particularly of private companies, to transfer ownership or at least a share of profits from capital ownership to their employees.

## Half of American workers receive some form of inclusive capitalism compensation

Inclusive capitalism is already part of the U.S. corporate landscape. In fact, almost half of U.S. workers receive some form of inclusive capitalism compensation, even though it is usually limited.<sup>60</sup> Some examples of inclusive capitalism include:

- The United States Steel Corporation pays quarterly cash profit-sharing payments to its unionized workforce.<sup>61</sup>
- Southwest Airlines' employees own a significant portion of its stock, awarded through their employee benefit plans.<sup>62</sup>
- Intel shares profit with its employees via cash payments and restricted stock options.<sup>63</sup>
- New Belgium Brewing employees own 32 percent of the company via an employee stock ownership program.<sup>64</sup>

To encourage inclusive capitalism, we can:

- **Expand tax incentives.** Under current law, owners of a business receive capital gains tax relief when they sell their shares in the business to their workers, provided the sale meets certain requirements. This has encouraged the smooth transition of ownership to employees. Smooth transitions such as these could be further facilitated by providing partial estate tax relief when the owner's estate transfers the successful firm to an employee stock ownership plan. In another example, under current law, companies circumvent the \$1 million limitation on the deductibility of executive compensation by taking advantage of the "performance-based pay" loophole that allows deductions for grants of company stock as pay. The performance-based pay exception could be limited to companies that include 80 percent of their workforce in the performance pay plan.<sup>65</sup>
- **Offer grants to regional inclusive capitalism centers.** These centers would provide outreach, education, and technical assistance to private-sector businesses on adopting sharing practices. The centers would also encourage companies to adopt supportive workplace cultures that offer workers solid base wages and benefits, as well as a say on the job.<sup>66</sup>

- **Stop policies that inhibit the growth of sharing programs.** Some policies present roadblocks to companies interested in adopting inclusive capitalism approaches, such as policies that render employee-owned companies ineligible for government contracts that are set aside for women- and minority-owned firms, even when the employee-owners otherwise meet the program qualifications.
- **Create an Office of Inclusive Capitalism to increase awareness about best practices.** The office would, for example, encourage business schools to include information on sharing programs in their curricula and highlight existing laws that promote inclusive capitalism such as state benefit corporation laws. These laws offer legal protections to businesses that look beyond short-term financial gains and create a material positive impact on society.<sup>67</sup>

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## Ensure basic workplace protections to maximize workforce participation

One way that middle-class families have reacted to stagnating wages since the 1970s—and resisted the negative effects of that stagnation—has been to increase the number of family members who are employed, also known as their family’s labor supply. Mothers’ full-time labor-force participation has increased dramatically between 1979 and 2012—from 27 percent to 41 percent—which enabled some families to have a higher standard of living through dual incomes, at least for a while.<sup>68</sup> In fact, the only married families that have seen real, inflation-adjusted income growth since the 1970s are married couple families with a working wife.<sup>69</sup>

However, increasing labor-force participation or work hours is no longer an option for most middle-class families. In the majority of families, all of the adults work, and only one in five children now have a full-time, stay-at-home caregiver.<sup>70</sup> This presents two related issues. First, when all adults in a household work, there is no longer someone in the home who can provide unpaid care to young, ill, or elderly family members; subsequently, the high cost of outsourced care creates significant opportunity costs to employment, which are felt most acutely by women. This is exacerbated by the second problem; namely, the fact that our nation’s labor standards have not been updated to reflect this change in family dynamics.

In a subsequent chapter, this report outlines policies that are designed to ensure that all children have access to high-quality child care that is affordable for working families. We must also ensure that workers have the flexibility to care for their families while also progressing in their careers.

Unfortunately, the majority of labor laws reflect an outdated notion of who works in the paid labor force and who provides unpaid care within the home. A lack of policies such as paid leave and workplace flexibility may have made sense in an era when most full-time workers were men with stay-at-home wives, but middle-class families have evolved and our labor standards must do so as well.

The United States is the only advanced economy, indeed one of only eight countries in the world, that does not guarantee working women the right to paid maternity leave.<sup>71</sup> We are also the only advanced economy that does not guarantee workers the right to paid sick days, or any form of paid leave at all.<sup>72</sup> This lack of family friendly policies negatively affects labor-force participation and earnings of women, which in turn negatively affects the economic stability of middle-class families.<sup>73</sup>

To address the needs of working families, we should:

- **Develop a federal paid family and medical leave program.** Building on successful state programs in California, New Jersey, and Rhode Island, the Family and Medical Insurance Leave Act, or FAMILY Act, would establish a federal program to provide up to 12 weeks of partial wage replacement for the same qualifying conditions covered under the Family and Medical Leave Act, which only provides unpaid leave to qualifying workers. A large majority of workers—between 77 percent and 84 percent—would be eligible for the program, ensuring that working families would have access to wage replacement when they need it most.<sup>74</sup>
- **Establish a national paid sick days standard.** The Healthy Families Act would allow workers in businesses with at least 15 employees to earn up to seven paid sick days per year. This leave could be utilized for a worker's own medical needs or to care for an ill family member.

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## Strengthen unions and empower workers

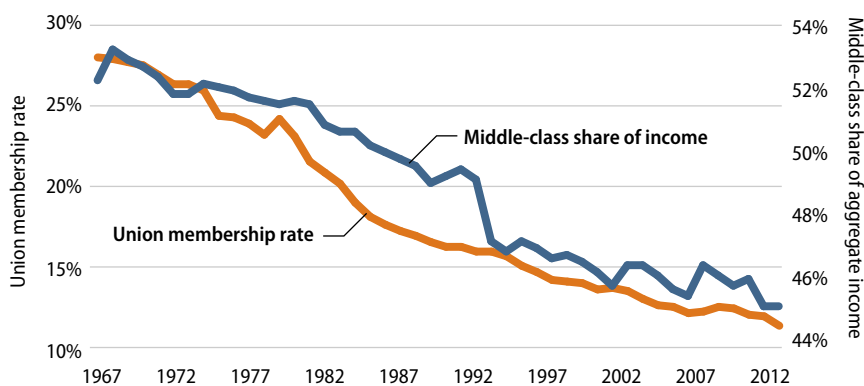
One of the most important, although often overlooked, factors that has contributed to the decline of America's middle class has been the steady decline in labor-union participation over the past several decades. Unions are critically important to the health of the middle class because when unions are strong, they fight for key middle-class interests both in the workplace and in the political arena.<sup>75</sup> As union representation has declined, however, many middle-class workers have found themselves increasingly shut out of the nation's economic gains and struggling to maintain their standard of living.

Research has repeatedly shown that union membership significantly increases the wages that workers receive, as well as their likelihood of having retirement and health care benefits.<sup>76</sup> For example, studies have shown that typical middle-class workers who are union members can expect to earn approximately 14 percent more than nonunion workers, even when controlling for factors such as age, experience, and education.<sup>77</sup> These so-called “union premiums” also tend to disproportionately benefit workers of color.<sup>78</sup> They can even help improve benefits for nonunion workers; when union density is sufficiently high in an area, the bargained-for benefits can set standards for other area employers, including those that employ nonunion workers.<sup>79</sup>

Given how important unions are for protecting middle-class interests and ensuring that workers are fairly compensated, it should come as no surprise that the decline in union membership since the late 1960s correlates strongly with the decline in a key measure of the middle-class’ health: their share of the nation’s total take-home income.

**FIGURE 2.3**

**As union membership rates decrease, middle-class incomes shrink**



Source: Union membership rate is from Barry T. Hirsch, David A. MacPherson, and Wayne G. Vroman, “Estimates of Union Density by State,” *Monthly Labor Review* 124 (7) (2001). Middle-class share of aggregate income is from the U.S. Census Bureau, Current Population Survey (Department of Commerce).

Between 1967 and 2012, nationwide union membership fell from 28.3 percent of all workers to an all-time low of 11.3 percent, with significant drops observed in all 50 states.<sup>80</sup> Over this same period, the share of the nation’s total income going to the middle 60 percent of households fell from 52.3 percent to only 45.7 percent.<sup>81</sup> The majority of the income lost by the middle class was redirected to those at the very top; the share of income going to just the top 5 percent of earners grew from 17.2 percent to 22.3 percent during this time, or more than one-fifth of all income earned in the United States in 2012.<sup>82</sup>



Unions helped build America's middle class, and if they are allowed to continue to decline, America's middle class will likely continue to decline with them. To reverse this decline, we should:

- **Modernize the union election process.** To put an end to needless delays, regulations should be put in place that reduce unnecessary litigation, streamline pre- and postelection procedures, and facilitate communications via the digital mediums workers now depend on.<sup>83</sup>
- **Ensure that all workers who would like to form a union are able to do so.** Regardless of their occupation or location, everyone should have the right to join a union if they desire to do so.<sup>84</sup> Congress should pass reforms to establish a fair process for workers to decide on union representation, expand coverage so more workers are provided the right to organize, and promote productive collective bargaining for first contracts—so that workers can negotiate for improved wages and benefits.
- **Better protect workers who choose to unionize.** Policymakers should establish more meaningful penalties for employers who fire or discriminate against employees for exercising their right to organize, as well as establish more substantive remedies for workers who have been wronged. This includes making the right to join a union a civil right. This would give workers who are discriminated against for exercising their right to organize a private right to sue, just as workers have a right to sue if they face other forms of workplace discrimination.<sup>85</sup>

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Improve education and workforce development programs, including a dramatic expansion of apprenticeship programs in high-growth sectors

Young Americans entering the labor market experience very high levels of unemployment and underemployment. Our education and training system is failing to connect young Americans with good jobs. Millennials are struggling with disproportionately high levels of unemployment, low-wage jobs, rising college costs, and spiraling student debt. Lack of sufficient jobs and jobs that fully utilize the skills of recent entrants to the labor market are keeping young people from getting on the path to a middle-class life.

The United States should invest in worker training that gives young people the skills employers are seeking. This can be done by allowing federal student aid to be used for non-degree programs that have been shown to improve employment outcomes; directing workforce investment funds to programs with demonstrated effectiveness; and creating incentives for employers to partner with community colleges to develop training programs that lead to good jobs. We believe one of the best ways to address the situation for many young people is to dramatically expand the availability of apprenticeships, a form of paid-worker training that leads to good, middle-class jobs.

Expanding access to this effective training model can address many of the challenges young people face in the labor market. Apprenticeships combine on-the-job learning and classroom instruction, and apprenticeship completers earn an average of \$301,533 more in wages and benefits over their careers than comparable workers.<sup>86</sup> And apprenticeships offer young people the opportunity to attain an education with little or no debt, as many programs allow students to earn college credit for their coursework and on-the-job training. Crucially, an apprenticeship offers a young person a job today—not just the hope that a job will be there after they invest in an expensive education.

But even though the U.S. Department of Labor administers a small system of registered apprentices, the training model is unfamiliar to most Americans. This is due largely to a lack of awareness among employers, few of whom understand the benefits and return on investment for apprenticeships. There is no targeted federal funding to help businesses offset the costs of sponsoring an apprentice, nor is there a national marketing effort to make businesses aware of the benefits of hiring apprentices. Fortunately, smart policies can address these challenges.

To address the dearth of apprenticeship programs and to help bring a source of new good, middle-class jobs to America's young people, policymakers should work with businesses to expand the U.S. apprenticeship system both in number of participants and available occupations. To do so, we should:

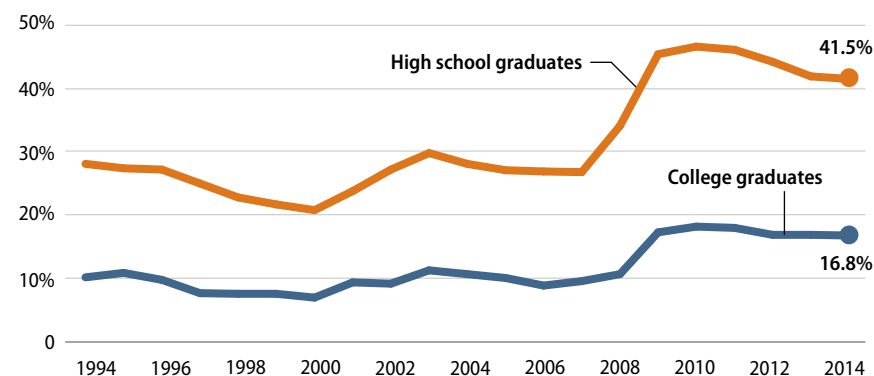
- **Create a federal tax credit for businesses.** Businesses that sponsor apprentices should receive a \$1,000 tax credit for each apprentice hired.
- **Establish competitive grants.** Grants that support the creation of new apprenticeships in new high-wage, high-growth occupations such as health care, information technology, and advanced manufacturing are particularly critical.

An apprenticeship offers a young person a job today—not just the hope that a job will be there after they invest in an expensive education.

- **Improve marketing to businesses.** The White House should work with the Departments of Labor and Commerce to create an employer-friendly website, increase outreach, and launch a national initiative to bring unemployed high school graduates into apprenticeships.
- **Leverage the federal workforce and federal contracting to support apprenticeships.** Establish apprenticeships in federal agencies and preference contractors that offer apprenticeships.
- **Improve the portability of apprenticeships.** By offering grants for employers to come together to write national guideline standards for apprenticeships in key high-growth occupations, we can ensure that apprenticeships meet the needs of employers and offer workers a credential that is truly portable.

FIGURE 2.4

### Combined unemployment and underemployment rate of recent high school and college graduates



Notes: High school graduates include young high school graduates between ages 17 and 20 who are not enrolled in additional schooling. College graduates include college graduates between ages 21 and 24 who do not have an advanced degree and are not enrolled in additional schooling. Underemployment includes those who work part time but want full-time work ("involuntary" part timers) and those who want a job and have looked for work in the last year but have given up actively seeking work ("marginally attached" workers).

Source: Heidi Shierholz, Alyssa Davis, and Will Kimball, "The Class of 2014: The Weak Economy is Idling Too Many Young Graduates" (Washington: Economic Policy Institute, 2014), available at [www.epi.org/publication/class-of-2014/](http://www.epi.org/publication/class-of-2014/).

# Conclusion

In 2000, the median American worker earned \$768 per week. Twelve years later, that same worker still made \$768 per week, even though productivity increased by 23 percent.<sup>87</sup> As the following chapters show, the costs of many key elements of middle-class security rose significantly over this period—from child care to health care to higher education. To alleviate the middle-class squeeze, we have to start by putting policies in place to ensure that more Americans workers are in good-paying, middle-class jobs.

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Chapter 3

# Early childhood

## Early childhood

### The middle-class squeeze in early childhood programs is real

- Child care is a major household expense, comprising 20 percent of the pay for moderate-income families.<sup>1</sup>
- The estimated cost of a high-quality public preschool program ranges from \$6,500 to \$11,000 across the country—a price out of reach for many families.<sup>2</sup>
- Fifty-four percent of 3- and 4-year-olds attend preschool but children in the bottom three income quintiles are least likely to attend.<sup>3</sup>

### Understanding how we got here

High-quality, early childhood programs are a critical component of ensuring that parents can access the workforce. Most children today have either a single working parent or two working parents,<sup>4</sup> meaning that employment is difficult without access to affordable, consistent, high-quality child care. Unfortunately, early childhood programs are neither accessible nor affordable for many low-income and middle-class families.

The annual cost of child care exceeds the median rent costs in every state.<sup>5</sup> Preschool programs are equally costly. Poor and low-income families spend the most on child care as a proportion of their income, making it difficult to put funds toward housing, retirement, and savings that we associate with the middle class. And despite the high cost of child care, quality is low, especially for children of color.<sup>6</sup>



For an example middle-class family of four paying for child care, child care costs rose by 37 percent in 12 years. See figure 1.3



More than half of families with an employed mother depend on parental or relative care for their young children, with one-quarter relying on child care centers. Multiple arrangements are common among families who often must piece together more than one child care provider to cover their work schedule.<sup>7</sup> About half of families in the United States access preschool when their children are age 3 and 4, though there is considerable variation by income; the wealthiest families are more than 40 percent more likely to access preschool than the poorest families.<sup>8</sup>

Publicly funded early childhood programs reach few families and often do not provide access to high-quality programs. Most public programs target low-income families yet fail to reach a majority of the neediest population. And middle-class families often do not qualify for public programs or cannot access them due to underfunding.

## Policy recommendations

High-quality, early childhood programs offer a two-generational approach to middle-class success; children gain additional learning and parents are better able to maintain employment or attend education programs to improve their economic situation.

Here are four things we can do today to address the middle-class squeeze:

- Provide high-quality preschool to all 3- and 4-year-olds
- Expand and reform the child care subsidy system
- Reform the Child and Dependent Care Tax Credit
- Expand Early Head Start-Child Care partnerships



# Early childhood

For middle-class families—and those trying to get there—access to affordable, high-quality child care and early education programs can set them up for success. This is a two-generational approach: continuous access to affordable, quality programs supports employment for parents, while access to healthy development and early learning prepares children for school.

On an average day in the United States, 11 million children spend time in the care of someone other than a parent.<sup>9</sup> Among children under age 6, 65 percent have either a single parent or two parents in the labor force.<sup>10</sup> Child care is a daily reality for most families, without which they could not make ends meet. While child care is typically treated as a work support for parents, the reality is that children begin learning from their environment at birth. During the first few years of life, rapid growth and development lay the foundation for future learning and skills. It comes as no surprise then that researchers have found links between children's developmental outcomes and the quality of child care.<sup>11</sup>

Early learning programs, such as Head Start or public and private preschool programs, typically have the explicit goal of promoting early childhood development and preparing children for school. Many families also rely on these programs to care for children while parents work. These programs can range in quality, but typically have higher standards than what is available in child care programs.<sup>12</sup>

Historically, early childhood programs have been bifurcated, with programs like the Child Care and Development Block Grant focusing on supporting working parents and programs like Head Start and state-funded preschool focusing on child development and school readiness. However, given that we know children are constantly learning from their surroundings and most families need child care in order to work, it makes little sense to think of them separately. We also know that families want their children to be in high-quality settings—regardless of whether the program is called child care, Head Start, or preschool—and that parents want to better their economic situation by working and going to school. And since we have an interest in

both strengthening and growing the middle class, these programs need to be accessible to low-income parents. That means structuring programs so that they provide high-quality early learning environments, cover a full working day (including nontraditional schedules), provide continuous access, and are affordable to parents.

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### Why child care matters: A two-generational benefit

Children who  
attend high-  
quality preschool  
programs earn  
more money later  
in life and are less  
likely to rely on  
public assistance.

When families have consistent access to affordable, high-quality early childhood programs, parents and children benefit.

Given the value we place on economic mobility, we want all children—regardless of parents’ income levels—to have an opportunity to become part of the middle class. But many children today are starting school without the skills they need to be successful. More than half of poor children and 40 percent of near-poor children are not ready for school at kindergarten. This means they could lack early literacy and mathematical skills or they could have learning, behavioral, or physical health issues. Even among moderate- and higher-income families, 25 percent of children are not ready for school.<sup>13</sup> This problem is particularly pronounced for low-income children of color who are most often victims of poverty,<sup>14</sup> but is by no means limited to poor children. Children from middle-class families also lag behind their higher-income peers when it comes to school readiness.<sup>15</sup> Much of the achievement gap that we see in later grades has its origins in the gap that exists at age 5.<sup>16</sup>

Fortunately, high-quality early learning programs can narrow the school-readiness gap. On average, children who attend high-quality preschool programs gain 4 months of additional learning and the highest-quality programs have produced learning gains of 6 to 12 months.<sup>17</sup> While gains are particularly pronounced for children of color, English language learners, and low-income children, middle-class children also benefit.<sup>18</sup> High-quality child care programs are also linked to better cognitive and social skills at kindergarten entry.<sup>19</sup> Over the long term, children who attend high-quality preschool programs earn more money later in life and are less likely to rely on public assistance.<sup>20</sup> Nobel Laureate James Heckman finds that the life-cycle effects of early childhood programs create at least a 10 percent return on investment, which is a higher return than in almost any other policy area.<sup>21</sup>

Access to affordable, quality child care and early education programs also can promote parents’ economic well-being. Data from around the country demonstrate that the lack of child care adversely affects parents’ economic stability. A New York City study found that one-third of families on the waiting list for child care subsidies

either lost their job or were unable to work before they received a child care subsidy. In North Carolina, a similar study found that one-quarter of families waiting for child care assistance lost their job or quit, and in Minnesota, researchers found an increased reliance on public assistance programs among families on the waiting list.

For families trying to break into the middle class or struggling to stay in it, early childhood programs can promote access to the workforce. Child care assistance can help. The benefits of child care assistance are particularly strong for single mothers, who are nearly 40 percent more likely to maintain employment over two years compared to those who do not have help paying for child care.<sup>22</sup>

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## The high cost of early childhood programs

Child care is one of the largest household expenses for most families, which makes it a key component of the middle-class squeeze. In fact, child care is more expensive than median rent in all 50 states. The average cost of child care varies considerably by the type of setting, age of the child, and geographic location, but constitutes a significant and often unaffordable expense. Child care for an infant costs the most, with the average annual cost by state ranging from \$5,000 in Mississippi to \$16,000 in Massachusetts. Child care for 4-year-olds, while slightly less expensive, still ranges from an annual average of \$4,000 in Mississippi to \$12,000 in New York.<sup>23</sup> It is important to note that these prices reflect the average cost of care, but that does not mean families are getting high-quality child care. On average, the quality of child care in the United States is mediocre to poor,<sup>24</sup> but there is certainly variation with some providers offering very high-quality programs.

Preschool costs, which are indistinguishable from child care costs in many cases, are also out of reach for many families. The estimated cost of a high-quality public preschool program ranges from \$6,500 to \$11,000 annually across the states—a price out of reach for many families.<sup>25</sup>

The high cost of preschool and child care squeezes families at all income levels. On average, all families with children under age 5 spend approximately 9 percent of monthly income on child care. Among families living below the poverty level, 36 percent of income goes to child care expenses. Families hovering above the poverty level at 100 percent to 199 percent of poverty spend about 20 percent of their monthly income on child care.<sup>26</sup> The high cost of child care means that families have less money to allocate to housing, retirement, and savings—all of which they need to be firmly in the middle class.

Child care is more expensive than median rent in all 50 states.



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## Access to high-quality early childhood programs

### Child care

While child care centers might be perceived as the most common source of care for working parents, the reality is that, as of 2011, just 25 percent of children under age 5 whose mothers work are primarily cared for in centers. About half of these families use a parent or relative as the primary source of child care. A smaller group—13 percent—use a home-based provider, including family child care and care in the child's home. Ten percent of these children have no regular child care arrangement, which likely reflects the fact that many families have to piece together a patchwork of arrangements in order to work. Nearly 30 percent use multiple arrangements, further indicating that some families struggle to cover their workday.<sup>27</sup>

Most center- and home-based child care in the United States is low to medium quality. A 2005 study measured child care environments and found that just 35 percent of centers and 9 percent of homes were of high quality. Children of color are much less likely to be in high-quality centers and homes.<sup>28</sup>

About 1.5 million children in the United States receive child care subsidies, which provide assistance to families who are working or enrolled in education or training programs.<sup>29</sup> The program reaches just one in six eligible families,<sup>30</sup> and 19 states have waiting lists or frozen intake.<sup>31</sup> Technically, middle-class families are eligible for the program, which caps out at 85 percent of state median income and averages around \$60,000 across the 50 states.<sup>32</sup> However, the reality is that states can only afford to serve the lowest-income families. Even among the families served, subsidy rates are typically too low to provide access to high-quality programs. Additionally, families tend to cycle on and off the subsidy system every few months, which can jeopardize parents' employment stability.

Families may also lose eligibility for child care assistance when they earn slightly more money, risking their access to child care altogether. Many families also need child care during periods of unemployment to allow parents to quickly pursue new employment opportunities. In some states, parents cannot receive child care assistance while they search for a job. When families lose a job and child care at the same time, it only prolongs unemployment and can mean that they lose their place in the middle class.

Some middle- and higher-income families benefit from the Child and Dependent Care Tax Credit, which allows families to claim up to \$3,000 in child care expenses for one child and \$6,000 for two or more children.<sup>33</sup> The tax credit is nonrefundable and primarily benefits middle- to higher-income families, with 60 percent of tax expenditures going to the top two quintiles.<sup>34</sup>

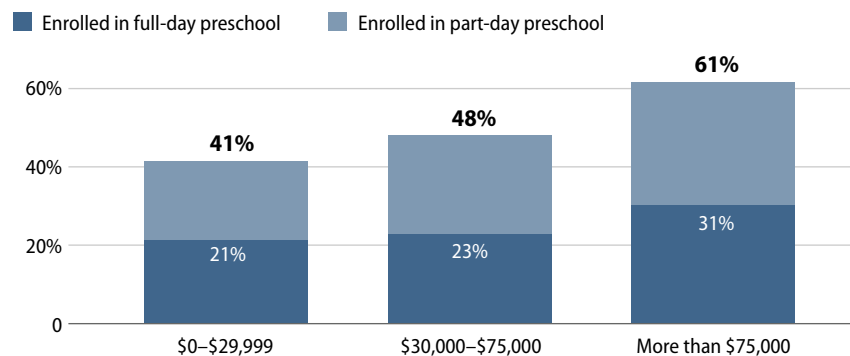
## Preschool

Fewer low-income and middle-class families have access to preschool, compared to families earning more than \$75,000, who have the highest access rate. (see Figure 1) These families are also most likely to access full-day preschool. Differences by race and ethnicity emerge as well, such that Hispanic children are least likely to have access to preschool and least likely to attend full-day programs.<sup>35</sup>

**FIGURE 3.1**

### Low-income children are less likely to attend preschool

Preschool enrollment for 3- to 4-year-olds, 2012



Source: Bureau of the Census, "Current Population Survey" (2012), Table 3, available at <https://www.census.gov/hhes/school/data/cps/2012/tables.html>.

Access to public programs that are free to families are limited in scope, reaching a small proportion of low-income 4-year-olds. The majority of families eligible for Head Start are below the poverty level, and within this population, only about half of eligible children access the program.<sup>36</sup> The situation is even worse for Early Head Start, which serves infants, toddlers, and pregnant women and reaches less than 5 percent of eligible children.<sup>37</sup>

Access to quality, state-funded preschool varies considerably by state, with 28 percent of 4-year-olds and 4 percent of 3-year-olds served nationally.<sup>38</sup> A handful of states, including Oklahoma, Georgia, and the District of Columbia, offer preschool to most 4-year-olds. However, 10 states do not provide a program.<sup>39</sup>

Both Head Start and state preschool programs vary in quality. A 2005 study found that 40 percent of Head Start programs were high quality, whereas 57 percent were medium quality and 3 percent were low quality. African American children were much more likely to be in a medium- or low-quality program, with 74 percent in a medium- or low-quality program, compared to 52 percent of white children.<sup>40</sup> Similarly, just five states have a preschool program that meets all 10 quality benchmarks established by the National Institute for Early Education Research. Of the 1.3 million children enrolled in state preschool programs, more than 40 percent are in programs that do not meet half the standards.<sup>41</sup>

# Policy recommendations

We know that expanding access to high-quality early childhood programs is a two-generational strategy that helps families enter the middle class and stay there. To provide access to high-quality care and fully realize the potential of early childhood programs, we need policies to:

- **Provide access to high-quality preschool for all 3- and 4-year-olds.** The federal government should partner with states to expand access to preschool that includes well-compensated teachers who hold a bachelor's degree, small class sizes and low teacher-to-student ratios, and a strong curriculum rooted in evidence. Passing the Strong Start for America's Children Act, which was introduced by Sen. Tom Harkin (D-IA), Rep. George Miller (D-CA), and Rep. Richard Hanna (R-NY) in November 2013 is a good first step toward this goal.<sup>42</sup> The bill would build on bipartisan support for preschool at the state level by investing federal dollars upfront and slowly shifting responsibility to states over the long term.
- **Expand and reform the child care subsidy system.** Funding levels for the Child Care and Development Block Grant, which provides resources to states for child care subsidies, are insufficient to reach even a majority of low-income parents, let alone those struggling to stay in the middle class. And even among families who receive child care assistance, amounts are typically too low to allow access to most high-quality child care programs. The child care subsidy system needs additional resources to help families access high-quality child care and quality standards that reflect children's development needs and the importance of the first few years of life.<sup>43</sup> In addition, child care assistance should decline gradually as parents earn more money rather than be cut off abruptly, which could jeopardize employment stability.<sup>44</sup>
- **Reform the Child and Dependent Care Tax Credit.** Under current law, families may claim up to \$3,000 in child care expenses for one child and \$6,000 for two or more children. The tax credit is nonrefundable, meaning that it can reduce a families' tax liability but families that owe nothing or very little in taxes cannot

take advantage of the credit. In addition, the average cost of child care far exceeds the credit amount. Making the tax credit refundable and raising the amount that can be claimed to cover more of the actual cost of child care would defray expenses for middle-class families and those trying to access the middle class.

- **Expand Early Head Start-Child Care Partnerships.** The Early Head Start, or EHS, program provides high-quality, early childhood programs, in addition to comprehensive services that provide developmental screenings, referrals to health care providers, and resources to parents. To receive federal funds, programs must meet quality standards and participate in a federal monitoring process. Congress recently provided funding for EHS expansion through partnerships with child care programs, which will bring the high-quality standards of EHS to child care settings and ensure that they provide an enriching environment for children well beyond custodial care. This initiative offers an opportunity to bring together the best of both worlds: high-quality early learning programs that also meet the needs of working parents. In 2014, Congress provided \$500 million for this initiative.<sup>45</sup> Congress should sustain and expand funding for Early Head Start-Child Care Partnerships in the coming years.

# Conclusion

To better prepare children for school and to promote parents' economic well-being, we must increase access to affordable, high-quality child care and early education programs for low- and middle-income families. Policies such as the Strong Start for America's Children Act, expanding and reforming the child care subsidy system, reforming the Child and Dependent Care Tax Credit, and expanding Early Head Start-Child Care Partnerships would help middle-class families. It would also help families trying to access the middle class to overcome cost barriers, gain access to higher-quality care, and loosen the grips of the intergenerational middle-class squeeze.

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Chapter 4

# Higher education

## Higher education

### The middle-class squeeze in higher education is real

- In 2002, a median-income family would have needed to spend 23 percent of its income to pay the tuition, fees, and room and board for one child in a four-year college. By 2012, a similar family would have needed to spend 33 percent of its income to pay those same expenses.<sup>1</sup>
- Among undergraduates who earned a bachelor's degree in the 2011-12 school year, the median amount borrowed was \$26,500, up nearly 60 percent from \$16,700 in the 2003-04 school year.<sup>2</sup>
- Students who attended public universities, colleges, and career-training centers borrowed \$19.6 billion during the 2002-03 school year; that amount rose to \$48.5 billion by the 2011-12 school year—a 98 percent increase in real terms in less than 10 years.

### Understanding how we got here

Since the mid-1960s, the federal government has responded to the need for a better-educated and better-prepared workforce by supporting the enrollment of low- and middle-income students in higher education through financial aid. This aid includes a combination of grants, loans, work-study assistance, and tax benefits. These efforts have led to increased college-going rates for every income group, especially for students from low- and middle-income families.

However, the price of higher education has outpaced earnings growth for nearly all American families, while grant support from the federal government has not kept up with college costs. This has resulted in an increasingly debt-dependent system because students and families must turn to student loans to cover the gap. The increase in tuition and fees has largely been driven by declines in state support to public colleges and universities, not the fact that these schools are spending more to educate students. State funding declined from 31 percent of total revenue at public institutions in 2003 to 22 percent in 2012.<sup>3</sup>



For an example middle-class family of four trying to save for two children's college educations, the annual amount required to save rose by 39 percent in 12 years. See figure 1.3



## Policy recommendations

Rising higher education costs are a huge part of the middle-class squeeze. Parents can only afford to pay a smaller and smaller share of the tuition and fees charged by colleges, resulting in students taking on increasing levels of debt before heading into an uncertain job market. What's more, the costs of higher education affect who applies to and who goes to college. This in turn constrains economic mobility, which affects both individuals and the overall economy.

There are three things that can be done today to help alleviate the middle-class squeeze in higher education:

- Promote consumer choice and assessing value in order to hold down tuition and fees and to increase institutional performance
- Restore public investment in higher education
- Promote innovations that can bring down costs and improve quality



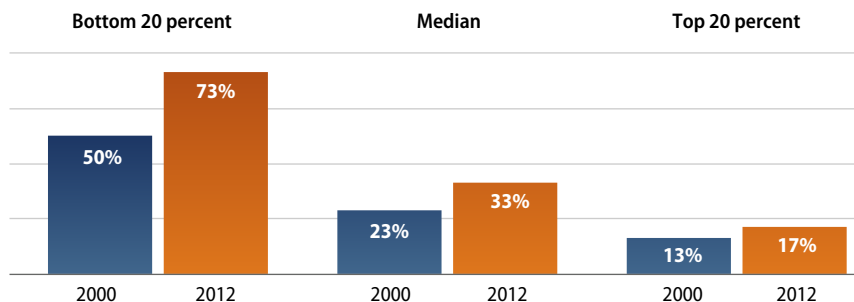
# Higher Education

Education beyond high school has long served as the pathway to the middle class. In recent years, however, college costs have skyrocketed, greatly contributing to the middle-class squeeze.

While the costs of higher education have perennially outpaced inflation, in the past few years, the costs have increased significantly while earnings have fallen for most American families. Consider the share of a family's income needed to meet postsecondary education expenses. In just the three years between academic years 2008-09 and 2011-12, the share of an average family's income that went to meet postsecondary education expenses—after accounting for any grants received—increased by a whopping 24 percent for public four-year colleges and universities, 21 percent for community colleges, and 10 percent for private, nonprofit colleges and universities.<sup>4</sup> In part, this reflects the higher tuition and fees charged by colleges and universities but also the fact that median family income fell by 3 percent during this period.<sup>5</sup>

FIGURE 4.1

**Percentage of income needed to meet annual average tuition, fees, and room and board expenses**



Source: CAP analysis of U.S. Census Bureau, "Table H-3. Mean Household Income Received by Each Fifth and Top 5 Percent, All Races: 1967 to 2012," available at <http://www.census.gov/hhes/www/income/data/historical/household/> (last accessed August 2014). For information on confidentiality protection, sampling error, nonsampling error, and definitions, see Bureau of the Census, *Current Population Survey, 2013 Annual Social and Economic Supplement* (U.S. Department of Commerce, 2013), available at [www.census.gov/prod/techdoc/cps/cpsmar13.pdf](http://www.census.gov/prod/techdoc/cps/cpsmar13.pdf).

In fact, by 2012, a family with the median income would be spending \$1 out of every \$3 in income just to pay the college costs of a single child. For families in the bottom 20 percent of income, that number approached \$3 out of every \$4 in income. Even the wealthiest families faced stiff increases over this period.

The tuition and fees that colleges and universities advertise are not transparent and do not factor in federal, state, and institutional grants. As a result, the advertised cost undoubtedly has discouraged some low- and middle-income families from considering enrollment and has likely led some of these same students to enroll in lower “sticker price” colleges. While less expensive programs can often be the best option—or even the only option, based on location—they can also lead to poorer outcomes and, ultimately, less return on investment. Steering students from low- and middle-income families to enroll in institutions that advertise lower tuition but from where a smaller percentage of students are likely to graduate is simply bad public policy.

Not surprisingly, the burden of tuition payments often translates into the burden of debt. This student debt has disproportionately affected communities of color. For students who graduated in the 2011-12 school year, for example, African American and Hispanic bachelor’s degree recipients borrowed 37 percent more and 5 percent more, respectively, than the median for bachelor’s degree recipients; white students borrowed 3 percent less.<sup>6</sup>

**FIGURE 4.2**

**Cumulative student-loan debt for program completers by race and ethnicity**

**Bachelor's degree**

Black or African American

**\$27,808**

Hispanic or Latino

**\$21,221**

White

**\$19,613**

Asian

**\$10,919**

Source: Data are from the 2011-12 National Postsecondary Student Aid Study. See National Center for Education Statistics, “National Postsecondary Student Aid Study (NPSAS),” available at <http://nces.ed.gov/surveys/npsas/> (last accessed August 2014).

## Increased reliance on tuition and fee revenues

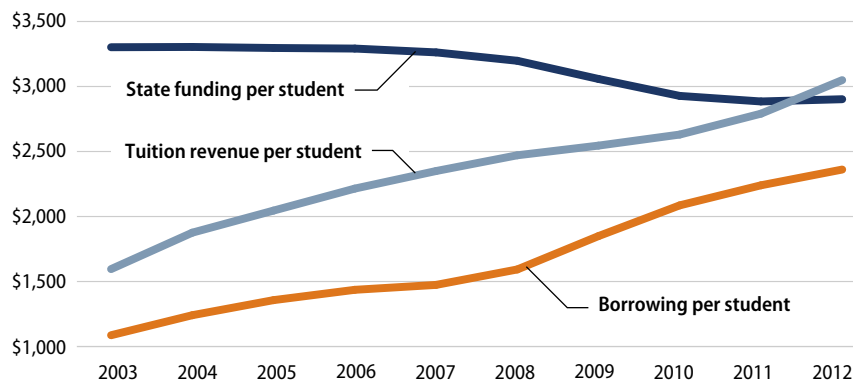
One of the main contributors to rising tuition fees has been the decline in state support for public colleges and universities. In fiscal year 2003, state funding accounted for 31 percent of total revenue at public institutions, the high point over the 10-year period we examined. This level has declined steadily since, with state investment reaching 22 percent of revenues in FY 2012.<sup>7</sup>

This has resulted in institutions' increased reliance on tuition dollars. Many students and families lack savings and other assets that can be used to pay increased tuition bills. Without adequate grant support from the federal and state governments and institutions, students' increased borrowing to pay tuition bills has been inevitable. In total, students who attended public universities, colleges, and career-training centers borrowed \$19.6 billion during the 2002-03 school year; that amount rose to \$48.5 billion by the 2011-12 school year—a whopping 98 percent increase in real terms in less than 10 years.<sup>8</sup>

**FIGURE 4.3**

### **State funding, tuition revenues, and student borrowing per student at public institutions**

Dollars per student, 2003–2012



Source: CAP analysis of U.S. Department of Education data. See endnote 3. See also Office of Federal Student Aid, "Title IV Program Volume Reports," available at <http://studentaid.ed.gov/about/data-center/student/title-iv> (last accessed January 2014).



Examining the combined effects of the increase in public institutions' reliance on tuition and fee revenue and the increase in student borrowing illustrates that the share of tuition financed with federal loans is also growing. In 2003, 68 percent of tuition dollars at public institutions were funded through federal student-loan borrowing; by 2012, that share rose to 77 percent.<sup>9</sup>

# Policy recommendations

The rising cost of higher education that is squeezing middle-class families is not inescapable. At the same time, it is possible to improve the performance of our nation's colleges and universities.

There is ample evidence to suggest that colleges can increase their graduation rates while becoming more economically and racially diverse. To do so, however, will require concerted action on the part of students and families, institutions, states, and the federal government. Among the steps that must be taken are:

- Promote consumer choice and assessing value in order to hold down tuition and fees and to increase institutional performance
- Restore public investment in higher education
- Promote innovations that can bring down costs and improve quality

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## Promote consumer choice and assessing value

Consumers need better tools to determine which institutions offer the best value for the price. These tools should provide greater transparency, creating a lever to drive institutions to keep tuition and fees down while boosting institutional performance.

The U.S. Department of Education recently has taken significant steps to keep college prices in reach for all Americans and to encourage institutions to make the prices they charge more transparent. Since 2011, the department has released lists that identify the institutions with the highest and lowest tuition and net prices—called “the high and low list.”<sup>10</sup> More recently, the Obama administration has added new consumer tools, such as the College Scorecard<sup>11</sup>—a web-based tool that provides a clear and concise view of key metrics such as net price, graduation

rate, and student-loan default rate—and the Financial Aid Shopping Sheet, which allows students to compare aid offers from each institution that has accepted them by presenting the aid package and net price in a consistent format.<sup>12</sup>

All three consumer-choice tools were developed using data that institutions of higher education already report or data that are available to the Department of Education and are designed to help potential college students at different points in the college-search process.<sup>13</sup> However, data limitations hamper these transparency efforts, since some vital information—such as graduation rates for those enrolled part time or those who transfer, graduate-education enrollment rates, and labor-market outcomes—is unavailable.

The United States needs a better data system at the federal level that includes graduation rates, graduate-education enrollment rates, the ability of graduates to repay loans, and labor-market outcomes. Such a robust student-record system would allow transfer students to be included in a school's completion rate. It would also allow for the development of detailed data on labor-market outcomes—for example, how many students in a particular program end up with jobs and how much those jobs pay after 1 year, 5 years, and 10 years. This data gathering by the federal government could be accomplished in a way that protects student privacy by removing all personally identifiable information from the system, producing only summary-level statistics that are made public. In order to create such a system, however, federal law must be amended; in 2008, Congress prohibited the establishment of a student-record system when the Higher Education Act of 1965 was last extended.<sup>14</sup>

The improved data on postsecondary education could also be used to develop or enhance a college-rating system. We recommend the creation of a federal accountability system with institutions placed in broad categories, rather than rankings, that indicate their performance against key metrics.<sup>15</sup> Among the key measures should be:

- Whether the institution provides access to underserved populations
- Whether the institution is affordable—after the consideration of federal, state, and institutional grants—to students from low- and middle-income families
- Whether the institution retains and graduates students from low- and middle-income families on time—two years for an associate's degree and four years for a bachelor's degree

- Whether graduates successfully go on to graduate school, other professional education, or enter the workforce—and whether they earn an adequate amount to meet the needs of their families while being able to comfortably repay their student loans

Under the proposed accountability system, institutions would be evaluated and categorized based on performance against all four measures. Students attending the best-performing institutions would gain access to additional student financial aid, while institutions with poor performance outcomes could lose eligibility to participate in the aid programs entirely. Ultimately, such a system could drive institutions of higher education to reduce costs while improving outcomes. It would also provide critical feedback to institutions to help them improve performance. Finally, the system would provide powerful consumer-choice tools to help guide low- and middle-income students to the schools that provide the better value.

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## Restore public investment

The Obama administration has worked with Congress to increase support for the Pell Grant program, which forms the basis for federal support to low- and middle-income students enrolled in higher education. Funding for Pell Grants has increased from \$18 billion in 2008 to \$34 billion in 2014, with the award amounts automatically increasing each year to reflect the higher cost of living.<sup>16</sup> Despite these increases, the maximum Pell Grant this year will cover the smallest share ever of the cost of public colleges and universities. In the 1980s, the maximum Pell Grant covered more than half the cost of attending a four-year public college. In the 2014-15 school year, the \$5,730 maximum Pell Grant will cover less than one-third of the cost. In the 2011-12 school year, the median income of Pell Grant recipients was \$17,200, and 41 percent of undergraduates received a Pell Grant, up from 28 percent just four years earlier.<sup>17</sup>

Given the pressure on tuition and fees at public colleges and universities due to cuts in state support, we recommend that the federal government create a new, competitive grant program<sup>18</sup> to encourage states to reinvest in postsecondary education. States would be required to match the federal grants. To be eligible, states would need to agree to implement reforms and innovations that increase the value of public colleges, universities, and training centers for students through a Public College Quality Compact. The compact would require states to:

- **Make college affordable** by guaranteeing that low-income students who pursue an associate's or bachelor's degree will receive grant aid from the compact to cover their enrollment at public institutions
- **Create sustainable funding** by developing a plan to create reliable funding streams for public institutions, ensuring that students and prospective students can prepare for and enroll in postsecondary education with certainty
- **Improve performance** by setting outcome goals for institutions, such as increased graduation rates, and by implementing proven, successful strategies that improve student performance at the institutional level
- **Remove barriers** and state and institutional policies that stand in the way of college completion by standardizing transfer-credit and admissions requirements, and by raising high school learning standards to conform to postsecondary institutions' academic material

A number of states are already implementing these kinds of reforms. Washington, California, Minnesota, and Massachusetts are implementing plans to provide sustainable funding streams for higher education. These states have raised revenues by increasing taxes, reinvesting in public higher education, and constraining tuition increases.<sup>19</sup> Twenty-five states have implemented and six other states are in the process of implementing performance-based funding systems that use a formula to allocate a portion of funding based on performance indicators, such as course completion, time to degree, transfer rates, the number of degrees awarded, and the number of low-income and minority graduates.<sup>20</sup>

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### Promote innovations that can bring down costs and improve quality

Driving down fees, increasing performance, and reinvesting in higher education are all necessary, but they are not sufficient. The education sector also must innovate in order to provide graduates with quality programs at affordable prices. Institutions need to invest more heavily in new programs and methods of instruction that better leverage research and the promise of new technology.

For example, research and development has shown that it is possible to improve significantly the quality of remediation and, thus, improve the outcomes of

underprepared students.<sup>21</sup> At California State University, Northridge, students who participated in blended-learning programs—which integrate robust, online learning activities with in-person classes—achieved course mastery and a deeper understanding of mathematical concepts. These students were more likely to persist in their programs of study and less likely to repeat subsequent related courses, resulting in substantial cost savings for students.<sup>22</sup>

In order to encourage these types of innovations, we recommend:

- **Increased support for the First in the World Fund.** This program provides funding to enable institutions of higher education, consortia, and other organizations to reduce costs and improve outcomes for students, particularly Pell Grant recipients. These grants will support the implementation of sustainable strategies, processes, and tools, including through the use of technology, to improve outcomes.
- **Use of experimental site authority.** The secretary of education should use his existing authority to conduct experiments to give institutions flexibility from existing federal requirements in exchange for a commitment to implement innovative programs that reduce costs for students. For example, aid is provided on the basis of the time that a student is supposed to be sitting in a classroom. The secretary could permit institutions to allow students to progress based on demonstration of competency. Another potential experiment to consider is using federal student-aid funds specifically for apprenticeships. Traditionally, apprenticeships do not lead to degrees or other postsecondary credentials; for this and other reasons, federal financial aid is not available for apprenticeship programs.<sup>23</sup> We have written a great deal lately about the need to grow apprenticeships<sup>24</sup> and believe it would be possible to provide federal aid through a well-crafted experiment to move students more quickly through apprenticeships and into the labor market. Doing so would reduce the opportunity cost associated with the time a student is out of the labor market. It would also reduce the living expenses of and any tuition and fees paid by students. When appropriately structured, such an approach could also be combined with other education and training to provide the apprentice a degree or other recognized credential.<sup>25</sup>
- **Creating an alternative to accreditation.** One of the most basic rules that govern the federal student-aid programs is that students are eligible to receive aid only if the institution of higher education in which they are enrolling is accredited by an agency recognized by the secretary of education.<sup>26</sup> Accreditors

assess each institution by consistently applying standards related to both inputs and outputs, such as the number of books in the library and the job-placement rate of graduates.<sup>27</sup> One promising idea would be to permit institutions with strong student-learning outcomes to participate in an alternative to accreditation.<sup>28</sup> Under this alternative approach, institutions could choose to focus exclusively on improving the learning outcomes of their students.

- **Increasing investment in research and development.** If we are going to see significant improvements in outcomes for our nation's colleges and universities, we must increase investments in research and development focused on improving the system. We must also carefully design evaluations of the investments that are being made under the new First in the World Fund and under the programs that the federal government uses to support low-income and minority students.<sup>29</sup> Federal research and development spending on education is less than 2 percent of all federal research and development spending.<sup>30</sup> Successful research and development efforts in higher education can help improve program quality and reduce costs.<sup>31</sup> We recommend reserving a small share—for example, 2 percent—of the federal support provided to postsecondary education institutions for research and development activities.

# Conclusion

The ongoing rise in tuition and fees faced by students and families is not inevitable, nor are poor outcomes from some of our nation's colleges and universities. There are significant steps we can take to improve performance and constrain costs, but everyone will need to move aggressively to make this happen.

Students and families will need to make better choices among postsecondary education programs. Institutions will need to invest in strategies that have been demonstrated effective and find cost savings by eliminating unproductive spending; they will then need to pass those savings on to students by reducing tuition and fees. States must reinvest wisely. Finally, the federal government needs to stop providing support for programs and institutions that perform poorly. If everyone moves together, we will see tuition and fees stabilize and perhaps begin to see an improvement in institutional performance.



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Chapter 5

# Health care

## Health care

### The middle-class squeeze on health care is real

- The health care costs paid by a family of four with an average employer-sponsored PPO plan rose by 85 percent from 2002 to 2012. When we include employers' premiums—which they generally pay for in lieu of increasing workers' wages—that family's health care costs increased by \$9,000.<sup>1</sup>
- An increasing number of middle-class families are spending a significant proportion of their income on health care costs each year. In 2009, 19 percent of people under age 65 were in families who spent more than 10 percent of their family's income on health care, compared with only 14 percent of families in 2001.<sup>2</sup>
- One in five people report having trouble paying medical bills, and 1 in 10 people report being unable to pay medical bills.<sup>3</sup>



For an example middle-class family of four, health care costs rose by 85 percent from 2002 to 2012. See figure 1.3

- In 1999, health care costs comprised 9 percent of total compensation for the median family of four. If its proportion of total compensation had remained at 9 percent in 2012—instead of almost doubling to 17 percent—the same family would have earned an additional \$6,000 that year to spend on other essentials.<sup>4</sup>

### Understanding how we got here

The United States spends approximately \$3 trillion per year on health care—nearly \$9,000 per person.<sup>5</sup> Although the rate of growth of health care costs has slowed considerably in recent years, this level of spending consumes about 17.5 percent of our national gross domestic product and is higher than health spending in any other country.<sup>6</sup> High and rising health care costs threaten the sustainability of the health care system and compromise investments in other critical areas of our economy, including education and transportation.

These costs also affect the economic security of middle-class families. Although families with members above age 65 face the highest costs—largely



due to the significant costs associated with long-term care—families of all ages have become increasingly burdened by health care costs.<sup>7</sup> What's more, the lack of information on health care prices and quality also makes it difficult for families to estimate and budget for health care expenses.

Since 2000, increased spending on health insurance premiums and out-of-pocket health costs have also largely offset any income increases for median-income families.<sup>8</sup> As costs have risen, employers have also had to contribute more toward employees' health insurance premiums, depressing wage growth.<sup>9</sup> Therefore, while there has been a significant, recent slowdown in the growth of health care costs—due in part to the Affordable Care Act's payment and delivery system reforms—we must do more to sustain these efforts.

## Policy recommendations

Reforms under the Affordable Care Act are helping millions of Americans access more affordable and high-quality health care. However, additional changes are still needed in order to lower the growth rate of health care costs and to bend the cost curve. While a number of policy changes are necessary to protect the health and economic security of middle-class families, some of the most important changes would be to:

- Accelerate the use of alternatives to fee-for-service payments to reduce costs and improve care coordination
- Leverage the new insurance marketplaces to further lower costs and improve the quality of plans
- Increase transparency to allow consumers to choose high-quality, lower-cost providers and services
- Reform restrictive state scope-of-practice laws to maximize the use of nonphysician providers
- Address cost shifting to employees by encouraging employers to share health care savings with employees



# Health care

Prior to recent coverage gains under the Affordable Care Act, or ACA, approximately 11 million middle-class individuals were uninsured.<sup>10</sup> Although 90 percent of uninsured individuals were employed, one in four middle-class individuals did not have access to health insurance through their jobs, largely because many of them were employed by small businesses that did not offer insurance.<sup>11</sup> In addition, a lack of insurance more drastically affects communities of color, who have lower insurance rates than whites. Although most people of color have a full-time worker in the family, they are more likely to be in low-wage jobs that provide limited access to employer-sponsored health insurance.<sup>12</sup>

While access to affordable coverage is important for all families, it is particularly important for middle-class families who may not be able to afford premiums without financial assistance but whose annual incomes are higher than the incomes of those who qualify for Medicaid. In 2009, for instance, a parent with a full-time minimum-wage job made too much to qualify for Medicaid coverage in more than half of all states.<sup>13</sup> Three out of four families of four with annual incomes of about \$44,000 to \$88,000 that were covered by employer-based insurance were asked to contribute a greater share of their income toward premiums and to shoulder greater out-of-pocket costs.<sup>14</sup>

The most obvious example of this trend is the growing number of high-deductible health plans, or HDHPs. These plans generally require patients to pay out of pocket for all nonpreventive care until a sizable deductible is met and are linked to savings accounts that consumers can use to pay for their care. These plans are designed to encourage patients to make cost-conscious decisions about their health care, but this cost-sharing structure can create financial burdens for lower-income individuals and individuals with chronic conditions. In 2013, 20 percent of all workers in an employer-sponsored plan were in an HDHP, compared with zero individuals in 2000 and only 4 percent of individuals in 2006.<sup>15</sup>



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## The costs of coverage for middle-class families

Rising health care costs have increased expenses for more middle-class families. The health care costs paid by a family of four with an average employer-sponsored PPO plan rose by 85 percent from 2002 to 2012. When we include employers' premiums—which they generally pay for in lieu of increasing workers' wages—that family's health care costs increased by \$9,000.<sup>16</sup>

Increased spending on health care by the middle class is a result of more expensive insurance premiums and higher out-of-pocket costs. Average premiums for employer-sponsored plans have increased above inflation. From 2012 to 2013, average family premiums increased by 4 percent, compared with the 1.1 percent increase in inflation.<sup>17</sup>

Families face other increases in their health care expenses as well. Many must pay for care prior to meeting their deductibles and then may be responsible for other co-pays and co-insurance. Since 2002, the percentage of people in employer-sponsored plans who had to meet a deductible before their insurance coverage began increased by 30 percent.<sup>18</sup> The average size of deductibles has also rapidly increased: Average annual deductibles for family coverage increased by 132 percent, to \$2,220, between 2002 and 2011. Individual coverage increased by 152 percent, to \$1,100, during that period.<sup>19</sup> In 2013, 38 percent of all people with employer-sponsored coverage were in plans with deductibles of at least \$1,000.<sup>20</sup> With the exception of preventive services—which the ACA requires plans to cover with no cost sharing—an individual in such a plan would most likely have to pay the full cost of all health care services, such as a visit to a doctor and any associated X-rays or lab tests, until they met their \$1,000 deductible.

Families' out-of-pocket costs also include cost-sharing requirements for services such as physician office visits, prescription drugs, hospital stays, and outpatient surgeries. Although the amounts of these costs vary by plan requirement and patient choice of provider—with cost sharing for in-network providers lower than for out-of-network providers—75 percent of covered people reported paying a co-payment to see primary care physicians and specialists in addition to any deductible.<sup>21</sup> Similarly, most workers are also responsible for additional cost sharing for hospital stays.<sup>22</sup>

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## High and rising health care costs squeeze middle-class families

Over the past decade, increases in premiums and other out-of-pocket health care costs have significantly outpaced the rate of inflation, as well as increases in wages

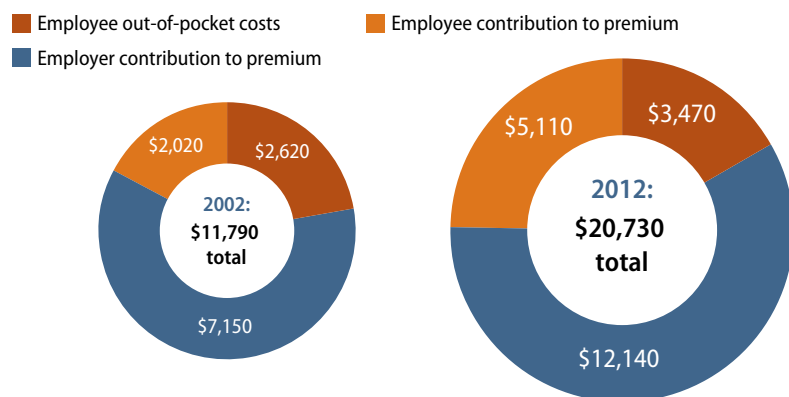
and median incomes.<sup>23</sup> This problem is even more severe for communities whose median incomes have decreased, such as African Americans, whose inflation-adjusted median household income decreased by 4.68 percent from 2010 to 2012.<sup>24</sup> Importantly, because employers must often choose between increasing workers' wages or continuing to offer health care benefit packages, increasing health costs have also depressed wage growth, further squeezing middle-class families.<sup>25</sup> One analysis shows that while health insurance premiums grew by more than 5 percent between 2000 and 2009, average hourly wages and salaries increased by less than 1 percent.<sup>26</sup>

Thus, while total compensation—wages plus an employer's contributions to health care premiums—for our example family of four increased by \$5,700 from 2000 to 2012, rising health care premiums consumed most of this increase and reduced workers' take-home pay. In 2012, the full cost of health care premiums—including contributions made by employers and employees—consumed 18 percent of a family's total compensation. This is compared with just 10 percent in 2000. Our analysis indicates that if health care costs had maintained their proportion of total compensation—instead of eating into workers' wages—the average family of four would have received an extra \$5,200 after taxes in 2012.<sup>27</sup>

**FIGURE 5.1**

### 2002–2012: Health care costs for middle-class families rose by \$9,000

Annual health care costs for the average family of four in an employer-sponsored PPO plan, 2002 vs. 2012



Note: All dollars are 2012 dollars.

Source: CAP calculations based on National Institute for Health Care Management, "Spending for Private Health Insurance in the United States" (2012), available at <http://www.nihcm.org/images/stories/DB4-Figure5.png>.

As a result of high health care costs and stagnant incomes, 19 percent of people under age 65 in 2009 were in families who spent more than 10 percent of their income on health care. This is up from 14 percent of families in 2001.<sup>28</sup> Although families with people above age 65 face the highest costs, largely because of the significant costs that are associated with long-term care, health care costs have increasingly burdened families of all ages.<sup>29</sup> In 2012, one in five people reported having trouble paying their medical bills. One in 10 people reported that they were not able to pay their medical bills.<sup>30</sup>

Prior to the insurance reforms of the ACA, households with major medical expenses reported having more than \$11,600 in unpaid credit card bills—about \$4,000 more than average households with debt.<sup>31</sup> Additionally, although 95 percent of families with a member receiving cancer care were insured, 46 percent stated that medical costs were burdensome.<sup>32</sup> A lack of information on health care prices and quality also makes it difficult for families to estimate and budget for health care expenses.

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### How the ACA is helping middle-class families

Reforms under the ACA are already helping millions of Americans afford quality health care. The law includes premium tax credits for middle-income individuals who enroll in a health plan through an exchange. Beginning in 2014, millions of individuals and families will receive annual tax credits that average more than \$4,000 to assist in purchasing insurance.<sup>33</sup> Importantly, the ACA also prohibits insurers from charging higher premiums or denying access to care based on pre-existing conditions or gender. The law also requires all nongrandfathered health plans to establish out-of-pocket limits, capping the amount enrollees must pay each year for in-network essential health benefits.

The ACA also requires plans to cover a number of preventive services with cost sharing, including important screenings, annual exams, and contraception. These services have the potential to greatly enhance health while lowering costs for individuals and families. Estimates show that in 2013, women saved \$483 million on birth control pills alone, an average savings of \$269 per woman.<sup>34</sup> Removing this considerable financial hurdle was especially important for many women of color who, prior to expanded preventive services through the ACA, did not obtain this type of care. Today, millions of African American women, Latinas, and Asian American women with private health insurance are currently receiving expanded preventive service coverage under the ACA.<sup>35</sup>

# Policy recommendations

The Affordable Care Act has expanded access to health insurance, and its reforms have likely helped lower health care costs. But the ACA should only be a starting point for lowering costs; other policy changes are needed to continue to lower the growth rate of health care costs and to bend the cost curve.<sup>36</sup> Five policy changes that will help accomplish this and lower costs for middle-class families include:

- Accelerating the use of alternatives to fee-for-service payments to reduce costs and improve care coordination
- Leveraging the new insurance marketplaces to further lower costs and improve the quality of plans
- Increasing transparency to allow consumers to choose high-quality, lower-cost providers and services
- Reforming restrictive state scope-of-practice laws to maximize the use of nonphysician providers
- Addressing cost shifting to employees by encouraging employers to share health care savings with employees

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## Accelerate the use of alternatives to fee-for-service payments to reduce costs and improve care coordination<sup>37</sup>

Our current fee-for-service payment system leads to wasteful and potentially harmful uses of high-cost tests and procedures. Instead of paying a fee for each service, public and private payers should pay a fixed amount to doctors and hospitals for a defined bundle of services or for all of a patient's care. All payers and providers should accelerate the use of alternative payment methods, especially bundled payments.

Under a bundled payment arrangement, an insurer or employer pays a fixed amount to health care providers for a bundle of services or for all the care a patient is expected to need during a period of time. For example, a bundle for total knee replacement surgery could begin after the patient’s diagnosis and include payment for the orthopedic surgeon; operating-room fees, including anesthesiology; and postacute care for 30 days. The bundle could also be expanded to include physical therapy and care for 90 days after the surgery. Health care providers have an incentive to coordinate care that the patient actually needs, using the fixed bundled payment amount. Providers’ payments are also contingent on quality and patient-experience measures, which focuses greater attention on improving quality.

Bundled payments not only lower costs for health care payers, but they can also lower out-of-pocket costs for consumers. Insurers can pass along these savings in various ways, and the ACA’s protections—including the “medical loss ratio” requirement that insurers spend a minimum percentage of premium dollars on care or otherwise pay rebates to their customers—make certain that insurers cannot use these savings simply to increase their profits.

As the largest payer, Medicare can lead the way in these efforts and encourage private payers to participate:

- Medicare should expand the current bundle of inpatient hospital services. Currently, this bundle includes services provided to patients up to three days prior to admission. That three-day window should be expanded to seven days.
- Medicare should expand the Acute Care Episode Demonstration program—which bundles payments for 37 cardiac and orthopedic procedures performed in hospitals.
- By 2017, Medicare should create bundled payments for at least two chronic conditions, such as adjuvant therapies for five leading cancers and care for coronary artery disease. Adjuvant therapies are additional treatments that lower the risk that cancer will return. For example, patients may receive chemotherapy or radiation following surgery to remove a tumor.

Action by Medicare would likely catalyze private payers to rethink their payment for high-volume or high-margin procedures or episodes of care. When insurers start to align payment with value, rather than volume, more closely, it will help lower costs not just for insurers but also for patients.

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## Leverage the new insurance marketplaces to further lower costs and improve the quality of plans

The new marketplaces—both state and federally run—should engage in active purchasing; this leverages their bargaining power to secure the best premium rates and to promote payment and delivery system reform. State marketplace officials have broad authority to establish requirements for plans that participate in the exchanges; the secretary of health and human services has similar authority for the federally facilitated marketplaces. Exchange officials should use this authority to exclude low-value plans and reward plans that offer more value to consumers.<sup>38</sup>

Another way to leverage insurance exchanges to lower costs is to require insurers who have not already done so to offer tiered insurance plans. Tiered insurance plans designate a tier of providers as high quality and low cost, and patients who choose these high-value providers will have lower cost sharing. Exchanges should offer at least one tiered product at the bronze and silver levels of coverage by 2016. To encourage consumers to select the tiered product, the insurer should offer a minimum premium discount.<sup>39</sup>

Transparency and consumer education are essential to increase awareness and trust in tiered products.<sup>40</sup> Quality and cost measures should be standardized and publicly disclosed, and standards should be set for how they are used to create tiers. Whenever possible, quality measures should use data from all payers. In contracts between insurers and providers, clauses that inhibit tiered products should be prohibited.<sup>41</sup>

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## Increase transparency to allow consumers to choose high-quality, lower-cost providers and services

Health care prices must be transparent and easy to understand. The Center for American Progress recently published a report that recommends a suite of policies necessary for greater price transparency.<sup>42</sup> The following steps should be taken immediately:

- The Department of Health and Human Services must ensure that the ACA's requirement that insurers provide cost-sharing information is implemented in a consumer-friendly way.
- The ACA's cost-sharing disclosure requirements should be modified so that the plan's quoted costs for episodes of care are guaranteed.

- Hospitals and other institutional health care providers should provide uninsured and out-of-network patients with episode-based costs, which would also be guaranteed.
- Insurers' provider directories should include rankings of higher-value providers to encourage patients to seek out their services.

Consumers also need to have information about which treatments are effective in order to make important health care decisions.

The ACA created a new independent nonprofit organization, the Patient Centered Outcomes Research Institute, or PCORI, to fund and disseminate research that evaluates the effectiveness of two or more prevention, diagnosis, or treatment options. This is known as comparative effectiveness research, or CER. CER will help patients and their doctors make informed decisions when choosing between different treatment options.

CAP has urged PCORI to rapidly scale up its investment in CER to at least 80 percent of its research funding by fiscal year 2016. Today, PCORI has dedicated far less of its funding to these purposes. While PCORI recently made a new funding announcement that has the potential to increase the share of its investment in CER, this single initiative should be part of a sustained commitment to funding high-priority CER. Future investments should focus on studies that:

- Address important gaps in evidence on treatments for common and high-cost conditions
- Produce actionable results in one to three years
- Synthesize existing CER studies

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### Reform restrictive state scope-of-practice laws to maximize the use of nonphysician providers

Restrictive state scope-of-practice laws prevent nonphysician providers from practicing to the full extent of their training. An extensive body of research has demonstrated that nurse practitioners and other nonphysician providers offer safe

and effective care at comparable quality to physicians for many services at a significantly lower cost.<sup>43</sup> Despite this, 31 states do not allow advanced-practice nurses to practice without physician supervision.<sup>44</sup> Making greater use of these providers would expand the workforce supply, which would increase competition and thereby lower prices.

Studies have shown that restrictive scope-of-practice laws limit the cost savings associated with care provided by nurse practitioners and other advanced-practice nurses.<sup>45</sup> As health coverage expands under the ACA, scope-of-practice reform can help meet increased demand for health services and counteract a potential provider shortage. We recommend that the federal government provide bonus payments to states that meet scope-of-practice standards delineated by the Institute of Medicine.<sup>46</sup>

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### Address cost shifting to employees by encouraging employers to share health care savings with employees

Lowering health care costs is the first step toward easing health care expenses for middle-class families. The second step is making sure that payers pass along those savings to consumers in the form of lower premiums or reduced cost sharing. As described above, because of changes made by the ACA, insurers' cost savings will eventually be reflected in premiums and other enrollee cost sharing. But those reforms do not apply to employers who are self-insured, functioning as their own insurer instead of purchasing health insurance from a health insurance company.

Today, employees know when their premiums or cost-sharing requirements increase, but they most likely do not know why their costs increase by a certain amount. Employers should provide this information each year when they announce benefit changes. These notices should explain how much the employer expects to pay, on average, for health care benefits per employee, as well as how much the employer expects the employee will spend, on average, for health care during the upcoming year. The employer should also explain how these amounts vary from the previous year and how much of the increase in employees' costs is due to medical inflation and how much is due to the employer shifting costs to employees. This greater transparency should discourage employers from cost shifting to their employees.





# Conclusion

Together, these changes will help lower health care costs for middle-class families. Affordable, high-quality health care is essential to economic security. Lower health care costs also benefit middle-class families in other indirect yet important ways. When federal and state governments lower their health care costs, it frees up funding for other critical areas, such as education and transportation, which further benefits America's middle class.

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Chapter 6

# Housing

## Housing

### The middle-class squeeze on housing is real

- Mortgage originations are at their lowest level in 17 years,<sup>1</sup> with many middle-class families locked out of the market, and cash buyers accounting for more than 40 percent of all home purchases at the end of 2013.<sup>2</sup>
- Half of all renters spend more than 30 percent of their income on housing while 27 percent spend more than 50 percent of their income—both sharp increases over the past decade.<sup>3</sup>
- The median household lost 31 percent of its home-equity wealth between 2005 and 2011,<sup>4</sup> and 13 percent of all mortgaged homes are still underwater—their owners owe about \$380 billion more than their homes are actually worth.<sup>5</sup>

### Understanding how we got here

Triggered by the burst of a housing bubble inflated by predatory and dangerous mortgage loans, the financial crisis of 2008 led to the most severe recession and loss of middle-class wealth since the Great Depression.

Consequences included the loss of millions of homes to foreclosure—frequently due to the unavailability of loan workout options—and widespread, severe housing-price declines that put millions more homes at risk. Cash investors—including traditional mom-and-pop landlords as well as private equity funds and other large institutional investors—have capitalized on bargain prices for homes across the country, purchasing millions of homes that they are then renting out. These investors have helped to reverse home-price declines—in some cases, potentially re-inflating bubbles—which has helped some homeowners recover their home equity but, ironically, may be locking potential homeowners out of the market. Even with this investment, many communities are still struggling with the legacy of blight and disinvestment wrought by the crisis.



For an example middle-class family of four, housing costs rose by 28 percent in 12 years.  
See figure 1.3



Concurrently, rental cost burdens have increased across the country due to an increase in the number of renters, declining incomes for all but the most well off, and inadequate programs to assist renters or to support the construction and preservation of affordable housing.

In the aftermath of the crisis, private capital has been less willing to take mortgage credit risk, leaving Fannie Mae, Freddie Mac, and the Federal Housing Administration to fill the void. Stung by the massive capital influx Fannie and Freddie required from the U.S. taxpayer, their regulator—the Federal Housing Finance Agency—has operated the companies in a very conservative manner, returning substantial profits to the U.S. Treasury but failing to support potential homeowners and the struggling housing market adequately.

## Policy recommendations

We can help address the middle-class squeeze on housing by increasing access to affordable credit, providing more affordable rental housing, and ensuring that cash investors do not lock potential homeowners out of the market. To do so, we suggest the following:

- The Federal Housing Finance Agency should require Fannie Mae and Freddie Mac to support a healthier and more equitable housing market by increasing both access to and affordability of mortgages, providing struggling borrowers with better loan modifications that include principal reductions, and capitalizing the National Housing Trust Fund and Capital Magnet Fund.
- Congress should reform the housing finance system to realign incentives, enable broader access to affordable and sustainable mortgages, and support the creation of more affordable rental housing.
- Regulators as well as state and local policymakers should closely monitor cash investor activity in the single-family rental market; evaluate its potential on tenants, rents, neighborhoods, and homeownership opportunities; and consider whether there are any policy changes needed.





# Housing

Whether they rent, own, or hope to own their home, middle-class families are increasingly feeling squeezed when it comes to finding affordable housing. The middle-class squeeze in housing can be seen in a few key ways:

- Potential buyers find it hard to obtain a mortgage
- Renters face escalating cost burdens
- The foreclosure crisis continues for many

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## Potential buyers find it hard to obtain a mortgage

Many households who want to buy a home—whether they want to stabilize their cost of housing, put down roots in a community, or benefit from the wealth gains that homeownership can enable—are finding that they cannot do so either because mortgage lenders have placed overly strict requirements on who can qualify for a mortgage or because they are competing with cash investors.

In March 2014, the average borrower credit score for a purchase mortgage was 728, and for Fannie Mae and Freddie Mac financing it was more than 750. Given that 63 percent of the population have a score below 750 and the median score is 711, many middle-class borrowers find themselves locked out of the market either because they cannot get a mortgage or can only get one at a higher-than-desirable interest rate.<sup>6</sup>

Additionally, as lenders look for higher down payments, borrowers with good credit scores and incomes but who hail from a lower-wealth background—including many people of color—often have more trouble qualifying for a loan as it can take decades to save for a 20 percent or even 10 percent down payment, especially in areas where home prices are higher.

Investors have been  
buying houses  
across the country  
at an alarming clip:

The result of tight credit has been a smaller home-purchase market. Comparing mortgage originations in 2012 to those in 2001—generally regarded as the last year of “normal” mortgage activity before the expansion of predatory lending and the growth of the housing bubble—the Urban Institute found that tight credit meant that 1.2 million fewer households received mortgages to buy a home in 2012 than would have been the case if lending standards had been more typical of the prebubble years.<sup>7</sup>

More than 40  
percent of home  
purchases were  
made with cash at  
the end of 2013.

This historically tight credit has decreased the number of potential buyers of homes, unnecessarily dampening our housing recovery and constraining economic growth. As a result, we have missed out on the economic multiplier effects of a strong housing market, including construction jobs and local and state tax revenue. Likewise, creditworthy households who wish to buy a home, yet cannot, have lost out on the ability to build wealth by buying a home at a time of historically low prices.

Seeing the steep decline in home prices and their ability to beat out potential owner-occupants, investors have been buying houses across the country at an alarming clip: More than 40 percent of home purchases were made with cash at the end of 2013.<sup>8</sup> In the past few years, the larger, institutional investors in this market have built a new industry based on buying up and renting out single-family homes—an industry that, if it grows unchecked, could have a large effect on tenants and neighborhoods.<sup>9</sup>

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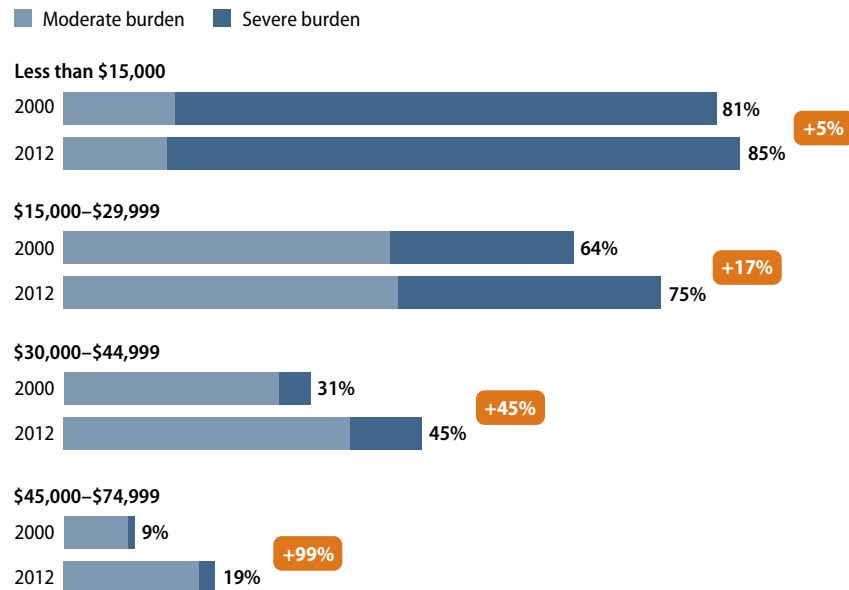
### Renters face escalating cost burdens

For the one-third of Americans who rent their home, the situation has not been much better. Based on the federal standard of housing affordability—defined as housing that costs less than 30 of household income—more than half of all renters are cost burdened, or paying more than 30 percent of their income on rent.<sup>10</sup>

FIGURE 6.1

## The cost of renting is increasingly burdening middle-class households

Percent burdened, by household income



Note: Numbers may not add up due to rounding

Source: Center for American Progress analysis of Minnesota Population Center, "Integrated Public Use Microdata Series," available at <https://usa.ipums.org/usa/> (last accessed June 2014). All data adjusted based on 2012 CPI-U.

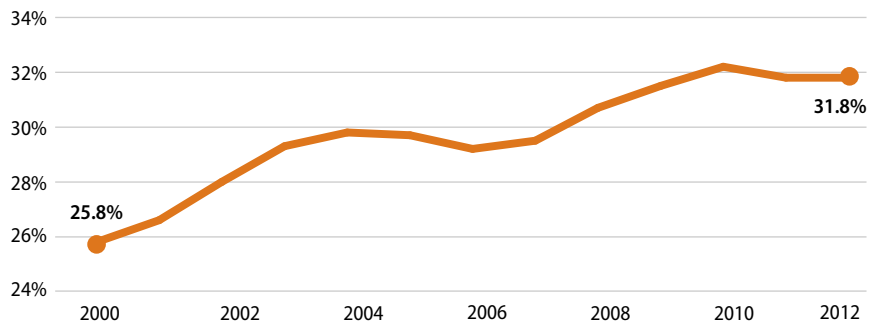
These cost burdens have effects both on family budgets and throughout the economy. The typical lower- middle-income renter who is severely cost burdened can only afford three-quarters of what her unburdened counterpart spends on food and less than half of what her counterpart spends on health care.<sup>11</sup> These statistics suggest that housing-cost burdens place great strains on households' abilities to afford basic goods and services.

These cost burdens are not likely to ease any time soon: None of the sources of increased demand for rental housing are expected to ease in the coming years.<sup>12</sup> While builders have stepped up their construction of apartment buildings, new units are still entering the market at a slow pace due to the low levels of construction during the market downturn,<sup>13</sup> and barely a third of new rental units are affordable to the median renter.<sup>14</sup> Perhaps most alarming, our nation is losing its lowest-cost rental units—the only homes very-low-income families can afford—at more than double the rate of typical rental units, largely because this housing stock is aging rapidly and not getting the maintenance required to keep it habitable.<sup>15</sup>

**FIGURE 6.2**

**Rent costs are rising more quickly than renters' incomes**

Median gross rent as a percentage of median renter's income



Note: All figures are in 2012 dollars and indexed based on weighted combination of housing, energy, and water/sewer costs.

Source: Calculations based on Joint Center for Housing Studies of Harvard University, "America's Rental Housing: Evolving Markets and Needs" (2013), Table A-1, available at [http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs\\_americas\\_rental\\_housing\\_2013\\_1\\_0.pdf](http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs_americas_rental_housing_2013_1_0.pdf).

## The foreclosure crisis continues for many

The foreclosure crisis wreaked havoc on neighborhoods and household finances across the country. Since the start of the crisis, there have been 5 million completed foreclosures, and about 650,000 homes are in some stage of foreclosure.<sup>16</sup> At least 1.4 million households have managed to avoid foreclosure through tools such as short sales but still lost their homes and any equity they had accumulated in it.<sup>17</sup> These foreclosures have cost homeowners, neighborhoods, and investors dearly: A typical foreclosure costs borrowers up to \$7,000 in administrative costs alone,<sup>18</sup> costs investors more than \$75,000,<sup>19</sup> reduces the value of neighboring homes,<sup>20</sup> and costs local governments through reduced property taxes and increased anti-blight expenditures.<sup>21</sup> A recent study even linked foreclosures to declines in neighbors' health.<sup>22</sup>

What's more, the wealth effects of the crisis were staggering, especially for households of color. The median white household lost 29 percent of their home-equity wealth between 2005 and 2011, while the median African American household and the median Hispanic household lost 38 percent and 55 percent of their home-equity wealth, respectively.<sup>23</sup> Loss of home equity can be seen directly in overall asset reductions: Whites lost about 26 percent of their net worth during this period, while African Americans lost 50 percent and Hispanics lost 61 percent.<sup>24</sup> For many households of color, their home is their largest asset: For African American families, homes account for more than half of all wealth, compared to 39 percent for whites.<sup>25</sup>

In recent years, home prices have been improving across the country, reducing the share of borrowers who are underwater, or owe more on their property than it is worth. But as of the first quarter of 2014, 13 percent of mortgaged homes are still underwater; while this is a marked improvement from a year earlier, when 20 percent of these properties were underwater, a significant number of borrowers still face the increased risk of foreclosure that being underwater brings.<sup>26</sup>

Additionally, this national figure obscures the fact that many communities are still struggling through a significant foreclosure crisis: More than 10 million Americans live in ZIP codes where between 43 percent and 76 percent of homeowners are underwater.<sup>27</sup> These neighborhoods are primarily communities of color, as in almost two-thirds of them, African Americans and Latinos account for at least half of the population. Many of these neighborhoods were once middle class but had been targeted by predatory lenders during the housing bubble. Neighborhoods like these have yet to benefit from the housing recovery, and they illustrate the importance of a robust policy response to our continuing foreclosure crisis.

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## How we got here

Despite popular perceptions to the contrary, the shoddy and frequently predatory mortgage lending in the 2000s did very little to increase homeownership rates. Between 1998 and 2006, only 9 percent of subprime loans were used for first-time home purchases, while more than half were refinancings, many of which drained equity from existing homes. Fairly soon after home prices flattened and began their decline, the resulting foreclosures outnumbered first-time home purchases.<sup>28</sup>

But in large part due to an insatiable appetite for these risky mortgages from Wall Street, their prevalence grew. Complex Wall Street financial products then spread the risk on these mortgages throughout the financial system, putting the global economy at risk when home prices began to flatten out. When homeowners began defaulting on their mortgages, it triggered the financial crisis along with the resulting recession and massive job losses.

When the mortgage-backed securities market collapsed and private capital markets retreated, the government stepped in to keep the market operational by bailing out and placing into conservatorship both Fannie Mae and Freddie Mac—the government-sponsored mortgage giants that guarantee payments to investors on mortgage-backed securities. For the first five years after the crisis, the agency serving as

conservator—the Federal Housing Finance Agency, or FHFA—operated the companies in a conservative manner, reducing access to credit and trying to wind down the government-sponsored enterprise’s businesses.

At the same time, the Federal Housing Administration, which has historically played a niche role supporting underserved and first-time homebuyers, played a crucial countercyclical role after the crisis<sup>29</sup>—its share of home-purchase originations shot as high as 40 percent.<sup>30</sup> But stung by losses, the agency has raised its fees significantly, leading to decreased market share and less demand for the mortgages it insures.

While the federal government enacted some programs to help borrowers refinance and provided incentives for private entities to modify mortgages, homeowners still need additional help. Currently, mortgage servicers—the parties that administer mortgages that are placed in securities and handle loan modifications—have no regulatory obligation to modify a loan, even when doing so would save investors money. Many loan modifications contain planned increases in interest rates that will increase the amount borrowers will need to pay in the future. And the tool that is frequently most effective in preventing unnecessary foreclosures—principal reduction—remains unavailable for many troubled borrowers, including those with loans owned by Fannie Mae and Freddie Mac and fully under the control of a federal agency.

Our housing finance system has also failed to produce and preserve enough affordable rental housing. This problem is particularly acute for very- and extremely-low-income households,<sup>31</sup> since the economics of rental housing production for these income levels require subsidies that are rapidly disappearing. But this is a growing problem for middle-class families as well: For renting households earning between \$15,000 and \$30,000, the share facing cost burdens increased 17 percent between 2000 and 2012. For those with incomes between \$30,000 and \$45,000, the share increased 45 percent.<sup>32</sup> When families spend an outsized portion of their budgets on housing, they have less to spend on food, medical care, and higher education, among other things, and they are also unable to save adequately to meet emergency needs.

# Policy recommendations

To restore greater health to the mortgage market and to protect homeowners, we suggest a number of policy changes.

First, we think FHFA has the ability to make a series of policy changes that will encourage homeownership and protect homeowners. This agency, which is now under new leadership, has recently signaled that it would like to see Fannie Mae and Freddie Mac support a healthier and more equitable housing market.<sup>33</sup> For example, FHFA has clarified the rules under which it requires lenders to buy back loans, which should help encourage them to lend more broadly, and it will no longer require Fannie and Freddie to reduce their share of the multifamily market, where most of their work supports affordable housing. The agency also is embarking on new initiatives to stabilize hard-hit neighborhoods and has announced that it will finalize new affordable housing goals and revisit a never-finalized rulemaking implementing a duty for Fannie and Freddie to serve certain underserved markets.

These changes are all excellent, but they should not stop there. In the short term, the FHFA should also:

- Change its pricing rules so that mortgages are equally affordable to all qualified borrowers. Right now, Fannie Mae and Freddie Mac charge higher fees to all but the most pristine borrowers. This policy drives up the cost of credit for many potential homeowners, pushes these borrowers to government-insured mortgages, and dampens demand for mortgages overall.
- Permit Fannie and Freddie to offer loan modifications with principal reductions. Principal reductions help keep borrowers in their homes,<sup>34</sup> encourage those borrowers to maintain their homes properly, and save money for the taxpayer by reducing the costs Fannie and Freddie have to bear when mortgages they guarantee go through foreclosure.<sup>35</sup>



- Allow Fannie Mae and Freddie Mac to make their contributions to the National Housing Trust Fund, which assists states in meeting the housing needs of very-low-income families, and the Capital Magnet Fund, which helps community-development financial institutions provide such housing. FHFA suspended these statutorily mandated contributions when Fannie and Freddie required taxpayer funds to stay afloat, but now that both companies are reporting profits, the suspension should be lifted.

Additionally, state and local officials should ensure adequate protections for tenants in single-family rental homes, and federal regulators should monitor cash investor activity in the single-family rental market; measure its impact on tenants, rents, neighborhoods, and homeownership opportunities; and take action as needed. In areas with a significant amount of cash investment, there are risks of home-price bubbles, a renewed cycle of price declines if the investors sell in bulk, or locking potential homeowners out of the purchase market if they are unable to compete with investors buying in cash.

To ease the middle-class housing squeeze in the long term, Congress should reform Fannie and Freddie to realign incentives, enable broader access to affordable and sustainable mortgages, and support the creation of more affordable rental housing. The new system should preserve the important functions Fannie and Freddie have played while eliminating the flawed ownership structure that led them to take excessive risk before the housing crisis. It should also more fully support affordable rental housing with financing programs aimed at building, operating, and preserving such housing.

# Conclusion

People require access to affordable housing—whether owned or rented—if they are to enter or stay in the middle class. Shelter is a basic human need, and when too great a share of a family budget goes toward housing, less remains for other priorities. No other single investment has done as much as homeownership to improve the financial circumstances and economic mobility of America’s families, and countless studies have demonstrated that appropriate housing opportunities play a unique role in ensuring strong and healthy families, strengthening neighborhoods, and boosting the overall economy. For these reasons, it is important that policymakers ensure a strong housing market and access to affordable housing opportunities for all.

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Chapter 7

# Retirement

## Retirement

### The middle-class squeeze on retirement is real

- As of 2013, 31 percent of non-retired Americans reported having no retirement savings and no pension, with persons of color being significantly more likely to report having no such savings.<sup>1</sup>
- As of 2010, 53 percent of American households were estimated to be in danger of having insufficient savings for retirement<sup>2</sup>—a problem that is likely to get worse as younger generations are projected to be even less well prepared than those currently near retirement.<sup>3</sup>
- As of 2010, American workers' total retirement savings shortfall—in other words, the difference between what they are projected to need in retirement and what they currently have—was estimated to be approximately \$6.6 trillion.<sup>4</sup>

### Understanding how we got here

Among the top concerns of middle-class Americans is whether or not they will be able to afford to retire.<sup>5</sup> While Social Security provides a critical baseline of income for retirees and must be strengthened so it can continue to provide in the future, it was never intended to be workers' only source of retirement income. To maintain their standard of living, retired Americans also depend on workplace retirement plans such as 401(k)s, pensions, and, to a smaller degree, private savings.

Unfortunately for many, saving for retirement has become much more difficult in recent decades as costs of other elements of middle-class security have risen and as workplace retirement plans have fundamentally changed. As employers have shifted away from pensions to 401(k)-style plans, employees have been forced to shoulder far more risk and to invest in savings vehicles that are often excessively costly.



For an example middle-class family of four, it was harder to save for retirement since the costs of other pillars of middle-class security—such as child care, higher education, health care, and housing—rose by more than \$10,000 in 12 years, while incomes remained stagnant. See figure 1.3



While some workers have managed to put away significant sums in this new system, many others have failed to save enough. The first problem is access: As of 2014, only 65 percent of private-sector workers had access to a workplace retirement plan, and only 48 percent of private-sector workers participated in one.<sup>6</sup> But even among those who do save, savings are often nowhere near adequate. As of 2010, more than 40 percent of households age 55 to 64 did not have any private retirement account, and the median account balance for those who did was only \$100,000<sup>7</sup>—barely enough to provide a few hundred dollars per month in retirement.<sup>8</sup>

Part of the problem is retirement plan features that unnecessarily drive up costs and are often difficult for workers to understand. For example, 401(k) fees—often expressed to savers as a tiny percentage of plan assets and frequently overlooked by many—can eat away between one-quarter and one-third of investment returns.<sup>9</sup>

## Policy recommendations

To secure dignity in retirement for more American families, we need to alleviate other elements of the middle-class squeeze—making it easier for households to save for retirement—and also address the failings in our current retirement system. To shore up our retirement system we should:

- Encourage the adoption of hybrid retirement plans—such as CAP’s Safe, Accessible, Flexible, and Efficient, or SAFE, Retirement Plan—at both the state and national levels.<sup>10</sup>
- Increase access to existing alternative savings options such as the low-cost Thrift Savings Plan.<sup>11</sup>
- Require 401(k) and Individual Retirement Account, or IRA, plans to be more transparent about fees and investment practices.<sup>12</sup>
- Make tax incentives for saving simpler and more fair by replacing existing tax deductions with a Universal Savings Credit and introducing a progressive match for low-income savers’ contributions.<sup>13</sup>





# Retirement

Stagnating incomes and increasing costs have left families with less money to set aside for retirement. At the same time, our private retirement system has failed to provide many retirees with the assets they need to supplement their Social Security benefits. Fortunately, if the appropriate reforms are put in place, saving for retirement can be made significantly easier, cheaper, and more secure for all Americans.

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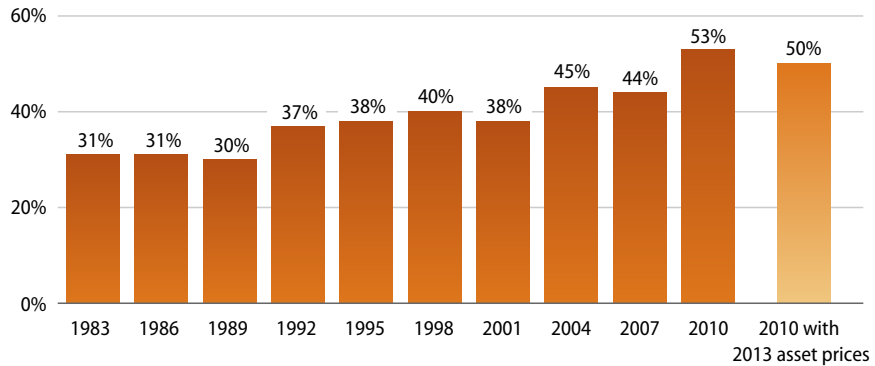
## The nature of the crisis

According to Boston College's Center for Retirement Research, as of 2010—the most recent year for which complete data are available—a full 53 percent of American households were at risk of not being able to maintain their standard of living in retirement.<sup>14</sup> And while recoveries in the stock and housing markets seen since 2010 may have improved this situation slightly, preliminary estimates indicate that the share of households likely to have insufficient savings remains unacceptably high. Center for Retirement Research calculations that incorporate these market gains and estimate what the percentage of households at risk in 2010 would have been if equity and house prices had been at their 2013 levels found the share at risk to still be an alarming 50 percent—significantly higher than it was a generation ago.<sup>15</sup>

FIGURE 7.1

**More Americans are at risk of having a lower standard of living in retirement**

Share of households at risk of not having enough money to maintain their standard of living in retirement



Source: Alicia H. Munnell, Anthony Webb, and Francesca Golub-Sass, "The National Retirement Index: An Update" (Chesnut Hill, MA: Center for Retirement Research at Boston College, 2012), available at [http://crr.bc.edu/wp-content/uploads/2012/11/IB\\_12-20-508.pdf](http://crr.bc.edu/wp-content/uploads/2012/11/IB_12-20-508.pdf); Alicia H. Munnell, Anthony Webb, and Rebecca Cannon Fraenkel, "Will the Rebound in Equities and Housing Save Retirees?" (Chesnut Hill, MA: Center for Retirement Research at Boston College, 2013), available at [http://crr.bc.edu/wp-content/uploads/2013/12/IB\\_13-17.pdf](http://crr.bc.edu/wp-content/uploads/2013/12/IB_13-17.pdf). Note that final column represents an estimate produced using household data from the 2010 Survey of Consumer Finances adjusted to reflect changes in equity and house prices that occurred between 2010 and 2013.

Many households are so unprepared simply because they have not been able to accumulate enough in savings. Partly to blame is the Great Recession, which damaged millions of families' balance sheets. However, even before the market downturn, Americans were falling far short when it came to building up enough assets for retirement. Indeed, many Americans have no money saved at all for retirement, with one 2013 survey finding that 31 percent of non-retired Americans—nearly one out of every three—reported having no retirement savings of any kind and no pension.<sup>16</sup>

Data from the Federal Reserve's comprehensive Survey of Consumer Finances—which also records how much families save—further illustrate the scale of Americans' saving inadequacy, particularly when it comes to the assets families have built up in today's most commonly used savings vehicles: private retirement accounts, such as workplace 401(k)s, Individual Retirement Accounts, or IRAs, and Keogh Plans.<sup>17</sup> As of 2010—the most recent year for which data are available—more than 40 percent of households ages 55 to 64 did not own any such retirement accounts, and the median account balance of all households in that age group was a paltry \$12,000.<sup>18</sup> Even for those who did own assets in such accounts, the median account balance was still only \$100,000—barely enough to provide a household with a few hundred dollars per month in retirement.<sup>19</sup>

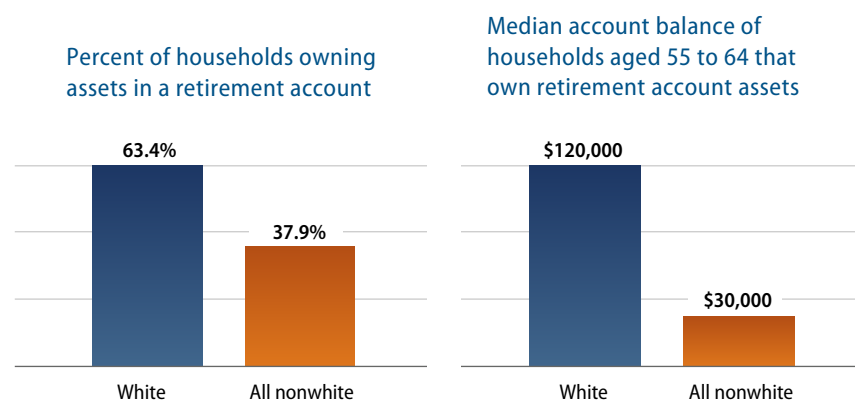
Matters only get worse when looking at younger workers. In 2010, roughly 48 percent of households ages 35 to 44 owned zero retirement account assets, and 53 percent of households ages 25 to 34 owned none.<sup>20</sup> Younger workers are also far less likely to have defined-benefit pensions than are older workers, meaning they will be even more reliant on their limited retirement account assets.<sup>21</sup> Consequently, it should come as no surprise that as of 2010, the Center for Retirement Research estimated that 62 percent of households ages 30 to 39 are at risk of not being able to maintain their standard of living in retirement; for households ages 50 to 59, it's 44 percent.<sup>22</sup>

Retirement preparedness not only differs by age, but it also differs greatly by race and income.

First, households of color are significantly less likely to own retirement accounts or to have a defined-benefit pension than are their white counterparts. As of 2010, only 16 percent of non-white working-age households had a defined-benefit pension through their current job and only 38 percent owned a retirement account, compared to 24 percent and 63 percent of white households respectively.<sup>23</sup> And the differences between these groups' retirement preparedness become more apparent when looking at the median account balances of those workers who do own a retirement account. In 2010, near-retirement white households' median savings were \$120,000, while the savings of households of color amounted to only \$30,000.<sup>24</sup>

**FIGURE 7.2**

**Households of color trail white households in retirement account ownership and total money saved**



Source: Nari Rhee, "Race and Retirement Insecurity in the United States" (Washington: National Institute on Retirement Security, 2013), available at [http://www.giaging.org/documents/NIRS\\_Report\\_12-10-13.pdf](http://www.giaging.org/documents/NIRS_Report_12-10-13.pdf). Note that all figures refer to the year 2010, as this was the last year for which complete data are available.

Other large disparities exist based on income. While it is not surprising that higher-income households are more likely to own retirement accounts, or that they have more in savings,<sup>25</sup> what is surprising is the degree to which retirement savings inequality has grown in recent decades. In 1989, the median retirement account balance of households in the top income quintile was roughly 3.7 times higher than the median account balance of households in the middle quintile.<sup>26</sup> By 2010, it was nearly seven times higher. The wealthy continue to pull further and further away, while the middle is stuck with far less than what is needed to maintain their standard of living in retirement.<sup>27</sup>

The costs of this lack of preparedness will be substantial for whoever picks up the tab. According the Center for Retirement Research, the estimated combined retirement savings shortfall among all American households—that is the difference between what they have saved and what they are projected to need—was approximately \$6.6 trillion in 2010; other estimates place this figure even higher.<sup>28</sup> To make-up the shortfall, millions of workers will likely be forced to muddle through by lowering their standard of living in retirement, working longer than they had ever envisioned, or relying on assistance from their family or government programs, potentially creating a significant drag on economic growth in the process.<sup>29</sup>

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## How we got here

Social Security has long been the bedrock of American retirement security. But, while Social Security does provide an essential baseline of income for retirees, it was never intended to be workers' sole source of income in retirement. Further strengthening the program and ensuring that it is able to continue to provide full benefits for generations to come—as CAP has previously proposed<sup>30</sup>—will certainly help many workers retire with security. But no matter how strong the Social Security system is, supplemental savings will always play a critical role.

Other forms of saving—such as 401(k)s, pensions, and private savings—have become even more important as national life expectancy has increased and the full retirement age for Social Security benefits has been raised to 67 years old. Together, these changes mean that workers are living longer and have more years of expenses to cover, but they must also wait longer to begin receiving full Society Security benefits.

Unfortunately for many middle-class households, saving for retirement outside of Social Security has become much more difficult in recent decades. The reasons for this are twofold: Simply finding the money to save has gotten harder for financially squeezed middle-class families, and changes to the saving vehicles available to them have made it more difficult to accumulate sufficient assets.

First, finding money to save for anything—including retirement—has become increasingly difficult for middle-class households as their incomes have stagnated and the prices of important goods and services have risen. Since peaking in 1999, the median household income has declined by more than \$5,000 in inflation-adjusted terms and was sitting below its 1989 level as of 2012.<sup>31</sup> In the meantime, as this report also shows, costs of many essential goods and services—from higher education to health care—have increased dramatically. Attempting to cover these increasing costs with stagnating earnings has left many families with less and less to save for retirement.

To make matters worse, current tax incentives designed to make saving for retirement easier disproportionately benefit those at the very top who need them the least, rather than benefitting those working families who are having the hardest time saving. Approximately 70 percent of the benefits of these tax incentives now flow to the top 20 percent of households, while only about 3 percent go to bottom 40 percent.<sup>32</sup> This is largely because these benefits are designed as tax deductions that provide greater tax relief to higher-income earners paying higher marginal tax rates than they do to lower-income earners in lower brackets. The consequence of this design is that the United States is now directing the vast majority of the monetary incentives it provides for saving to individuals who would have likely saved anyway, while not providing enough support to those working families most in need of support.

Even when families do manage to save, however, the changing nature of the savings vehicles available to them has made it increasingly difficult for middle-class households to build up sufficient assets.

The most prominent of these changes has been the movement among private employers away from defined-benefit retirement plans, such as pensions, toward defined-contribution plans, such as 401(k)s. While workplace pensions were considered the norm among workplace retirement plans a generation ago, by 2013, only 19 percent of private-sector workers had access to a defined-benefit plan at work.<sup>33</sup> By comparison, 59 percent of workers had access to a defined-contribution plan in 2013.<sup>34</sup>

While pensions have always had their own shortcomings, and some workers—particularly those prone to changing jobs often—may have benefited from this change, this transition has effectively transferred the majority of the risks associated with saving for retirement away from employers and onto individual savers. Now, instead of the company being responsible for setting aside enough money to provide all of its workers with a promised level of benefits, it is individual savers who must confront the risks—including that their investments may underperform, that a sudden drop in the market right before they retire could force them to work for years longer, or that they could simply outlive their savings.

For individual workers with little-to-no investment experience, successfully navigating the multitude of complex decisions required to manage these risks can become an almost impossible task. If workers postpone saving for too long or save too little, they may find themselves with far less than they need at retirement. If they misallocate their investments—as many inexperienced investors are prone to do<sup>35</sup>—their savings may grow too slowly, leaving them in a similar predicament. And if they draw down their assets too quickly in retirement, they may simply run out of money.

On top of these challenges, several design features of modern 401(k) plans further undermine employee saving. For example, because 401(k) accounts are typically tied to individual employers, workers switching jobs must often go through a complicated process to rollover their savings into a new work plan or IRA—a process that often results in significant savings ‘leakage’ as many workers opt to cash out a portion of their plans instead.<sup>36</sup> Unnecessarily high fees charged to savers by plan providers can also eat away between one-quarter and one-third of investment returns and may force workers to retire years later than planned if they want to hit their savings targets.<sup>37</sup>

It must be remembered, however, that employees encountering all of these obstacles at least have access to workplace retirement plans: a benefit millions of Americans still lack. While the switch from defined-benefit plans to defined-contribution plans should have allowed far more employers to offer retirement plans since the latter is cheaper to provide, this large growth in coverage has unfortunately not occurred. In fact, some worker surveys show retirement plan access has dropped significantly since the late 1990s.<sup>38</sup> Even employer surveys—which tend to report higher coverage rates than worker surveys—only showed 65 percent of private-sector workers having access to a workplace retirement plan as of 2014, with only 48 percent actually participating in one.<sup>39</sup>

In summary, saving for retirement has become significantly more difficult for middle-class families in recent decades as incomes have stagnated, access to retirement benefits has remained limited, and savers have been forced to shoulder more risk and make more complex decisions. Our current retirement system is overly complicated, overly costly, and overly risky, and it should come as no surprise that so many Americans are struggling to save enough to afford a secure retirement.





# Policy recommendations

Fortunately, there is no reason America's retirement system must remain the way it is and a number of options exist for significantly improving how families save for retirement. These options can be divided into two camps: broader systemic reforms that can be implemented over a longer period of time and more moderate tweaks of the existing system that can help savers immediately.

In the long term, transitioning away from individual defined-contribution plans that are strictly tied to workers' employers to hybrid plans that incorporate features from both defined-benefit and defined-contribution plans—such as CAP's proposed SAFE, Retirement Plan—would be the best method for ensuring that all Americans can afford a secure retirement.<sup>40</sup> These plans can help workers save significantly more at a lower cost and with lower risk by combining the best elements of a traditional pension—including regular lifetime payments in retirement, professional management, and pooled investing—with the best elements of a 401(k), such as predictable costs for employers and portability for workers.

## How CAP's SAFE Retirement Plan works

- Plans would be organized as nonprofit organizations run by independent boards whose sole objective would be to maximize participants' long-term benefits.
- Plans would be available to all workers regardless of whether their employer previously offered a retirement plan, and benefits would be portable when workers change jobs.
- Each worker would select a plan, and his or her employer would only need to facilitate enrollment and any required payroll deductions.
- Investments would be pooled together and professionally managed to maximize returns, and a financial mechanism called a "collar" would enable the plan to save excess returns from good years to maintain benefits in bad years.
- The risks of a SAFE Plan would be spread among workers and retirees rather than borne solely by employers, as they are in a traditional pensions, or individual workers, as they are in a 401(k).

Indeed, modeling done by CAP has shown that a worker invested in a plan like the SAFE Plan would be nearly 2.3 times more likely to maintain their standard of living in retirement than a worker with a typical 401(k) making identical contributions.<sup>41</sup> Alternatively, a worker in a SAFE Plan could achieve the same likelihood of maintaining their standard of living in retirement as one with a typical 401(k) by contributing half as much of their paycheck.<sup>42</sup>

Despite these advantages of hybrid plans like the SAFE Plan, however, some savers will always have the background knowledge, interest, and time to invest in a 401(k)-style plan and may prefer the greater control over their investments such plans allow. To accommodate these savers and simultaneously expand retirement plan access even further, policymakers should also consider coupling the adoption of hybrid plans with the opening up of the Thrift Savings Plan to all workers.<sup>43</sup>

The Thrift Savings Plan is the 401(k) plan currently available only to federal employees. The Thrift Savings Plan is a model 401(k) plan with very low fees, strong oversight, smart investment options, and an annuity option. All of these features help savers in the Thrift Savings Plan accumulate greater assets and be better prepared for retirement than most people in typical 401(k) plans.<sup>44</sup> Opening up this plan to all workers would not only give many more workers a chance to save through a workplace plan, but also provide them with access to one of the best 401(k) plans available.

While pushing for the adoption of hybrid plans such as the SAFE Plan and working to open up the Thrift Savings Plan, however, policymakers should also do their best in the short term to make the existing retirement system less predatory and more accessible.

Among the first steps should be to require 401(k) and IRA plan providers to be more transparent about the fees they charge for holding and investing savers' assets. As mentioned above, these fees can eat away workers' retirement savings and greatly reduce the returns received by savers on their investments. A recent CAP analysis found that the average fees paid by a typical worker could cost them nearly \$100,000 over their lifetime, compared to if they were invested in a low-fee plan.<sup>45</sup>

To help workers make informed decisions and encourage employers to seek out lower-cost options for their employees, CAP has proposed a simple solution: place a warning label on all retirement plan literature that informs consumers about the high risks of fees and lets them know how the fees in a given plan compare to fees in other plans of the same type.<sup>46</sup> This is one example of how transparency surrounding defined-contribution plans can not only be increased in a low-cost fashion, but also in a way that will help workers save thousands of dollars over the course of their careers.

Finally, immediately addressing the upside-down tax treatment of retirement savings would also go a long way toward helping working families save enough for retirement. Replacing the existing complex web of tax deductions that disproportionately benefit the wealthy with a Universal Savings Credit that would turn all existing deductions into one single, streamlined credit—as CAP has previously proposed<sup>47</sup>—would ensure that middle-class families and those at the bottom of the income distribution are provided the same effective tax benefits as those at the very top. It would also make it easier for all households to understand and access incentives for saving. Matching low-income savers' contributions to their retirement nest eggs via additional progressive tax credits would go even further and could help many families currently struggling just to make ends meet save enough for a secure retirement.<sup>48</sup>



# Conclusion

As saving for retirement becomes increasingly difficult, more and more middle-class families have found themselves facing the very real possibility that they may not have enough saved to maintain their standard of living during retirement. Fortunately, there are a number of steps that policymakers can take to help these families catch up and afford a dignified retirement, starting with making our retirement system less complex, less risky, and less costly to savers.

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Chapter 8

# Conclusion



# Conclusion

Working hard to get ahead has always been part of the American Dream. But the reality for millions of Americans is that in spite of working hard, they are still falling behind. Not only did real median incomes decline between 2000 and 2012, but even married couples with two children—a type of family that tends to have higher incomes—saw their median income stagnate over this period. This happened during a time when costs for key components of middle-class security for this family rose by more than \$10,000.<sup>1</sup>

The costs of child care, health care, and higher education have all risen by double digits in real terms in recent years.<sup>2</sup> Add the rising costs for housing, and you can see why retirement savings are worryingly low. The latest estimates show that half of all American households are in danger of having insufficient savings for retirement.<sup>3</sup>

The middle-class squeeze also shows that much of the problem facing the U.S. economy is one of demand, and this is largely a function of kitchen-table economics. As America's middle class is stretched thin just covering the basics, it should come as no surprise that consumer demand is still weak more than five years after the end of the Great Recession.<sup>4</sup> And since consumer spending drives 70 percent of the U.S. economy,<sup>5</sup> it is no wonder that businesses are sitting on record profits as cash stores rather than investing in new factories and workers.<sup>6</sup> Simply put, there is real concern about whether there will be enough consumer demand to justify new investment.

The middle-class squeeze is part of the new economics of inequality, and this new normal has worrying consequences for the U.S. economy as a whole. In August 2014, ratings giant Standard & Poor's warned that "the current level of income inequality in the U.S. is dampening G.D.P. growth."<sup>7</sup> Standard & Poor's concluded that:

*The challenge now is to find a path toward more sustainable growth, an essential part of which, in our view, is pulling more Americans out of poverty and bolstering the purchasing power of the middle class.<sup>8</sup>*

This idea is not new. But as the data in this report show, the timing for millions of American households—and for the U.S. economy overall—is urgent.

To reverse the middle-class squeeze—alleviating the pressure on middle-class families and enabling more households to make it into the middle class in the first place—policymakers must first focus on jobs. It is not enough for the unemployment rate to fall; we also need to be sure that Americans are not dropping out of the labor force and that the U.S. economy is creating jobs with middle-class incomes.

The jobs piece of the middle-class-squeeze puzzle has many facets, but many of the policy prescriptions required are straightforward: boosting demand through public investments, ensuring basic workplace protections that encourage higher workforce participation, and enacting sensible policies that promote shared capitalism by ensuring that more workers will do well when their companies do well.

But as we know, even if incomes rise, that alone is not enough to alleviate the middle-class squeeze. Addressing rising health care costs must be a part of the solution to address the squeeze if American workers are going to stop seeing their compensation eroded by health care expenses. There are numerous practical policies that can build on the initial success of the Affordable Care Act in cost containment and help ensure that costs are not increasingly transferred to employees.

Additionally, we need to ensure that every family has high-quality early childhood options; this two-generational investment will pay dividends both for current workers struggling to stay in the workforce—parents—and for our next generation of workers—their children. That same commitment to investment needs to continue through higher education, matching public support with reform so that students are able to get the skills and training they need to match their talents and ambitions.

Housing and retirement make up the remaining two big-ticket costs squeezing the middle class—and they are very much related. Millions of American households are counting on their homes not just for basic shelter but also for a key part of their retirement savings. The federal government must continue to enact reforms that support a healthier and more equitable housing market. For those who are unable to buy homes, creation of a more affordable rental market will help them meet a basic need and will make it more likely that they can save enough to become homeowners.

Our retirement system needs both long-term and short-term fixes. In addition to offering all American workers hybrid plans that incorporate features from both defined-benefit and defined-contribution plans, policymakers can do more now to protect workers' savings through basic fee disclosures that could save typical American workers up to \$100,000 in excess fees and allow them to retire three years sooner than they would be able to under higher-fee plans.<sup>9</sup>

For too long, conventional wisdom has said that much of the political process is broken and that we therefore will have to wait for a different year—or a different Congress—to enact change. But America's middle class cannot wait any longer.

If we are going to alleviate the middle-class squeeze, we have to act now.

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# Methodology

The U.S. Commerce Department’s Economic and Statistics Administration, under then-Undersecretary and current University of Wisconsin Chancellor Rebecca Blank, released its “Middle Class in America” report in 2010. The report showed how families of various incomes and structures “might achieve a middle class lifestyle.”<sup>1</sup> Instead of focusing on the definition of the middle class that is based on a family’s place in the national income distribution, the report calculated the cost of middle-class aspirations—such as paying for children’s college education and paying for a mortgage—and how various types of families could afford them.

In “Middle-Class Squeeze,” the authors calculate the cost of middle-class security—housing, college savings, health care, child care, and retirement. Using the median income for a married couple with two children—one of the family types featured in “Middle Class in America”—the authors show that it is more difficult for the median married family to afford middle-class security in 2012 than it was for that same family type in 2000, as its income stayed essentially the same—with only a \$650 increase—while the cost of middle-class security rose by \$10,600.

This report relies on the methodology of “Middle Class in America” as much as possible: It uses similar approaches to calculate families’ incomes, as well as the costs of college savings, health care, cars, and taxes. It uses a different approach to calculate the costs of housing and retirement and includes child care—an expense that “Middle Class in America” did not include. Finally, after subtracting the value of all calculated expenditures, this report calculates a residual called “everything else”—a category that covers everything not explicitly listed above, such as groceries, clothing, telephones, and emergency savings. In contrast, “Middle Class in America” calculated a value for “non-aspirational expenditures,” such as food and clothes, and then allocated the residual income left after subtracting all calculated housing expenses.

All numbers are in 2012 dollars using the Consumer Price Index Research Series Using Current Methods, or CPI-U-RS.<sup>2</sup> The following sections detail the methodology of how each category’s numbers were calculated.



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## Child care

These numbers are based on U.S. Census Bureau child care data in “Who’s Minding the Kids.”<sup>3</sup> The report is issued in odd years; the authors used the 1999 and 2011 reports. They also used the number for a family making more than \$4,500 per month—or \$60,000 per year.

“Middle Class in America” does not include child care as an expense but shows that 84 percent of married couples with two children in this income group have two earners, which makes child care a required expense for many families to achieve this income at some point. While not every family has child care costs, the other pillars of middle-class security cost \$8,200 more in 2012 than they did in 2000. This creates a squeeze even if families are assumed to have no child care costs.

Additionally, the Census Bureau’s calculation of child care expenditures includes a variety of child care arrangements, including variation by the number of hours in care, the type of setting, and the quality of the program.<sup>4</sup> This amount likely does not represent the cost of a high-quality program, which many parents need in order to be able to work. The average cost for full-time center-based child care is much higher, ranging from \$15,000 to \$22,000 per year depending on the region of the country, according to a parent survey conducted by Child Care Aware of America.<sup>5</sup> This report’s 2012 estimate of child care costs—\$8,700—is significantly lower. Unfortunately, Child Care Aware of America does not provide an estimate for 2000 or a proximate year.

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## College savings

The authors’ analysis is based on the methodology from “Middle Class in America.” Assumptions include that the rate of return on college savings outpaces college inflation by 1 percent and that both of the family’s children attend four-year public universities, live at home for one year, and borrow to pay for one year of expenses. Based on the authors’ analysis, 18 years of saving were assumed.

A ratio of grants to tuition was taken from the U.S. Department of Education 2000 and 2012 National Postsecondary Student Aid Studies.<sup>6</sup>

The authors used a \$10,000 band around the 2000 and 2012 incomes of the median married couple with two children for the dependent students’ family incomes to

calculate the appropriate grant amount. They then multiplied these ratios by the full tuition price of a four-year public university to calculate a net tuition appropriate for the family's income. The net tuition, books, transportation, and "other expenses" were multiplied by six—as two children attend school for four years but borrow for one year—and the room and board number was multiplied by four—as both children live at home for one year and borrow room and board costs for another year. The authors then added these costs together to create a required college savings for the family. Finally, they calculated the annual savings necessary to achieve this required college savings based on a real rate of return of 1 percent—which was based on the assumption that the rate of return on college savings outpaces college inflation by 1 percent.

These data come from the College Board's "Trends in College Pricing" from 2000 and 2012.<sup>7</sup>

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## Health care

The authors used the sum of employee-side premiums and out-of-pocket costs for the average family of four in an employer-sponsored PPO plan from the National Institute for Health Care Management report, "Spending for Private Health Insurance in the United States."<sup>8</sup> They used the 2002 number for 2000, since reliable and consistent data on out-of-pocket costs and employee-side premiums for a family of four were unavailable before 2002. Critically, this understates the amount by which health care costs have risen; it only covers 10 years of health care cost growth, rather than 12.

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## Housing

The authors' calculations are based on "Median monthly costs including all mortgages plus maintenance costs for owner occupied" in the Census Bureau's American Housing Survey for 1999 and 2011,<sup>9</sup> as the survey is only available in odd years. This number includes mortgage, maintenance, utilities, and property tax expenses.

"Middle Class in America" calculates housing costs as a residual—the money left over after all other expenses—so its number differs a good deal conceptually from the number in this report.

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## Retirement

The authors assumed that families are saving 10 percent of pretax income for retirement. The 10 percent figure is an approximation of the standard recommendations of financial industry professionals. No single definitive recommendation exists for what percentage of income an individual should set aside for retirement. However, industry professionals usually place the total recommended contribution percentage between 10 percent and 15 percent of income—including both employee and employer contributions to retirement funds—with some favoring a slightly narrower range of 12 percent to 15 percent and with others suggesting much higher savings rates for workers who have postponed beginning to save until their 30s and 40s. Thus, while the total savings rate that should likely be recommended based on these suggestions would be closer to 12 percent or 13 percent, these totals would include employer contributions that do not come directly out of a worker's own take-home income. Consequently, the authors settled on 10 percent—at the lower end of the suggested savings-rate range—to account for potential employer contributions while still ensuring that all workers save at a rate within the adequate range.

Similarly, some academic research has recommended rates that fall in the 10 percent to 15 percent range for individuals who begin saving in their mid-20s and who are earning medium incomes, although the exact rate will vary significantly depending on the rate of return they receive on their investments and at what age they wish to retire. Vanguard, Fidelity, Charles Schwab, and the Center for Retirement Research at Boston College all offer recommendations and research.<sup>10</sup>

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## Taxes

This figure is based on the authors' calculation of the combination of federal and state and local tax rates multiplied by the family's income.

Federal tax rates come from the Tax Policy Center's calculation of the average tax rate of the median family of four.<sup>11</sup>

State and local tax rates are based on the methodology from "Middle Class in America." Data come from the D.C. Office of Revenue Analysis' report "Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison."<sup>12</sup> Only income taxes were used, as property taxes are already counted as part of the housing number.

The 2000 tax rate comes from the 2006 D.C. Office report—which covers 2005—in order to ensure comparability and consistency, since the 2012 report uses a family of three and reports prior to 2005 used a family of four. “Middle Class in America” also used the family-of-three number for its calculation for a family of four. The tax rate was calculated with interpolated values of the tax rates that face different income brackets—\$50,000, \$75,000, and \$100,000—and families’ nominal incomes.

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## Cars

The authors calculated the cost of two cars driven 10,000 miles each using the national average from The American Automobile Association’s “Your Driving Costs” reports from 2002 and 2012.<sup>13</sup>

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## ‘Everything else’

This is the median income of a married couple with two children minus the cost of the other items listed above. This category includes groceries, clothing, telephones, emergency savings, and everything else not listed above. Income data come from the authors’ analysis of Center for Economic and Policy Research Current Population Survey Annual Social and Economic Supplement extracts from 2001 and 2013.<sup>14</sup>

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## Endnotes

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