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# RESEARCH REPORTS

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## How Are We Doing?

*Although the economy is on a roll, some pundits claim that middle class Americans are being rolled. However, the middle class appears to be holding its own vis-a-vis other income groups.*

By most measures, the economy is strong. After peaking at 6.3 percent during June 2003, the unemployment rate decreased to 4.6 percent during May, and it could be headed even lower in the months ahead. Nearly two-thirds of all industries added employees during the past year.

Constant-dollar GDP increased at an annual rate of 5.3 percent in the first quarter of 2006. In 2004 and 2005, output increased a respectable 4.2 percent and 3.5 percent. If the economy grew at three percent year-in and year-out, the standard of living of the average American would triple during his or her lifetime.

Yet uneasiness is pervasive. The Conference Board's Index of Consumer Confidence, which measures attitudes toward the economy, fell in May owing to "apprehension about the short-term outlook for the economy, the labor market and consumers' earning potential." Many commentators appear eager to provide the time-worn explanation that the benefits of the boom are mostly accruing to the well-off, while middle-class Americans are left to founder.

If the pessimism of Americans regarding their economic prospects is unwarranted by the state of the overall economy, might it be warranted by a trend of income distribution toward greater inequality?

### *Measuring Income*

The answer to this question can depend on the income measure cited. An unbiased observer should not use a measure selected only after an exhaustive search to find the one that backs one finding or another. Of course, whatever number is used should be adjusted for price inflation, to determine whether income gains are keeping pace with the cost of living. Less obvious is what measure of central tendency, or "average," to use. Paul Krugman, Princeton economist and New York Times columnist, illustrates the point:

> Say 10 middle-class guys are sitting in a bar. Then the richest guy leaves, and Bill Gates walks in. Because the richest guy in the bar is now much richer than before, the average income in the bar soars. But the income of the nine men who aren't Bill Gates hasn't increased, and no amount of repeating "But average income is up!" will convince them that they're better off.

Chart 1 shows "mean" household income, which is calculated by adding up all incomes and dividing by the number of households there are. The other series plotted in the chart is "median" household income. For any given year, half the households earn more than the me-

Chart 1: **Mean and Median Household Income**
(Constant 2003 Dollars)

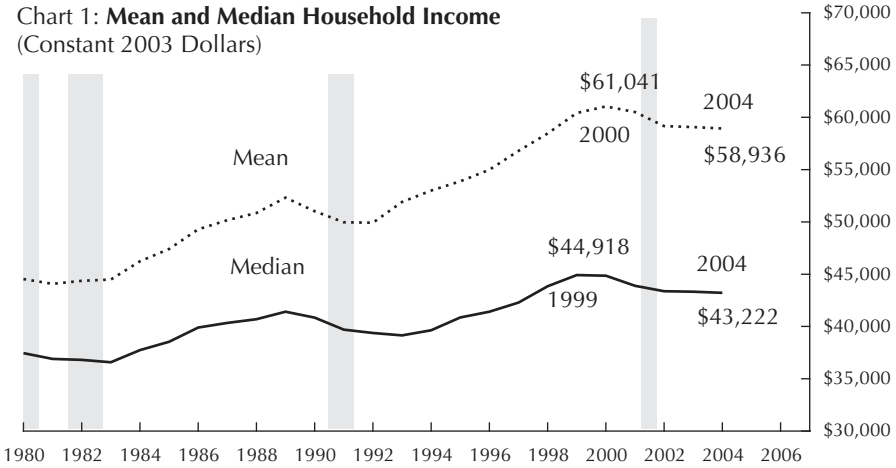



Table 1: **Median Household Income**

| (Constant 2003 Dollars) | *2003* | *1998* | *1993* |
|---|---|---|---|
| Money Income | $43,318 | $43,825 | $39,165 |
| less government transfers | 39,896 | 40,249 | 35,157 |
| plus capital gains (losses) | 40,263 | 40,586 | 35,370 |
| plus health insurance | 42,295 | 42,459 | 37,393 |
| less Social Security taxes | 39,695 | 39,863 | 35,034 |
| less federal income taxes | 37,274 | 36,805 | 32,420 |
| plus earned income credit | 37,490 | 36,968 | 32,530 |
| less state income taxes | 36,688 | 35,858 | 31,733 |
| plus non-means-tested gov't cash transfers | 40,605 | 39,653 | 35,592 |
| plus Medicare | 42,679 | 41,702 | 37,262 |
| plus school lunches | 42,690 | 41,714 | 37,273 |
| plus means-tested gov't cash transfers | 42,876 | 41,921 | 37,505 |
| plus Medicaid | 43,465 | 42,298 | 37,911 |
| plus means-tested gov't noncash transfers | 43,629 | 42,459 | 38,104 |
| plus home equity* | 45,154 | 44,302 | 40,230 |

* Annual benefit from converting home equity into an annuity, net of property taxes.
Source: Current Population Survey, Census Bureau.

dian income and half earn less. The disparity between the curves arises because the distribution of income is skewed upward; that is, unlike Lake Wobegon, nearly everybody earns below average.

After the median income peaked in 1999 and mean income peaked in 2000, both decreased and have yet to show any signs of rebounding. Looking back, however, the current situation is reminiscent of the path median income followed in the late 1980s and early 1990s, when it took the series seven years to return to the level it peaked at in 1988. And although the gap between the two measures has widened noticeably during the past quarter century, they have recently moved almost in lockstep.

But this data counts only "money income." It does not include the effects of capital gains, income taxes, or noncash benefits such as employer-provided health insurance, government assistance, or returns on home equity—adjustments that paint a more accurate picture of household well-being. Although cash income may be stagnant or even decreasing, households may be benefiting from tax cuts, capital gains, and the housing boom.

### *Alternative Measures*

In the early 1980s the Census Bureau began reporting income measures that incorporate the effects of taxes and noncash benefits in addition to reporting money income. The various alternative measures for the years 2003, 1998, and 1993 are shown in Table 1.

Most of the adjustments *add* to median household income, with the largest adjustments coming from non-means-tested government cash transfers (e.g., Social Security and unemployment benefits), which added nearly $4,000 dollars in 2003. Employer-provided health insurance and Medicare added roughly $2,000 each. Home equity, the remaining major contributor, represents the annual benefits of converting one's home equity into an annuity, net of property taxes. Separately, capital gains added about $500 to median income in 2003.

Perhaps even more significantly, federal and state income taxes, and payroll taxes, take a large but decreasing bite out of money income. Together, these taxes reduced median income by $5,800 in 2003, one thousand dollars less than five years earlier.

With all 14 adjustments, median household income was 104.2 percent of money income in 2003. Moreover, while median money income decreased by 1.2 percent between 1998 and 2003, adjusted income increased by 1.9 percent, owing primarily to lower taxes and higher home equity.

Finally, none of these measures considers the effect of decreasing household size (which averaged 2.67 persons in 1993, 2.61 in 1999, and 2.57 in 2003).

Table 2: **Income Concentration (Gini Index)**

| | *2003* | *1998* | *1993* |
|---|---|---|---|
| Money Income | 0.45 | 0.45 | 0.45 |
| less government transfers | 0.51 | 0.50 | 0.51 |
| plus capital gains (losses) | 0.50 | 0.51 | 0.52 |
| plus health insurance | 0.50 | 0.51 | 0.51 |
| less Social Security taxes | 0.50 | 0.51 | 0.52 |
| less federal income taxes | 0.48 | 0.49 | 0.49 |
| plus earned income credit | 0.48 | 0.49 | 0.49 |
| less state income taxes | 0.48 | 0.48 | 0.49 |
| plus non-means-tested gov't cash transfers | 0.42 | 0.43 | 0.43 |
| plus Medicare | 0.41 | 0.42 | 0.42 |
| plus school lunches | 0.41 | 0.42 | 0.42 |
| plus means-tested gov't cash transfers | 0.40 | 0.41 | 0.41 |
| plus Medicaid | 0.40 | 0.41 | 0.41 |
| plus means-tested gov't noncash transfers | 0.39 | 0.41 | 0.40 |
| plus home equity | 0.39 | 0.40 | 0.40 |

### *But What About Inequality?*

Economists use the "Gini index" to measure the *dispersion* of income across the entire income distribution. The Gini index ranges between zero (which would indicate that every household has the same income) and one (which would indicate that one household receives all the income).

The Gini index changed little between 1993 and 2003 under any given income definition, which indicates that the gap between income groups has not widened across time. (See Table 2.) Income distribution in any given year, however, is affected by taxes and the value of noncash benefits.

Federal income taxes not only make incomes more equal but the effect was greater after the "Bush tax cuts."

The table also shows that government transfers reduce income inequality more than the tax system does. In 2003, the Gini index fell from 0.5 to 0.48 after adjusting for all taxes, while including transfers lowered the index to 0.39.

There may well be grounds for the average American's increasing pessimism regarding his or her own economic outlook (see next article). However, they must be found in developments other than the state of the economy as a whole or the trend of income inequality. ❑

## A SNAPSHOT OF AMERICANS' FINANCES

*Americans do not save much. Just over half of all families saved regularly in 2004, and even fewer invested in retirement accounts, according to the Federal Reserve's latest Survey of Consumer Finances. Even so, families' net worth increased between 2001 and 2004, largely due to the increase in housing prices. The housing boom, however, is a thin reed for longer-term financial security.*

For years, the United States has been at the bottom of the league tables for saving. And, in the past few quarters, personal saving, which is measured in the national accounts as the difference between outlays and disposable income, has actually turned negative.

This compares starkly not only with the pattern in other advanced countries (and with many emerging-market countries as well), but also with earlier U.S. history. The recent trend has been one of sharp decline from saving rates that averaged 9 percent in the 1970s and 1980s to today's negative readings. (See Chart 1 on the next page).

Estimates of the personal saving rate are subject to large measurement errors and large revisions, and today's negative rate could eventually be revised upward. For example, the saving rate, according to today's statistics, peaked in the early 1980s. But as *initially* reported, the saving rate back then was

much lower and had fallen sharply from a peak reached in the 1970s. Time will tell if today's low saving rate is similarly revised away.

Other data, however, suggest that the lack of personal saving is not a statistical illusion. The broader pattern for the nation—represented, for example, by the current-account deficit—is also one of dissaving. The nation's consumption and investment exceeded production by six percent of GDP last year, a historically large gap by any standard. (See Chart 2.) Foreigners, in effect, supplemented domestic saving to that large an extent.

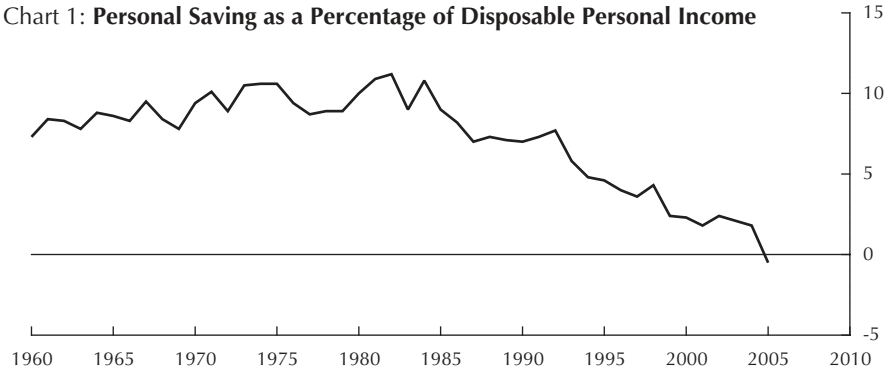
The nation's apparent dearth of saving was underscored recently with publication by the Federal Reserve Board of its triennial Survey of Consumer Finances (SCF).[1] The survey, which was based on 2004 data from 4,522 families, found that, while soaring housing prices had added to the net worth of American families since 2001, only about half of all families had saved regularly, and the fraction of families with retirement accounts fell.[2] American families may have benefited from bubbly home prices in many parts of the country, but that is a thin reed for longer-term financial security.

The SCF is a rich data set, but the following findings seem to stand out as the most important:

1) Little more than half of all families (56 percent) saved at all in 2004 (other than, say, passively through increased home equity). Not surprisingly, the percentage of families that saved rose with family income (81 percent of families in the highest income decile reported that they had saved, as compared with 34 percent in the two lowest deciles). The percentage that saved was virtually constant from one age of family head to another (with the conspicuous exception of the elderly, who naturally save at lower rates than the rest of the population).

2) Even fewer families (41 percent) save as a matter of priority. The remainder view saving as what is "left over" from income (by accident rather than by design) at the end of the year.

Chart 1: **Personal Saving as a Percentage of Disposable Personal Income**




Source: Bureau of Economic Analysis

3) The net worth—the difference between families' assets and their liabilities—of the lowest two income deciles is minuscule, with a median of only $7,500 (see the table on the next page). The median is the halfway mark; half of the families in this group had a lower net worth, and half had a higher net worth.

Moreover, most of that net worth is in the form of home equity. The *financial* assets of the bottom 20 percent of the income distribution amount to little more than the cash in their wallets on a really good payday ($1,300). Even families in the bottom 20th to 40th percentile of the income distribution have little net worth—a median $34,000, with this, too, skewed to homeownership rather than financial assets. Strikingly, despite rising home equity, this figure is distinctly lower than it was in previous surveys going back as far as 1992.

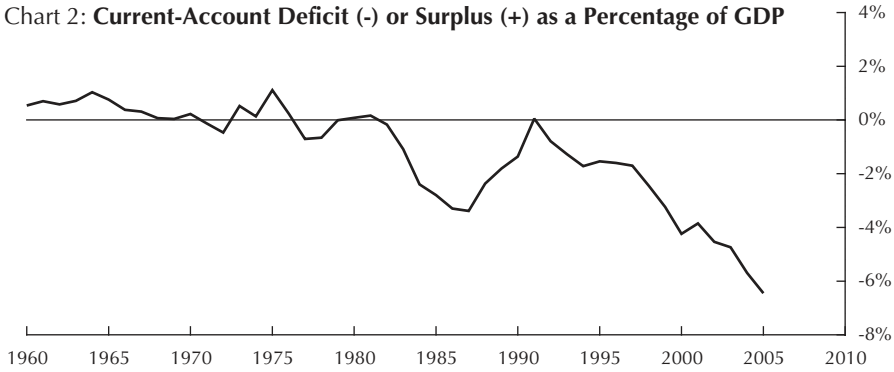
Among all families, median net worth changed little from 2001 to 2004, increasing from $91,700 to $93,100. (All figures are in constant 2004 dollars.) It fell a sharp 24 percent among one demographic group—families headed by persons with less than a high school diploma. Broken down by age, however, net worth fell only among households headed by persons in the 35-44 age group. In contrast, it rose sharply among those closest to retirement, the 55-64 age group.

4) Retirement and liquidity dominate among the main reasons Americans save—retirement presumably among those at relatively high income levels, liquidity among those at relatively low income levels. The fraction of families citing retirement as their most important reason for saving increased sharply in the past decade, from one fourth of families in 1995 to one third in 2004. This likely reflects the twin trends of an aging society and the reduced availability of employer-funded pensions.

5) With housing prices (as well as the incidence of homeownership) on the rise, savings in the form of home equity has become an even larger portion of household wealth. By 2004, the median value of home equity in primary residences was seven times the median value of financial assets ($160,000 as compared with $23,000), whereas in 2001 it was only four times as large. The median value of financial assets actually declined during the three-year period, reflecting the slump in the stock market from record highs and accentuating the importance of homeownership in the typical family's balance sheet.

6) Renters, meanwhile, without the benefit of rising home prices, continue

Chart 2: **Current-Account Deficit (-) or Surplus (+) as a Percentage of GDP**




Source: Bureau of Economic Analysis

[1] "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, February 2006. The full report is available at www.federalreserve.gov.

[2] In the SCF, the term "family" is used in much the same way as the term "household" in Census data, and it includes one-person families.

**Median Net Worth of Families, By Income Group**
(Thousands of 2004 dollars)

| | *1995* | *1998* | *2001* | *2004* |
|---|---|---|---|---|
| *Percentile of income:* | | | | |
| Less than 20 | $ 7.4 | $ 6.8 | $ 8.4 | $ 7.5 |
| 20-39.9 | 41.3 | 38.4 | 39.6 | 34.3 |
| 40-59.9 | 57.1 | 61.9 | 66.5 | 71.6 |
| 60-79.9 | 93.6 | 130.2 | 150.7 | 160.0 |
| 80-89.9 | 157.7 | 218.5 | 280.3 | 311.1 |
| 90-100 | 436.9 | 524.4 | 887.9 | 924.1 |

Source: Survey of Consumer Finances, Federal Reserve Board.

to own little. The median value of financial assets owned by renters, who constitute as much as one-third of all families, was a mere $3,000 in 2004, as compared with $4,000 in 2001. Renters tend to be younger, which helps explain their small financial assets. The decrease in renters' holdings since 2001 may also be partly explained by the continued increase in homeownership rates. As more people become homeowners, the remaining pool of renters increasingly consists of those with assets that are insufficient to buy a home.

7) Few Americans seems to be on track to enjoy any semblance of financial ease in retirement. The nation's retirement system is often said to be a three-legged stool: Social Security, employer-sponsored retirement plans, and private saving. Even with its long-term actuarial imbalance, Social Security may well be the healthiest of the three, relying as it does on the general taxing power of the federal government and the nation's expressed will to support the elderly. The other two legs are now visibly shaky.

For years, Corporate America has been shedding its defined-benefit pension plans, in an effort to remain competitive in an increasingly challenging global economy. And, as the SCF makes clear, private saving for retirement is falling woefully short, with but one-half of all families owning a retirement account and with the median value of those accounts reaching only $35,000. Even those on the eve of retirement (in the 55-64 age group) owned sparsely funded retirement plans, with a median value of just $83,000. Funding for retirement was ample (into six figures) only among the top income decile of families

To be sure, the SCF does not include data on employer-sponsored defined-benefit plans, which would soften this picture considerably. Those are, however, an increasingly endangered species. In the past two decades the number of such plans offered in the private sector has fallen by almost 75 percent, as small- and mid-sized companies (and even some large companies) have dropped them in favor of defined-contribution plans.

8) Few families own stock outright (21 percent), although many (50 percent) hold equities indirectly in IRAs, 401(k)s and other retirement accounts, and still others (15 percent) own them in the form of non-retirement mutual funds and other pooled assets. Bonds, in contrast, are very tightly held: only 2 percent of families hold them directly. Direct holdings of any significance are almost exclusively among top-income and elderly families. However, many families across the income distribution hold bonds indirectly in mutual funds, IRAs, etc.

9) Americans routinely break the first rule of investing: diversification. Among outright holders of equities, 60 percent had stock in three or fewer companies—among them their own employers. The lesson from the experience of employees from Enron and other failed companies whose 401(k) plans were replete with company stock apparently has not yet sunk in.

10) The SCF does not point to overwhelming debt burdens, to judge by the ratio of total debt to total assets (15 percent) and the ratio of scheduled debt payments to income (18 percent). Both ratios increased only slightly from 2001 to 2004.

Not all that much comfort lies there, however, given that two of the factors that helped keep these ratios relatively steady—sharply rising home values and falling interest rates—have largely run their course. Now, families face the risk that home equity values will level off or fall as the economy keeps advancing cyclically and interest rates continue to rise. And while families kept their debt-service payments under control from 2001 to 2004 partly by refinancing their mortgages at lower interest rates, some will now face higher payments as the rates on adjustable-rate mortgages increase.

The distribution of household debt raises another warning light. As of 2004, some 12 percent of families face debt payments exceeding 40 percent of income. And almost 10 percent of debtors were delinquent (60 days late or more) on at least one payment. Low-income families, who have the least to fall back on, were more likely to be behind on payments. Both figures edged upward between 2001 and 2004, a period when interest rates were generally falling. Highly-indebted families presumably will face increased financial pressure now that rates are rising.

### *Conclusion*

Public polls reflect growing concern on the part of Americans that their saving is inadequate, especially their saving for retirement. They cannot have failed to notice the wide attention given in the past few years to Social Security's long-term actuarial deficit and to Corporate America's shedding of its pension liabilities. Failure to act against the background of these warnings signs could push retirement out for many and even put it out of reach for many others.

Rising home values buffered many families from the impact of lower stock valuations in the 2001-2004 period and have helped offset the lack of other saving. But it is questionable whether most Americans will be able to finance a comfortable retirement by continuing to rely mainly on large increases in the value of their homes. ❑

**PRICE OF GOLD**

| | *2004* | *2005* | —— *2006* —— | |
|---|---|---|---|---|
| | *Jun. 10* | *Jun. 9* | *Jun. 1* | *Jun. 8* |
| Final fixing in London | $384.95 | $422.50 | $625.00 | $614.00 |

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