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Unburdening America's Middle Class

Shrinking Families' Debt Burden Faster Is Imperative for Strong, Sustained Economic Growth

Christian E. Weller November 2011

Introduction and summary

Excessive leverage—too much household debt—remains the scourge of our economy. It holds back consumer spending and results far too often in massive economic distress for millions of American families facing record-high foreclosures. Too much household debt also leaves banks reluctant to extend new loans for home purchases and business expansions because these lenders already have billions of dollars in bad loans on their books and don't want to throw good money after bad.

This all slows business investment. Businesses want to meet the existing demand of consumers and other businesses primarily with their existing capacity. Businesses have no incentive to quickly build up new capacity unless households can dig out from under the mountain of debt more quickly than has been the case so far.

Helping American workers and their families deleverage can occur through three channels. One is to leave the decline of debt to market forces through massive home mortgage foreclosures and tight lending standards that prevent the expansion of much new credit. Another, less-painful possibility for households is the refinancing of existing debt into lower-interest-rate debt, thus making it easier to repay their total outstanding debt. And the final way to deleverage household debt is an increase in after-tax incomes. Incomes can grow due to more jobs, higher wages, lower taxes, and better unemployment insurance benefits, among others.

A closer look at the data on household indebtedness in the United States illustrates the importance of deleveraging swiftly for a strong economic recovery as well as the value of a multipronged approach in reducing deleveraging through faster declines in outstanding debt, more refinancing into lower-cost debt, and quicker increases in personal incomes. Consider that:

- Economic growth stays too low. Gross domestic product, or GDP, grew at an annual rate of 2.5 percent in the third quarter of 2011. The economy has expanded now by 5.6 percent in inflation-adjusted terms, the slowest growth during the first nine quarters of an economic recovery since World War II. Business investment

expanded at a strong 16.3 percent in the third quarter of 2011, while export growth remained subpar with 4.0 percent, consumption regained some strength, expanding at 2.4 percent, but only because personal saving fell precipitously. And, government spending was flat. Economic growth is still too low to create sufficient jobs to substantially reduce the unemployment rate. Low personal income growth is holding back consumer demand and fiscal troubles of governments in the United States and abroad impede U.S. economic growth.

- The debt is highest among the middle class. Middle-income families before the crisis had a debt-to-income ratio of 155.4 percent in 2007, the last year for which data are available, for families with incomes between \$62,000 and \$100,000, which constituted the fourth quintile of income in our nation in 2007. This ratio is higher than for any other income group. Families in the top 20 percent of income (with incomes above \$100,000) had a ratio of debt to income of 123.6 percent, and families in the third quintile (with incomes between \$39,100 and \$62,000) owed 130.7 percent of their income. Households in the bottom 40 percent of the income distribution (with incomes below \$39,100 in 2007) owed well below 100 percent of their income.
- This high debt holds back consumption in the current recovery. Households used their homes as ATMs before the crisis, financing record shares of consumer spending with debt. But this trend reversed with the onset of the housing and financial crises, when households could no longer use their homes as ATMs. What's more, inflation-adjusted consumption expanded by only 4.3 percent from the start of the recovery in June 2009 to June 2011, marking its slowest growth of any recovery of this length since World War II.

All of these highly indebted households offer little incentive for businesses to invest more quickly. Highly indebted households also have high debt payments and thus less money to spend on other consumption items. And businesses may conclude that there is a likely slowdown for future consumption because consumers will remain heavily indebted into the foreseeable future. Businesses will conclude that there will be slow consumption growth in the future and thus invest less. The high debt levels of the past may thus help explain in part that business investment is well below its long-term historic trend.

So what can policymakers do to correct this problem? Well, in some cases Americans with heavy debt loads simply have too much debt for policy to intervene effectively. Policy reforms cannot help everybody, but for most Americans

in the middle class, the wherewithal to pay off their debt is within reach if given a fighting chance. Helping that process along more swiftly should be a top priority for policymakers. Here's why:

- It could take many more years for debt to reach sustainable levels if the decline in household debt is left to market forces alone. Debt levels could reach the levels of the 1990s, which went along with a fast growing economy and strong financial markets, only by the end of 2017 if after-tax income continues to grow at the rate of last year and debt stays flat. (see Table 1 on next page) This “do-nothing” scenario means prolonged foreclosures and tightening lending standards. It could alternatively take until September 2036 to reach the debt-to-after-tax-income ratio of the 1990s if income growth stays moderate and debt starts growing at the modest rate of 3 percent per year.
- Refinancing into lower-cost debt, especially mortgages, could accelerate deleveraging and boost consumption. Households, which today are able to take advantage of historically low mortgage rates if they are eligible for refinancing, could reduce their mortgage payments by substantial amounts and thus reach sustainable debt levels more quickly if they received targeted help in refinancing. They could then use the savings to pay back their debt more quickly. Refinancing alone would bring households to the debt levels of the 1990s about 18 months earlier than doing nothing would, assuming that refinancing lowers the debt service burden of consumers by 1 percent of their after-tax income and if the savings are used to repay the outstanding debt. (see Table 1 on next page)
- Boosts to after-tax incomes would allow household debt to fall to sustainable levels years earlier than it otherwise would. Raising after-tax income growth from the 4 percent levels of the past year to 7 percent could help households reach the debt levels of the 1990s about two-and-a-half years earlier than doing nothing. (see Table 1) The benefits from faster income growth are larger than from refinancing since interest rates cannot fall much further from where they are now. The combination of refinancing and faster income growth would allow households to reach the debt levels of the 1990s more than three years sooner than they would by doing nothing.

TABLE 1

Unburdening our middle class

Pathways to sustainable debt-to-after-tax-income ratios

| Category | Share of saving explained by change in category, previous labor market contractions | Share of saving explained by change in category, Great Recession | Relative difference | Share of saving explained by change in category, two years after labor market contraction ended | Expected change after Great Recession |
|---|---|--|---------------------|---|---------------------------------------|
| Motor vehicles and parts | -102.8 | -27.3 | -73.4% | -60.00% | -15.9% |
| Furnishings and durable household equipment | -44.3 | -12.4 | -72.0% | -4.70% | -1.3% |
| Recreational goods and vehicles | -16.6 | -8.6 | -48.2% | -13.50% | -7.0% |
| Other durable goods | -8.1 | -2.2 | -72.8% | -2.10% | -0.6% |
| Food and beverages purchased for off-premises consumption | -62.7 | 0.6 | -101.0% | 68.80% | -0.7% |
| Clothing and footwear | -50.9 | -9.4 | -81.5% | 17.40% | 3.2% |
| Gasoline and other energy goods | -8.8 | -12.1 | 37.5% | -3.20% | -4.4% |
| Other nondurable goods | -10.9 | 1.5 | -113.8% | -2.20% | 0.3% |
| Services | 196 | -16.0 | -108.2% | -90.20% | 7.4% |
| Personal interest payments | -3.7 | -18.2 | 391.9% | -8.30% | -40.8% |
| Personal current transfer payments | 13.9 | 4.1 | -70.5% | -1.60% | -0.5% |
| Housing and utilities | 46.60% | 2.50% | -94.6% | -15.40% | -0.8% |
| Health care | 125.00% | 22.20% | -82.2% | -32.00% | -5.7% |
| Transportation | -16.50% | -9.70% | -41.2% | -10.70% | -6.3% |
| Recreation services | 9.50% | -5.40% | -156.8% | -9.30% | 5.3% |
| Food services and accommodation | -15.70% | -6.30% | -59.9% | -7.10% | -2.8% |
| Financial | 28.60% | -13.90% | -148.6% | -15.00% | 7.3% |

Notes: The scenarios assume a starting debt-to-after-tax-income level of 114.3 percent in June 2011. The average debt-to-after-tax-income ratio for the period from December 1994 to March 2001 was 89.1 percent, which is one possible threshold for sustainable debt levels, as discussed in the text. The scenarios further assume an after-tax income growth of 4 percent and debt growth of 0 percent for the baseline “do-nothing” proposal. Fast income growth is assumed to equal 7 percent.

Refinancing assumes a reduction of the debt service burden—measured as debt service to after-tax income—by 1 percent of after-tax income, and it assumes that the savings will be used to repay the outstanding principal. See text for further discussion of the effect of refinancing and after-tax-income growth on deleveraging.

Source: Author’s calculations based on Release Z.1 Flow of Funds Accounts of the United States. Washington, DC: BOG.

The continued high debt levels that households carry on their shoulders pose a major drag on household spending and on the economy. Policymakers thus face a choice to leave the adjustment of high debt levels relative to after-tax incomes to market forces alone, with all of the economic pain that it entails. Or policymakers could do something about it by:

- Helping more borrowers refinance at historically low interest
- Boosting after-tax incomes through faster job creation by investing in infrastructure
- Enacting temporary payroll tax breaks
- Extending unemployment insurance benefits

In the pages that follow, then, this paper will examine in more detail the consequences of high indebtedness to American families and the broader economy before exploring the benefits of encouraging the more swift resolution of high indebtedness in our society. We then discuss some basic policy guidelines that policymakers should consider to make this happen in the coming years.

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