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MEMORANDUM

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NEW ENGLAND PUBLIC POLICY CENTER

To: Representative Susan Almy, Chairperson, Ways and Means Committee, and New Hampshire House of Representatives
From: Robert Tannenwald, Director and Joanna Helou, Research Assistant
Re: Growing financial strain among middle class households
Date: February 20, 2007

You recently requested information on financial stresses experienced by middle-income households and how they have changed over time. (I believe that Representative Majors initiated this request.) To investigate this issue, we used data from the *Survey of Consumer Finances*, conducted by the Board of Governors of the Federal Reserve System. This survey arguably provides the most comprehensive and authoritative data on household finances, broken out by income class. Unfortunately, it was last conducted in 2004. (The Board is scheduled to release the 2007 survey in early 2009.) In interpreting this memo, please keep in mind that consumer debt patterns may have changed since then.

Whether the financial condition of the nation's middle class has deteriorated in recent years depends on the measure. While on average the middle class took on a lot more debt, it was able to cover it with rapid appreciation in wealth, especially in home values. However, the average debt-service burden (debt payments as percentage of income) went up sharply for the middle class—more so than for other income groups.

Middle-income households have suffered the greatest increase in the percentage of households severely burdened by debt (debt-service as a percentage of income of more than 40 percent). Overall, the results suggest considerable disparity in financial position within the middle income group. Some have enjoyed increasing financial comfort, while the financial position of others has deteriorated.

Debt levels increased, but so did asset levels

All income groups increased their debt outstanding as a percentage of their income between 1989 and 2004. In general, the lower the income group, the higher the percentage point increase (Table 1).

Table 1: Debt as a percentage of income, all U.S. households (2004)

Income percentile	1989	1992	1995	1998	2001	2004
Less than 20th	42%	76%	92%	87%	82%	120%
20th to 39.9th	51%	63%	76%	80%	81%	112%
40th to 59.9th	66%	78%	82%	97%	96%	135%
60th to 79.9th	83%	86%	99%	114%	99%	136%
80th to 89.9th	78%	85%	98%	103%	103%	135%
90th to 100th	53%	76%	65%	69%	60%	85%

Source: Author's calculations based on the 2004 Survey of Consumer Finances

However, all income groups also enjoyed an even more rapid increase in the value of their assets as a percentage of their income over the same period. As a result, their net worth rose as a percentage of their income (Table 2). In the middle income quintile (which comprises households in the 40.0th to 59.9th percentile range), net worth as a percentage of income rose from 392 percent to 447 percent. The smallest percentage point increases occurred in the 20.0th to 59.9th percentile range. The top 10 percent enjoyed the largest percentage-point increase.

Table 2: Net worth as a percentage of income

Income percentile	1989	1992	1995	1998	2001	2004
Less than 20th	415%	505%	667%	602%	525%	672%
20th to 39.9th	448%	405%	451%	477%	477%	467%
40th to 59.9th	392%	372%	340%	372%	404%	447%
60th to 79.9th	333%	325%	348%	378%	451%	496%
80th to 89.9th	364%	351%	370%	409%	467%	455%
90th to 100th	577%	639%	620%	705%	748%	839%

Source: Author's calculations based on the 2004 Survey of Consumer Finances

However, in 2004, the average middle-class household was less liquid than its 1989 counterpart, because the equity in its home accounted for a larger fraction of its assets. Furthermore, one's home provides shelter. The financial consequences of defaulting on debt, therefore, were more severe for many households in 2004 than in 1989, because the risk of foreclosure was higher. Granted, new financial instruments give households more opportunities to tap the equity in their home, but only if they incur more debt (e.g., reverse mortgages and home equity loans), adding financial risk. Low-income households are less likely to face this exposure because many lack sufficient income to qualify for debt (although they face plenty of other financial hardships).[1] Middle class households, by contrast, can qualify for loans but have relied increasingly on their house for collateral. A sudden financial shock, whether induced by a spike in interest rates, a medical problem, divorce, or some other development, can therefore cause a major disruption.

[1] According to the 2004 *Survey of Consumer Finances*, 52.6% of all families in the lowest income quintile held any type of debt, compared to 84% in the 40th to 59.9th quintile.

The burden of carrying debt

If interest rates are low, a household can afford a higher level of debt than it could if interest rates are high. Consequently, in order to evaluate the financial burden that debt imposes on a household, one should also estimate the percentage of its income allocated to debt service. For middle class households, this percentage rose from 15.6 percent to 19.4 percent between 1995 and 2004. By contrast, over the same time period, debt-to-income ratios fell or rose very little in every other income category. In 2004, middle-income households had the highest ratio among all income groups (Table 3).

Table 3: Debt payment as a percentage of income

Income percentile	1995	1998	2001	2004
Less than 20th	19.1%	18.7%	16.1%	18.2%
20th to 39.9th	17.0%	16.5%	15.8%	16.7%
40th to 59.9th	15.6%	18.6%	17.1%	19.4%
60th to 79.9th	17.9%	19.1%	16.8%	18.5%
80th to 89.9th	16.6%	16.8%	17.0%	17.3%
90th to 100th	9.5%	10.3%	8.1%	9.3%

Source: Survey of Consumer Finances, 2004

A similar picture emerges in comparisons among income classes in the share of households bearing debt-to-income ratios in excess of 40 percent. Granted, in 2004 this percentage was twice as high in the lowest income quintile as in the middle quintile. However, between 1995 and 2004, this percentage rose far more rapidly among middle-income households than in any other income class (Table 4).

Table 4: Percentage of households with high debt burdens (debt service-to-income ratio exceeding 40 percent)

Income percentile	1995	1998	2001	2004
Less than 20th	27.5%	29.9%	29.3%	27.0%
20th to 39.9th	18.0%	18.3%	16.6%	18.6%
40th to 59.9th	9.9%	15.8%	12.3%	13.7%
60th to 79.9th	7.7%	9.8%	6.5%	7.1%
80th to 89.9th	4.7%	3.5%	3.5%	2.4%
90th to 100th	2.3%	2.8%	2.0%	1.8%

Source: Survey of Consumer Finances, 2004