Reality Check

Life and Debt

Why American Families Are Borrowing to the Hilt

A Century Foundation guide to the issues

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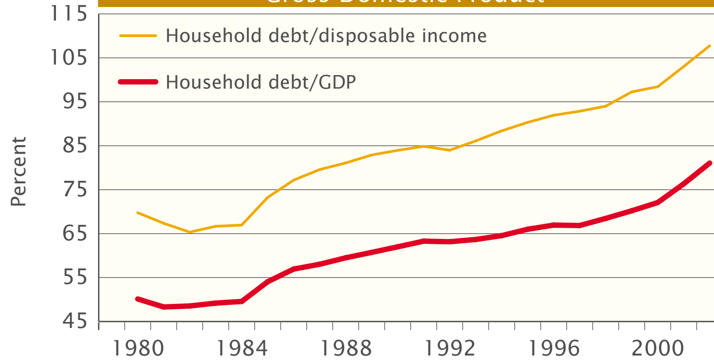
Household debt and personal bankruptcies have climbed to record-high levels, while the average family has only enough in savings to cover one or two lost paychecks. Mortgage debt alone has increased by about 12 percent each of the past two years (encouraged by the Federal Reserve keeping interest rates at historic lows), and overall household debt has grown by about 9 to10 percent each year since the 2001 recession.[1] Average credit card debt is $8,367 among families with at least one card, compared to $3,332 ten years ago.[2]

Today, debt held by households is equal to 80 percent of gross domestic product, compared to just 50 percent in 1980. And debt levels recently climbed above 100 percent of the value of annual disposable income for the first time on record (see Figure 1, page 2).

1. "Flow of Funds Accounts of the United States," statistical release, Z.1 release, Federal Reserve Board, June 10, 2004, available online at http://www.federalreserve.gov/releases/Z1/.
2. Data from Cardweb.com, cited in "Digging Out of Debt," SmartMoney.com, June 19, 2002, available online at http://www.smartmoney.com/debt/advice/index.cfm?story=digoutofdebt.

Figure 1. Outstanding Debt as a Percentage of Disposable Personal Income and Gross Domestic Product

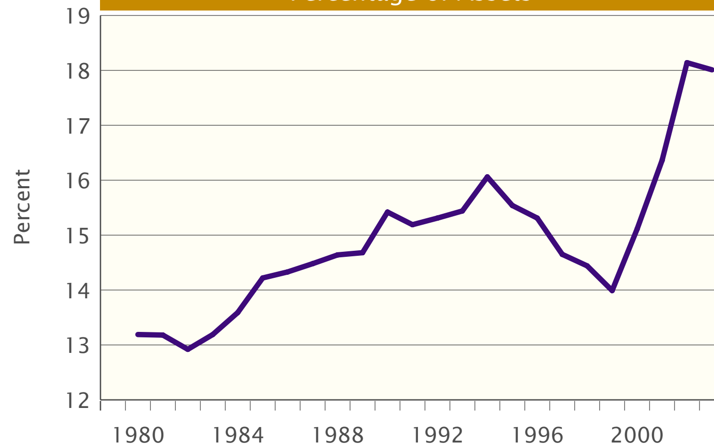


Source: "Flow of Funds Accounts of the United States," statistical release, Z.1 release, Federal Reserve Board, June 10, 2004, available online at http://www.federalreserve.gov/releases/Z1/.

The rising market value of stocks and housing assets during the 1990s alleviated concerns about this growing indebtedness, since households feel free to borrow more when their assets are growing. But with the steep decline in the market that began in 1999 and wiped out trillions of dollars in "paper" wealth, household debt as a proportion of assets shot up substantially (see Figure 2).

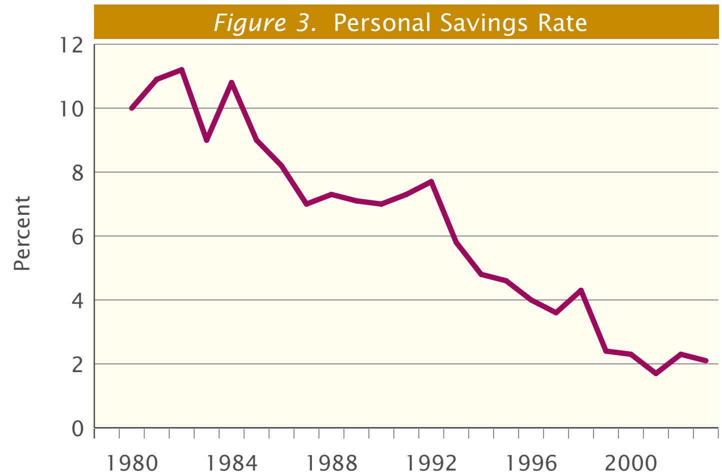
And yet, the slowdown in new debt growth that typically characterizes a slumping economy did not take place. In fact, despite the weak job market and declines in income, debt continued to grow in large part because property values remained remarkably high, cushioning stock market losses and encouraging families to keep borrowing.

Figure 2. Household Debt as a Percentage of Assets



Source: "Flow of Funds Accounts of the United States," statistical release, Z.1 release, Federal Reserve Board, June 10, 2004, available online at http://www.federalreserve.gov/releases/Z1/.

One troubling side effect of long-term debt growth is its impact on personal savings, which are now hovering near the lowest levels on record (see Figure 3). Most experts agree that a large share of the population is not saving enough to prepare for emergencies or their future retirement needs.



Source: National Income and Product Accounts, Bureau of Economic Analysis, U.S. Department of Commerce, available online at http://www.bea.gov/bea/dn/nipa web/TableView.asp?SelectedTable=58&FirstYear=2, using as parameters 002&LastYear=2004&Freq=Qtr.

Home Improvement?

By a substantial margin, homes are the largest asset of the vast majority of Americans. The ranks of homeowners grew throughout the 1990s—increasing from 64 percent of households in 1990 to 68.6 percent at the end of 2003.[3]

But the continued strength of the housing market has come at a cost: a sizable increase in mortgage debt, which is now equal to about 80 percent of household disposable income, up from slightly less than half in 1980.[4] Increases among lower-income families have been especially large: median mortgage debt nearly

3. Housing Vacancies and Homeownership—Historical Tables, *Current Population Survey*, Bureau of the Census, U.S. Department of Commerce, revised April 22, 2004, Table 14, available online at http://www.census.gov/hhes/www/housing/hvs/historic/histt14.html.
4. "Flow of Funds Accounts of the United States," June 10, 2004.

tripled between 1989 and 2001 for households with incomes in the lowest 20 percent of the earnings spectrum, and more than doubled for those in the next-lowest 20 percent (see Table 1).

Burdensome debt among these families is partly attributable to lending practices that have lowered the bar for homeownership. Families unable to offer a significant down payment or meet requirements for creditworthiness now have numerous

Table 1. Median Value of Mortgage Debt by Income Group, 1989 and 2001 (2001 dollars)

	1989	**2001**	**% change**
Lowest 20%	$9,635	$28,000	191
20–39.9%	$17,894	$40,000	124
40–59.9%	$28,906	$56,109	94
60–79.9%	$50,929	$75,589	48
80–89.9%	$57,811	$90,958	57
90–100%	$96,352	$134,000	39

Source: Survey of Consumer Finances, Federal Reserve Board, Table 14, available online at http://www.federalreserve.gov/pubs/oss/oss2/2001/bulltables.xls.

options for purchasing a home through "subprime" or "unconventional" mortgages—at the price of higher payments, fees, and sometimes foreclosure. The proliferation of these risky loans, combined with increasingly unmanageable housing costs, has driven the annual number of home foreclosures up 250 percent since 1980, from about 114,000 to more than 550,000 in 2001.[5]

Adding to housing debt loads are record levels of mortgage refinancing activity, spurred by lower interest rates and the appreciation of housing values. Between 2001 and 2003, families extracted a record $333 billion in cash from their homes, stimulating the economy and allowing households to improve their homes, pay down higher interest credit card debt, or simply acquire extra spending money.[6] But refinancing and additional mortgage borrowing has increased both the size and length of loans for homeowners who refinance, especially for those who take out cash. The Federal Reserve found that 45 percent of homeowners who refinanced had liquefied some home equity, resulting in a higher monthly payment for 40 percent of them and a longer loan life for 80 percent.[7]

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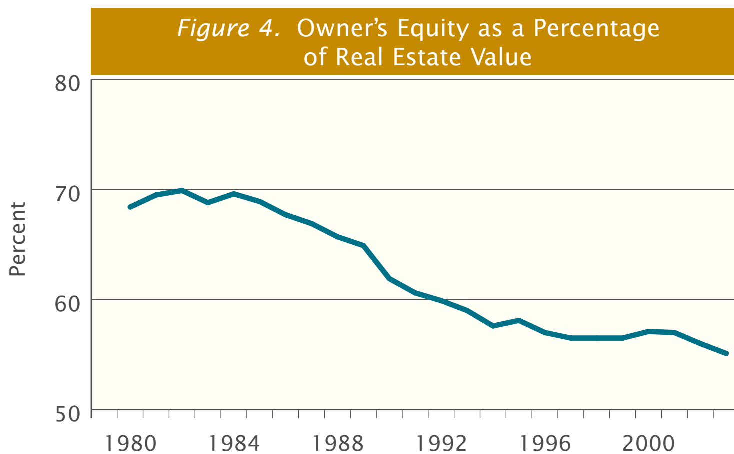
5. Data from Bureau of the Census, U.S. Department of Commerce; see "Re: The Skyrocketing Foreclosure Rate Caused by Subprime Mortgages," letter to Michael Oxley, chairman, and Barney Frank, ranking member, Financial Services Committee, U.S. Congress, House, from Margot Saunders, managing attorney, National Consumer Law Center, Washington, D.C., December 1, 2003, available online at http://www.consumerlaw.org/initiatives/predatory_mortgage/oxley_letter.shtml.
6. "State of the Nation's Housing 2004," Joint Center for Housing Studies of Harvard University, 2004, available online at http://www.jchs.harvard.edu/publications/markets/son2004.pdf.
7. Glenn Canner, Karen Dynan, and Wayne Passmore, "Mortgage Refinancing in 2001 and Early 2002," *Federal Reserve Bulletin,* December 2002, pp. 469–81, available online at http://www.federalreserve.gov/pubs/bulletin/2002/1202lead.pdf.

Refinancing activity also has played a role in large increases in mortgage debt among older households, which traditionally expected to own their houses by retirement. Among households with members aged seventy-five and older, the median value of mortgage debt has more than quadrupled since 1989. For households in the sixty-five to seventy-four age bracket, the median mortgage debt has more than tripled. For those in the fifty-five to sixty-four age range, the number of families with outstanding mortgage debt has doubled since 1989 and now represents about half of all near-retirees.[8]

Despite the rise in home values, household assets are more leveraged now than ever before. Owners' equity in their homes has fallen to a record low of 55 percent (see Figure 4), and the Center for Economic Policy Research has estimated that the equity/market value ratio could fall as low as 43 percent if housing prices decline substantially.[9] Lower

Figure 4. Owner's Equity as a Percentage of Real Estate Value



Source: "Flow of Funds Accounts of the United States," statistical release, Z.1 release, Federal Reserve Board, June 10, 2004, available online at http://www.federalreserve.gov/releases/Z1/.

8. *Survey of Consumer Finances,* Federal Reserve Board, Tables 11A and 11E, available online at http://www.federalreserve.gov/pubs/oss/oss2/2001/bulltables.xls.

9. Dean Baker and Simone Baribeau, "Homeownership in a Bubble: The Fast Path to Poverty?" Center for Economic and Policy Research, Washington, D.C., August 13, 2003, available online at http://www.cepr.net/homeownership_in_a_bubble.htm.

equity leaves families more vulnerable to an economic crisis, because they have less in assets to serve as a safety net.

The rise in mortgage debt may soon prove harmful to families in another way: the spectacular growth of housing values in the past few years has led many economists to warn of a price bubble that has yet to burst. While housing prices have historically followed the rest of the economy fairly closely, the housing price index has exceeded the nonshelter consumer price index by more than thirty-three percentage points since 1995.[10] Another foreboding sign is that the housing market has continued to soar in many metropolitan areas, while rental prices and demand, which usually fluctuate in step with housing prices, have weakened dramatically.

The impact of a bubble is difficult to predict since trends in housing markets vary a great deal based on location and many homeowners hold onto their homes even when values decline (unlike other assets such as stocks, which can be sold quickly). Still, a correction in prices could leave many homeowners with mortgage balances that are greater than the market value of their homes, that is, with negative equity.

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10. Ibid.

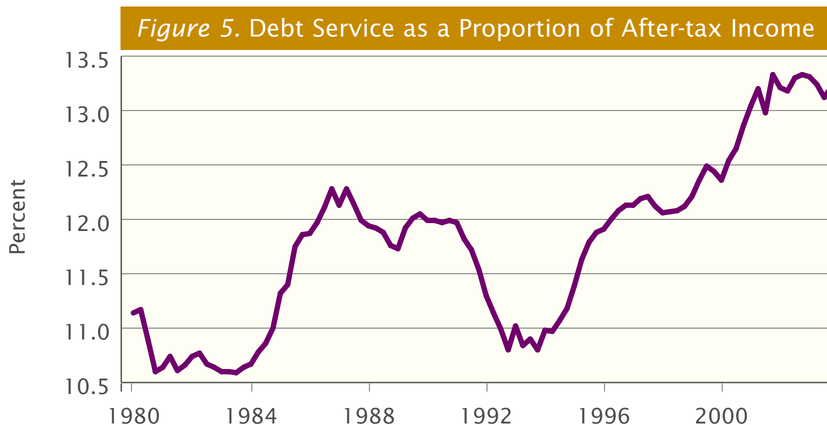
Piling On

Households are spending more of their incomes than ever on servicing their debts. The debt burden indicator constructed by the Federal Reserve, which measures how large a proportion of families' incomes goes toward paying off debts, reached a new high recently (see Figure 5). Low-income families have become especially vulnerable—27 percent of households in the lowest income group now report spending a staggering 40 percent of take-home earnings on debt payments.[11]

Where Is It All Going?

Debt burdens are at record levels because families have been stretched to the limit in recent years. With more income going to housing and other rising expenses related to medical care, education, vehicles, child care, and so forth, families are relying on credit as a way to meet everyday needs. Remarkably, a family with two earners today actually has less discretionary income, after fixed costs like medical insurance and mortgage payments are accounted

Figure 5. Debt Service as a Proportion of After-tax Income



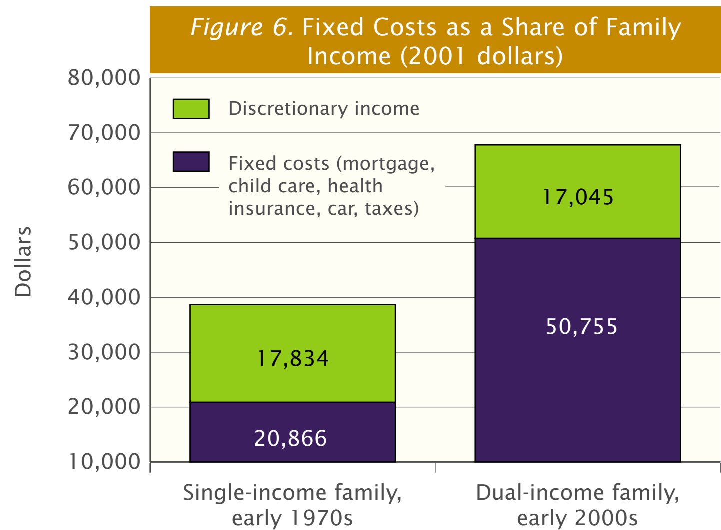
Source: "Household Debt Service and Financial Obligations Ratios," Federal Reserve Board, May 7, 2004, available online at http://www.federalreserve.gov/releases/housedebt/default.htm.

11. *Survey of Consumer Finances,* Federal Reserve Board, Table 14, available online at http://www.federalreserve.gov/pubs/oss/oss2/2001/bulltables.xls.

for, than did a family with only one breadwinner in the 1970s (see Figure 6).

In addition to credit cards, families are taking on larger and longer loans in order to finance other spending. Outstanding debt held in installment loans was worth more than $1.2 trillion at the end of 2003, an increase of more than 50 percent since 1995 in inflation-adjusted dollars.[12] Some types of installment debt have increased considerably in recent years; for example, average student loan debt increased 35 percent in real dollars between 1997 and 2002,[13] and average auto loans have risen 34 percent in real dollars since 1995, to $26,295 in 2003.[14]

Figure 6. Fixed Costs as a Share of Family Income (2001 dollars)



Note: Based on median incomes for dual- and single-income families in 1973 and 2001, less contemporaneous taxes. Fixed costs are based on average costs in both years for health insurance, mortgage payments, and car payments. Average costs of a second car and child care have been added to the 2001 case.

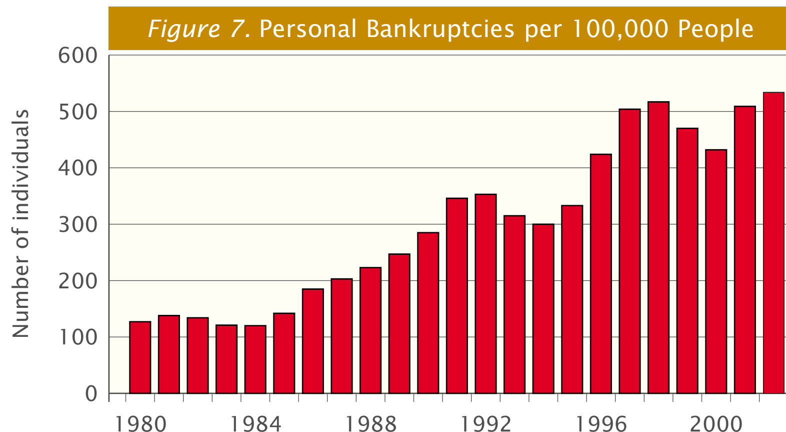
Source: Elizabeth Warren and Amelia Warren Tyagi, *The Two-Income Trap: Why Middle-Class Mothers and Fathers Are Going Broke* (New York: Basic Books, 2003), p. 51.

12. "Consumer Credit," statistical release, G.19 release, Federal Reserve Board, June 7, 2004, available online at http://www.federalreserve.gov/releases/g19/. Author's calculation from consumer price index, Bureau of Labor Statistics, U.S. Department of Labor.
13. Sandy Baum and Marie O'Malley, "College on Credit: How Borrowers Perceive Their Education Debt—Results of the 2002 National Student Loan Survey," final report, Nellie Mae Corporation, Braintree, Mass., February 6, 2003, available online at http://www.federalreserve.gov/pubs/oss/oss2/2001/scf2001home.html.
14. "Consumer Credit," June 7, 2004.

Why Worry?

The very low interest rates of recent years have cushioned the impact of new debt acquired by consumers. But with economic recovery taking hold, most observers predict the Federal Reserve will be forced to raise rates, which will make payments more difficult for consumers with rate-sensitive loans, such as adjustable-rate mortgages, home equity lines of credit, and credit cards.[15] Moreover, since mortgage payments and minimum credit card payments consist mostly of interest, the effect on these families' bottom lines may be considerable. For example, if adjustable mortgage rates rose from 6 percent to 8 percent, mortgage payments on these loans would jump by close to a third.

Figure 7. Personal Bankruptcies per 100,000 People



Source: Author's calculations using data from the American Bankruptcy Institute, Alexandria, Va., and the Bureau of the Census, U.S. Department of Commerce.

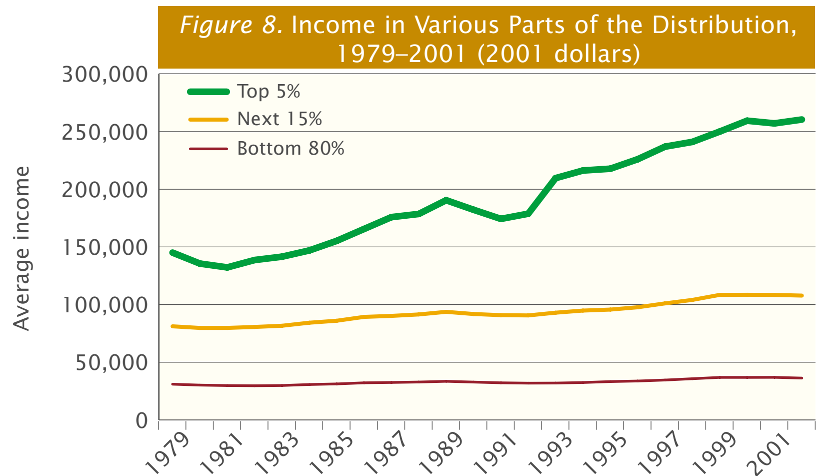
Even with low rates and rising real estate values, personal bankruptcies have soared (see Figure 7). There were 1.5 million filings in 2002, compared to only about three hundred thousand in 1980. More than 90 percent of

15. Paul Blustein and Nell Henderson, "A Nation Chained to Rates: As Borrowing Costs Rise, Repercussions Will Resonate throughout the Economy," *Washington Post*, April 17, 2004, p. E1, available online at http://www.washingtonpost.com /wp-dyn/articles/A18892-2004Apr16 .html.

those who file for bankruptcy are from the middle class, and the vast majority have children.[16]

Unfortunately, the one scenario that would ensure that families could start paying down their debts—rising incomes—does not seem to be developing. Average incomes for the bottom 80 percent of the income distribution grew by only $6,000 in inflation-adjusted dollars between 1979 and 2001, and have not grown at all since then (see Figure 8).

Figure 8. Income in Various Parts of the Distribution, 1979–2001 (2001 dollars)



Source: Historical Income Tables—Households, *Current Population Survey,* Bureau of the Census, U.S. Department of Commerce, Table H-3, available online at http://www.census.gov/hhes/income/histinc/h03.html.

Reversing the deterioration in household finances will require stronger income growth, less borrowing, and more saving. Politicians will debate how to accomplish these goals, but recent policies clearly have not helped.

16. Elizabeth Warren, "Financial Collapse and Class Status: Who Goes Bankrupt?" 41 *Osgoode Hall Law Journal 114* (2003), cited in Elizabeth Warren and Amelia Warren Tyagi, *The Two-Income Trap: Why Middle-Class Mothers and Fathers Are Going Broke* (New York: Basic Books, 2003), p. 194.

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