

A TALE OF TWO RECOVERIES: WEALTH INEQUALITY AFTER THE GREAT RECESSION

BENJAMIN LANDY

Economic inequality has long been a fact of American life. And for many years, a certain level of inequality was accepted, even encouraged, as incentivizing creativity and rewarding hard work. But in the last several decades, the rewards accruing to the top of the income distribution have grown disproportionate, and median wages stagnant. Social mobility—the potential to move from one socioeconomic class to another—has slowed, allowing intergenerational advantage to accumulate and compound in the form of wealth.

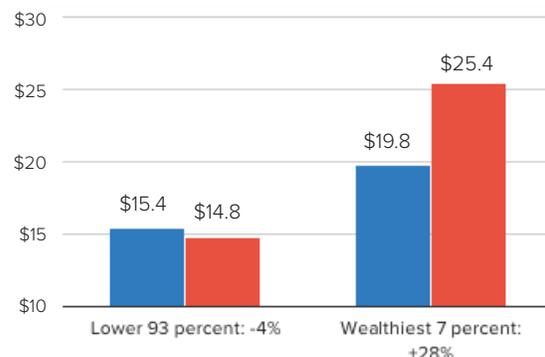
In the past, the trend towards higher inequality was slowed or even reversed slightly during recessionary periods, as top incomes fell with capital gains. The upward movement of wealth inequality also tended to level off or decrease, as declining stock markets took a heavier toll on the net worth of wealthier, stock-owning households. Rising inequality resumed during economic expansions, sometimes with renewed vigor, but rarely at the expense of the middle class.

The Great Recession of 2007 to 2009 and the subsequent economic recovery have not followed that script. Due to the unique circumstances of the housing boom and bust cycle that precipitated the financial crisis, low- and middle-income homeowners were hit particularly hard, with households in the bottom four-fifths of the wealth distribution experiencing a 39.1 percent decline in net worth between 2007 and 2010. The top 20 percent, by contrast, lost just 14 percent of their net worth.

The inequality of the economic recovery has been even worse. According to a Pew Research Center analysis, every dollar and

more of aggregate gains in household wealth between 2009 and 2011 went to the richest 7 percent of households. Aggregate net worth among this top group rose 28 percent during the first two years of the recovery, from \$19.8 trillion to \$25.4 trillion. The bottom 93 percent, meanwhile, saw their aggregate net worth fall 4 percent, from \$15.4 trillion to \$14.8 trillion. As a result, wealth inequality increased substantially over the 2009–2011 period, with the wealthiest 7 percent of U.S. households increasing their aggregate share of the nation’s overall wealth from 56 percent to 63 percent.¹ (See Figure 1.)

Figure 1. Wealth inequality worsened during the first two years of the recovery
 Aggregate net worth of households in trillions of 2011 dollars



Source: Pew Social Trends

Understanding how this wealth divide came about, and why it widened in the wake of the subprime and financial crises, is a

critical first step towards developing policies that address rising inequality. To that end, this Century Foundation issue brief will explore the combination of housing price inflation and debt-fueled consumption that led to the financial crisis of 2007–08 and the resulting recession; why the wealth gap matters; and explain how the differing asset allocation strategies pursued by low, middle- and high-income households have worked to accelerate the stratification of household wealth by class.

The Illusion of Wealth

Since the end of the Great Recession, the economic divergence of the richest one percent from the bottom ninety-nine has entered the American consciousness as a permanent fact and fixture of contemporary political life. But for the better part of two decades, rising wealth inequality was obscured by cheap money and soaring home prices; a debt-fueled substitute for real prosperity. Median household income growth was stagnant or in decline from 2000 to 2005, but the interest rate on credit cards had never been lower. The stock market was lackluster, but real estate was posting annual returns between 10 and 20 percent. As a result, Wall Street began pushing a host of dazzling financial products—home equity lines of credit, NINJA (No Income, No Job, no Assets) loans, hybrid ARMs—that made it easier than ever for the middle class to bet big on the housing market.

For a while, that bet paid off: From 2001 to 2005, rising home values and plummeting interest rates allowed Americans to extract an average \$1 trillion per year from their homes, net of closing costs and repayment of other mortgage debt—more than triple the annual “free cash” available over the 1991 to 2000 period and equal to nearly 12 percent of personal disposable income. About half of the money found its way back into the housing market, either by funding new home purchases or home improvements, and a quarter paid for non-home asset purchases like financial securities, stocks and business equity. The remainder went towards personal consumption, including credit card, auto and student loan debt.²

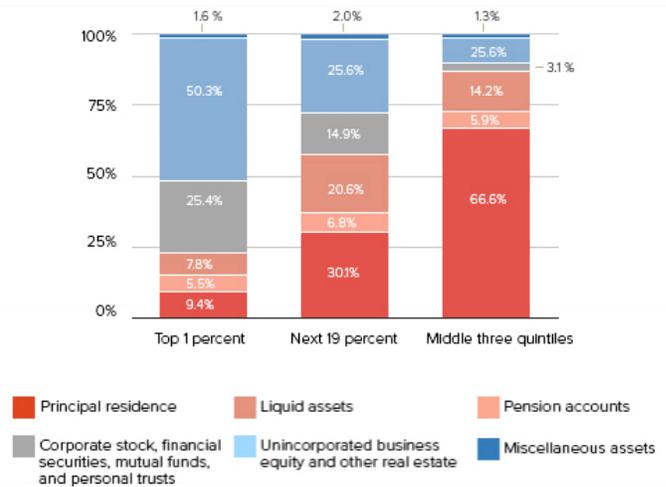
When the bubble burst in 2007–08, Americans were left with a crushing debt hangover. Home values fell 30 percent in real terms between 2007 and 2009, and continued to fall through 2012, erasing over \$6 trillion in accumulated housing wealth and leaving 12 million homeowners underwater.³ U.S. stock indexes lost half their value as the subprime crisis deepened and consumer spending plunged. All told, household net worth dropped \$16 trillion from its pre-crisis peak of \$67.4 trillion in the third quarter of 2007 to \$51.4 trillion at the end of the first quarter of 2009—the same level of household wealth, adjusted for inflation, as in 1999.⁴

Not all households experienced this loss equally, however. While housing made up two-thirds of all middle class wealth in the mid-2000s, the wealthiest one percent had about 90 percent of their gross assets in stocks, securities, and other forms of business equity. Middle class families were therefore seven times

as exposed to the housing bubble and collapse, while wealthier families were comparatively insulated. (See Figure 2.)

Figure 2. Composition of household wealth, 2010

Percent of gross assets

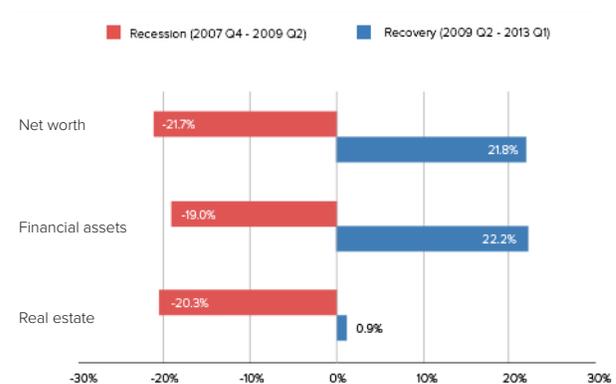


Source: Wolff (2012)

Those distributional differences account for nearly all of the variation in wealth growth since the end of the Great Recession. Because U.S. stock markets rebounded quickly—the S&P 500 rose 60 percent in real terms between its 2009 nadir and the end of 2010 alone—those with large holdings of non-home financial wealth were able to begin rebuilding their wealth almost immediately. (See Figure 3.) Mean (average) net worth, which is skewed upwards by the high concentration of wealth at the top of the distribution, fell just 17.7 percent between 2007 and 2010, from \$563,800 to \$463,800 per household. Housing prices, by comparison, did not begin to rebound until early 2012, causing median net worth (the value at which one-half of households have lower net worth and one-half have higher net worth) to drop a staggering 47.1 percent between 2007 and 2010, from \$107,800 to \$57,000 per household.⁵

Figure 3. The fall and rise of household net worth

Inflation-adjusted percent change



Source: Federal Reserve, Flow of Funds data (Z.1)

Note: Image has been updated.

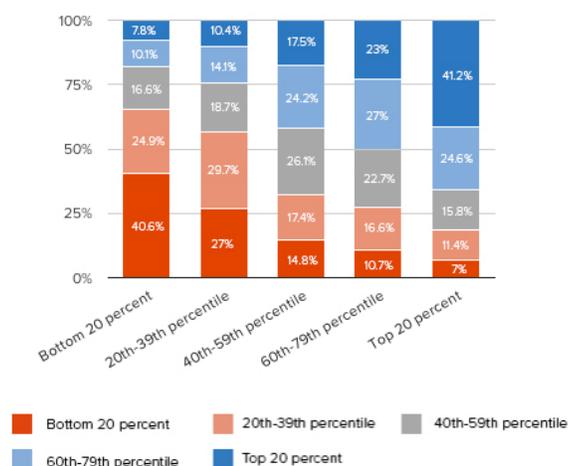
WHY WEALTH INEQUALITY MATTERS

Most discussions about rising inequality have focused on market income (wages and compensation net of federal taxes and transfers), particularly the role of capital gains. But the widening income gap can only tell us so much about economic inequality. Wealth, or household net worth—defined as the total market value of household assets (e.g., bank deposits, stocks, real estate, business equity) minus liabilities (credit card debt, student loans, home mortgage)—gives us a more complete picture.

Wealth represents the accumulation of surplus income in the form of savings or investment, creating a store of financial resources available for “improving life chances, providing further opportunities, securing prestige” and “passing status along to one’s family.”⁶ For most Americans, having wealth means the ability to buy a home, start a business, afford a college education for their children, and be insured against medical and financial emergencies. High levels of wealth can also buy influence, social capital and political power, in a way that high income alone cannot.

In each case, wealth functions primarily to ensure financial stability over time, perpetuating the accumulation of advantage and disadvantage across generations along racial, class and ethnic lines. As the distribution of wealth has become more stratified, this intergenerational link has also become stronger. Today, 41 percent of Americans raised at the bottom of the wealth distribution remain there as adults, just as 41 percent of those raised at the top remain there, too. Only 8 percent rise from the bottom to the top, and 7 percent fall from the top to the bottom.⁷ (See Figure 4.)

Figure 4. Social mobility is lowest at the top and bottom of the wealth distribution
Chances of moving up or down the wealth ladder, by parent’s quintile

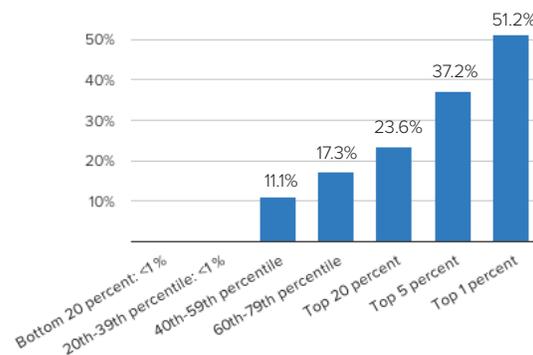


Source: The Pew Charitable Trusts

To a large degree, this “stickiness” at the top and bottom of the wealth distribution is a function of the savings rate, which is itself a function of income inequality. As incomes rise, people increase the rate at which they save and invest. For the bottom 40 percent

of the income distribution, this rate hovers around zero on net, as any savings are offset by equivalent debts. At the middle of the income distribution, the savings rate rises to 11.1 percent, and to 23.6 percent for those in the top quintile. Only the richest one percent saves more than they spend, with a savings rate of 51.2 percent.⁸ (See Figure 5.)

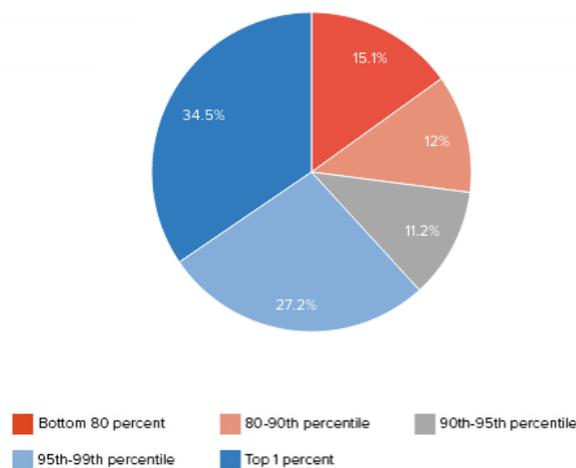
Figure 5. Estimated savings rate, by income level



Source: Dynan, Skinner and Zeldes (2004)

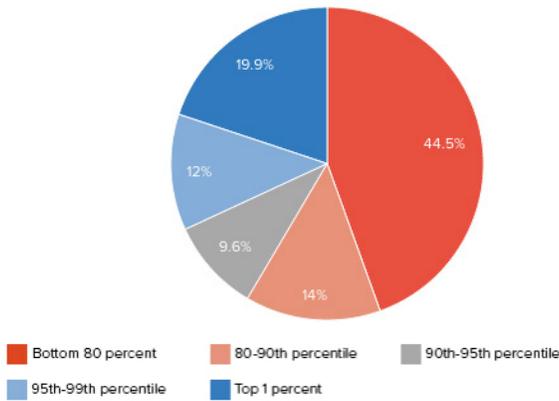
As a result, the distribution of wealth is far more unequal than that of income. In 2007, households in the top 10 percent of the wealth distribution controlled 73.1 percent of all national wealth, compared to 41.5 percent of national income received by the top 10 percent of the income distribution. Wealth was even more concentrated for the top one percent, who held 34.6 percent of total wealth in 2007—roughly double the share of income received by the top one percent of the income distribution.⁹ (See Figure 6.)

Figure 6. Wealth distribution, 2007



Note: The bottom 40 percent share of total household net worth is 0.2%, the middle 20 percent is 4%, and the next 20 percent is 10.9%.

Income distribution, 2007



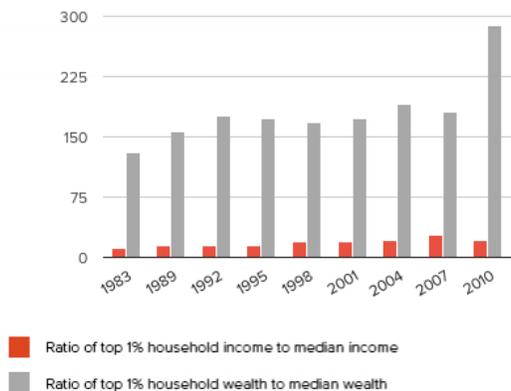
Note: The bottom 40 percent share of pretax household income is 12.3%, the middle 20 percent share is 13.1%, and the next 20 percent is 19.1%.

Source: Wolff (2012)

The wealth gap has also widened over time, with 90.2 percent of all wealth growth between 1983 and 2010 accruing to the wealthiest 10 percent of the distribution, and 38.3 accruing to the top one percent. For the bottom 60 percent of households, meanwhile, real wealth actually declined, from an average \$28,900 per household in 1983 to just \$13,000 in 2010. As a result, the share of national wealth belonging to the top 10 percent rose to 76.7 percent in 2010—the highest percentage share since the late 1920s. The share belonging to the bottom 60 percent fell to less than 2 percent.¹⁰

This upward redistribution of wealth has resulted in incredible disparities between ordinary Americans and those at the top. In 1983, the wealthiest one percent had 131 times as much wealth as the median household, while the top one percent of the income distribution earned only 11 times more than the median. By 2010, the top one percent-to-median ratio for wealth had soared to 288-to-1, and 21-to-1 for income.¹¹ (See Figure 7.) Still, these figures pale in comparison to the fortunes of the “Forbes 400,” for whom the average net worth was \$3.8 billion in 2011, or approximately 65,000 times that of the median household.¹²

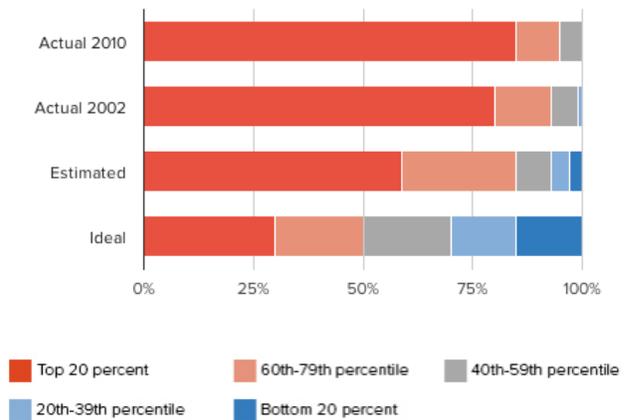
Figure 7. Wealth inequality rose sharply from 2007 to 2010



Source: Wolff (2012) and author’s calculations based on U.S. Census Bureau and the World Top Incomes Database (Alvaredo, Facundo, Atkinson, Piketty and Saez)

These levels of wealth inequality are far higher than most Americans assume. In one well-known study, behavioral economists Michael I. Norton and Dan Ariely asked a nationally representative sample of 5,522 “regular Americans” to describe an ideal wealth distribution for the United States, and to estimate its actual distribution. Overall, the respondents created an “ideal” wealth distribution that allocated just over 30 percent to the top quintile, about 20 percent each to the next two quintiles, 15 percent to the second-to-last quintile, and 10 percent to the bottom. Their estimate of the actual distribution was far less equal: Nearly 60 percent to the top quintile, 20 percent to the next quintile, and successively smaller portions allocated to the bottom three quintiles. The actual distribution (in 2002, the year Norton and Ariely used in their study; and 2010, the most recent year available), shown below, illustrates the distance between perception and reality. (See Figure 8.) The following graph (Figure 9) shows how the wealth distribution has grown more unequal over time.¹³

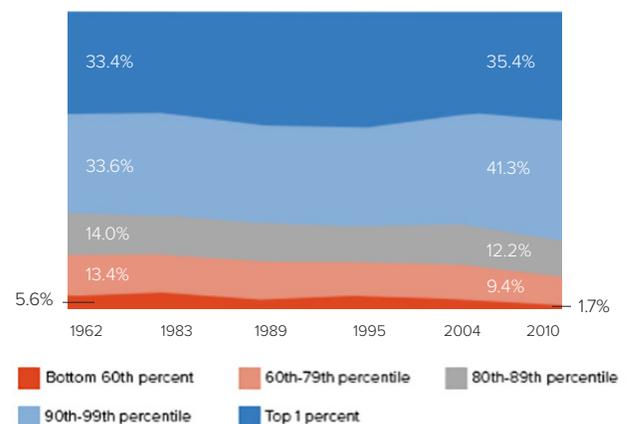
Figure 8. Americans’ estimated and ideal distribution of wealth



Source: Norton and Ariely (2011) and Wolff (2012)

Figure 9. Distribution of total net worth, 1962-2010

Percentage share of wealth, by wealth group



Source: Wolff (2012)

WEALTH INEQUALITY BEFORE AND AFTER THE GREAT RECESSION

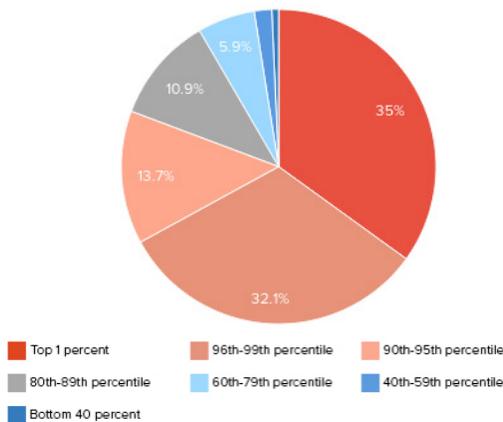
Wealth inequality, like income inequality, has known deleterious effects on education, social mobility, health outcomes, and even violent crime.¹⁴ But recent studies also suggest that rising inequality drives lower- and middle-income households to increase their borrowing, using debt to maintain their standard of living compared to higher income households. A greater concentration of wealth at the top of the distribution leads richer households to seek out new forms of investment assets, particularly debt-based securities. As the flow of funds between wealthy creditors and lower-income debtors increases, so does the size and instability of the financial sector. When the debt-to-income ratio reaches a critical point, the financial system destabilizes.¹⁵

The financial crisis of 2007–08 and the ensuing Great Recession followed this pattern closely. However, the pre-crisis period beginning in the mid-1990s (and accelerating during the debt-fueled consumption of the early 2000s) contained several distinguishing features that worked in combination to heighten both the severity of the recession and the inequality of the subsequent recovery.

Asset and investment inequality

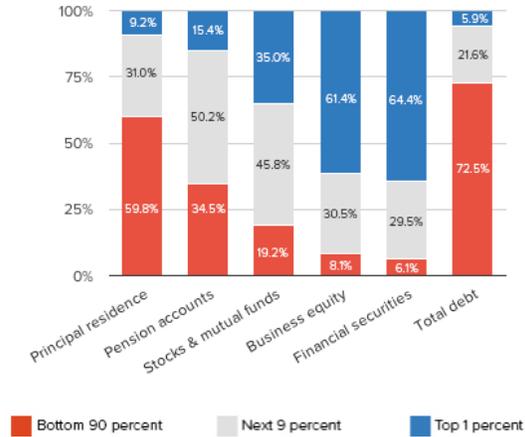
First, the distribution of different types of financial assets varied significantly between households at the top, middle and bottom of the wealth distribution. Between 1983 and 2001, the wealthiest 10 percent of households controlled an average 81.1 percent of all stocks and mutual funds, including both direct ownership and indirect ownership through retirement funds. They also controlled 87.3 percent of all financial securities and 90.6 percent of business equity. By 2010, the top 10 percent share of stocks remained stable at 80.8 percent, but had risen to 93.9 percent of financial securities and 91.9 percent of business equity. The only asset class majority controlled by the bottom 90 percent of the wealth distribution was housing. From 1983 to 2001, the bottom 90 percent held an average 65.3 percent of all principal residence housing wealth, and 59.8 percent in 2010.¹⁶ (Figures 10 and 11.)

Figure 10. Concentration of stock ownership



Source: Wolff (2012)

Figure 11. Wealth distribution in the U.S., by asset type



Source: Wolff (2012)

For the first few decades of the postwar era, these distributional differences in the composition of household wealth had little effect on economic inequality. In fact, both income and wealth inequality declined between 1929 and 1973, a period referred to by economists as the “Great Compression.” Income inequality began to rise in the mid-1970s, but until the mid-1980s, U.S. stock indexes and housing prices moved more or less in tandem with the consumer price index, generating no real increase in value. Then, in the mid-1980s, the stock market entered a dramatic bull cycle, significantly outpacing any growth in housing. Wealth inequality, which had remained relatively stable between 1962 and 1983, began to rise. (See Figure 12.)

Figure 12. Financial assets have appreciated faster than housing

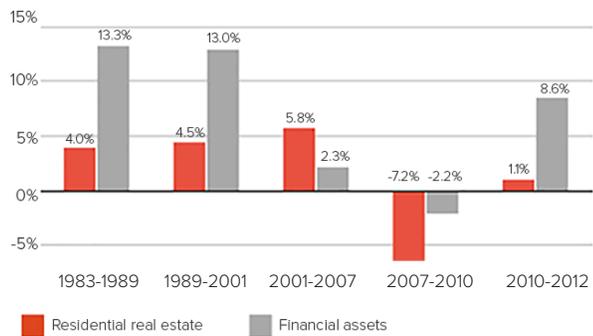


Source: Federal Reserve Bank of St. Louis

From 1983 to 1989, financial assets appreciated at an average annualized rate of 13.3 percent, unadjusted for inflation; and 13 percent annualized between 1989 and 2001. Housing, by contrast, rose just 4 percent from 1983 to 1989, and 4.5 percent between 1989 and 2001—only slightly above the average rate of inflation (3.6 percent and 3.2 percent, respectively).¹⁷ (See Figure 13.)

Figure 13. Returns on financial assets have outpaced real estate

Nominal rates of return, by asset type and period



Source: Wolff (2012) and author's calculations

Wealth inequality and financial instability

That dynamic changed in the aftermath of the dot-com crash, when the S&P 500 fell 40 percent, and the NASDAQ 75 percent, between 2000 and 2003. With interest rates at record lows and home prices rising despite the 2001 recession, yield-hungry investors plowed money into the residential real estate market, including financial instruments for underwriting and securitizing mortgage debt.

As a result, low- and middle-income homeowners suddenly found themselves in the unusual situation of having declining real median incomes, but skyrocketing home equity and unprecedented access to credit. Whereas residential real estate had traditionally functioned as an illiquid, tax-advantaged store of surplus income, higher property values allowed homeowners to increase their relative consumption level despite rising inequality. In 1983, households in the middle three quintiles of the wealth distribution owed approximately \$37 in debt for every \$100 they owned in equity, an amount equal to 66.9 percent of annual income. By 2010, that ratio had doubled, with middle class households using their homes as collateral to increase their debt to approximately \$72 per \$100 in equity, or 134 percent of income. The top one percent of the wealth distribution, meanwhile, decreased their debt-to-equity ratio from .59 to .35, or from 86.8 percent of income to 60.6 percent.¹⁸

Financial institutions also began to take bigger risks. In 2003, the average leverage ratio at the five largest investment banks was about 20-to-1, or twenty dollars in liabilities for every one dollar in equity. By 2007, that ratio was closer to 33-to-1; so high that a decline in asset values as little as 3 percent could wipe out a company.¹⁹ Yet few people realized how unstable the system had become. Default risk was hidden in structured mortgage-backed securities (MBS) called collateralized-debt obligations (CDOs), which the rating agencies incorrectly labeled high-grade and safe for investors, including the major investment banks themselves.

Accurate risk pricing was further obscured by the massive and increasing volume of credit default swaps (CDS): financial products that allowed MBS and CDO holders to insure their

investment against default, but also allowed speculators without any stake in the underlying securities to place unlimited bets on the same mortgage. Few investors knew what these products were really worth, and few financial institutions had the requisite capital to cover their potential losses.

Crisis and recovery

The fallout, when home prices started to decline in 2006, was severe. Homeowners with adjustable-rate mortgages were unable to refinance at lower rates, leading to rising delinquency and foreclosure rates. Household net worth and residential construction both declined, lowering consumer spending and economic output. Bank losses led to bank failures, turmoil in the stock markets, constricted liquidity and plummeting business investment.

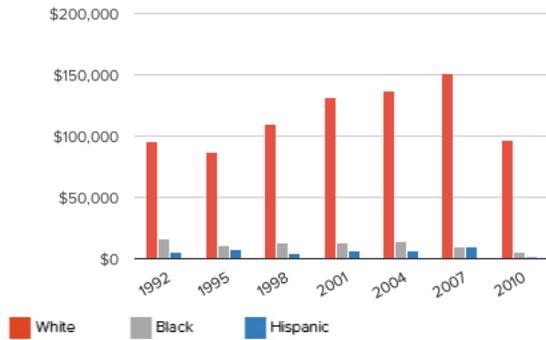
In 2008, the federal government passed a series of bills intended to avert recession, beginning with the Economic Stimulus Act in February, the Housing and Economic Recovery Act in July, and the Emergency Economic Stabilization Act in October, which created the \$700 billion Troubled Asset Relief Program (TARP) to purchase toxic bank assets. Yet no comparable “bailout” for homeowners was forthcoming. Although homebuyers and financiers both had made poor decisions in the run-up to the financial crisis, the federal government ultimately did little to help the 12 million households with negative home equity, i.e. underwater on their mortgages.

Some demographic groups were hit harder than others by the housing market collapse. Families more likely to have bought a home towards the peak of the housing bubble, when interest rates and lending standards were at their lowest levels, or who were the victims of predatory lending, experienced the greatest decline in home equity. For example, while the overall percentage of homeowners with negative equity (i.e. those who owed more on their mortgage than the value of their home) rose from 1.8 percent in 2007 to 8.2 percent in 2010, the rate among homeowners under age 35 rose from 5.5 percent to 16.2 percent. Young homeowners saw a 58.7 percent decline in average home equity over the same period, more than double the 25.7 percent average among all households. The trend was similar among less-educated households, whose delinquency rate was about seven times that of college-educated households in 2009.²⁰

African-American and Hispanic homeowners also fared worse than average, in part due to predatory lenders pushing subprime loans on minority communities, even when their income and credit rating qualified them for less expensive mortgages. The net worth of African-American households, who had made considerable wealth gains throughout the 1990s and early 2000s, fell 64.2 percent between 2004 and 2010, from a median value of \$13,700 to just \$4,900 per household. (See Figure 14.) Hispanic households, meanwhile, saw a stunning 48.3 percent decline in average home equity between 2007 and 2010—more than any other racial or ethnic group—as well as the highest rate of delinquency in 2009 (15.4 percent).²¹

Figure 14. Median net worth, by race

In 2010 dollars



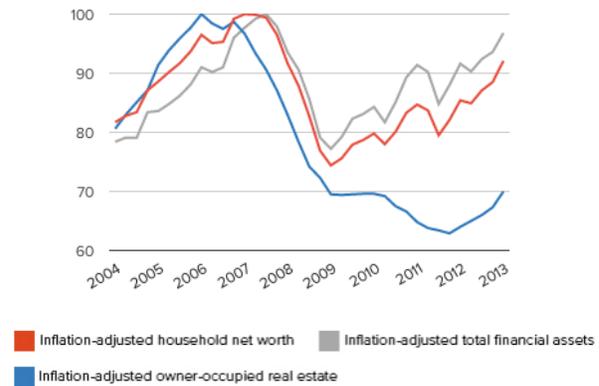
Source: Wolff (2012)

The slow pace of wealth recovery in minority communities has its roots in historical housing segregation and other forms of discrimination that have discouraged asset building. But the racial wealth gap also reflects the fact that minority households have lower average incomes than white households, resulting in a larger percentage of their net worth being concentrated in residential real estate. In this way, the racial wealth gap—like the age and education wealth gaps—is a microcosm of the growing divide between the richest one percent and the bottom ninety-nine throughout the U.S. economy.

These divisions have intensified in the last four years of the economic recovery as the value of residential real estate and financial assets continue to grow apart. This divergence is not obvious from the Federal Reserve's quarterly Flow of Funds report, which is widely cited in the media as evidence that household net worth has returned to nominal pre-crisis levels. However, a distributional analysis can be approximated by comparing the Federal Reserve data on total inflation-adjusted household financial assets and owner-occupied real estate. Here it is obvious that nearly every dollar in aggregate household wealth recovery is attributable to the rising value of financial assets, which are disproportionately held by high-net worth households. Residential real estate, which remains the largest single asset held by the middle class, is still 30 percent below its 2006 peak nationwide.²² (See Figure 15.) Absent some larger policy change, that situation is unlikely to change any time soon: U.S. tax policy actively promotes investment income over labor income by setting a lower rate for capital gains, disproportionately benefiting high-net worth households.

Figure 15. A wealth recovery for the one percent

Index values equal 100 at respective peaks



Source: Federal Reserve, Flow of Funds data (Z.1)

In many ways, the housing boom that precipitated the Great Recession was amplified by the joint effort of homeowners, bankers, and investors to financialize the residential real estate market. For a while, this had the intended effect of lowering consumption inequality—if not income inequality—as lower- and middle-income families were encouraged to transmute illusory home equity into cash. The bursting of the housing bubble was a wake-up call that the widening gulf between the nation's wealthiest one percent, and the bottom 40 percent who have close to zero net assets, cannot and will not be solved by debt-based or other financial gimmicks; but by rising incomes and smarter saving. Broad-based economic prosperity needs to be built from the middle-class outwards, not financially engineered from the top down.

BENJAMIN LANDY is a Policy Associate at The Century Foundation, where he writes about income inequality, college access and affordability, retirement security, and domestic politics. He contributes to TCF's Graph of the Day feature and holds a B.A. from Columbia University, where he studied 19th and 20th century American history.

APPENDIX: DATA SOURCES

All data in this report consist of author's calculations based on the following sources.

1. Richard Fry and Paul Taylor, "A Rise in Wealth for the Wealthy; Declines for the Lower 93%," Pew Research Center, 2013.
2. Alan Greenspan and James Kennedy, "Sources and Uses of Equity Extracted from Homes," Finance and Economics Discussion Series (FEDS), 2007.
3. "CoreLogic Equity Report," CoreLogic, Inc., 2013, accessed July 20.
4. Z.1 Financial Accounts of the United States, Federal Reserve Statistical Release.
5. Edward Wolff, "The Asset Price Meltdown and the Wealth of the Middle Class," National Bureau of Economic Research, 2012.

6. Melvin L. Oliver and Thomas M. Shapiro, *Black Wealth, White Wealth: A New Perspective on Racial Inequality* (CRC Press, 2006).
7. Susan K. Urahn and Erin Currier, et. al., "Pursuing the American Dream: Economic Mobility Across Generations," The Pew Charitable Trusts, 2012.
8. Karen E. Dynan, Jonathan Skinner, and Stephen P. Zeldes, "Do the Rich Save more?" *Journal of Political Economy* vol. 112, no. 2 (2004).
9. Lawrence Mishel, Josh Bivens, Elise Gould, and Heidi Shierholz, *The State of Working America*, 12th Edition (Cornell University Press, 2012).
10. Ibid.
11. Edward Wolff, "The Asset Price Meltdown and the Wealth of the Middle Class," National Bureau of Economic Research, 2012.
12. Lawrence Mishel, Josh Bivens, Elise Gould, and Heidi Shierholz, *The State of Working America*, 12th Edition (Cornell University Press, 2012).
13. Michael I. Norton and Dan Ariely, "Building a Better America—One Wealth Quintile at a Time," *Perspectives on Psychological Science* (2011).
14. Kate Pickett and Richard Wilkinson, *The Spirit Level: Why Greater Equality Makes Societies Stronger* (Bloomsbury Press, 2009).
15. Michael Kumhof and Romain Ranci re, "Inequality, Leverage and Crises," IMF Working Paper (2010).
16. Edward Wolff, "The Asset Price Meltdown and the Wealth of the Middle Class," National Bureau of Economic Research, 2012.
17. Edward Wolff, "The Asset Price Meltdown and the Wealth of the Middle Class," National Bureau of Economic Research, 2012.
18. Ibid.
19. Alan Blinder, "Six Errors on the Path to the Financial Crisis," *New York Times*, January 24, 2009, accessed July 24, 2013.
20. Edward Wolff, "The Asset Price Meltdown and the Wealth of the Middle Class," National Bureau of Economic Research, 2012.
21. Ibid.
22. Z.1 Financial Accounts of the United States, Federal Reserve Statistical Release.