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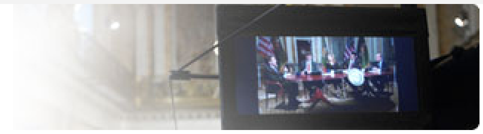


Remarks by Assistant Secretary Karen Dynan at the 2016 National Association of Business Economists Policy Conference

3/8/2016

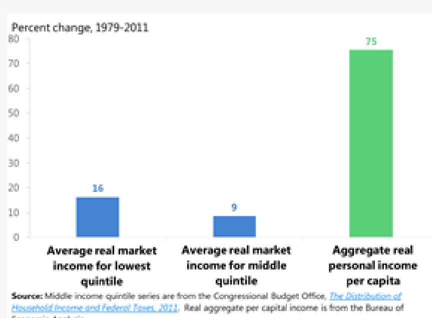
WASHINGTON - Thank you for that kind introduction, and I want to thank the organizers for inviting me to speak today. It is always a pleasure to engage with NABE participants because so many of you are closely following what is going on in the economy and thinking about how to improve future economic prospects—whether it is in the context of strengthening the business or organization you are affiliated with or in the context of the broader economy. And, indeed, strengthening future economic prospects is at the heart of what I do at the Treasury Department.

Today I want to talk about household economic security and public policy. I chose this topic partly because we are doing so much work in this area in the Office of Economic Policy at the Treasury Department and partly because it's where my roots as a researcher lie. My talk will cover three challenges to household economic security. First, I will discuss the slow income growth experienced by households in the lower and middle parts of the distribution in recent decades. Next, I will turn to swings in households' use of debt and leverage. And, the final part of my talk will focus on the large number of households with low saving. In each case, I will discuss the challenges we face and the role that public policy can play to improve outcomes.

Slow Income Growth for Households in the Lower and Middle Parts of the Distribution

As is well known, market incomes of households in the lowest and middle parts of the distribution have failed to keep pace with growth of the overall economy during the past several decades. And, we have learned from the experience of the past several years that the underlying economic forces that generated that pattern have not abated.

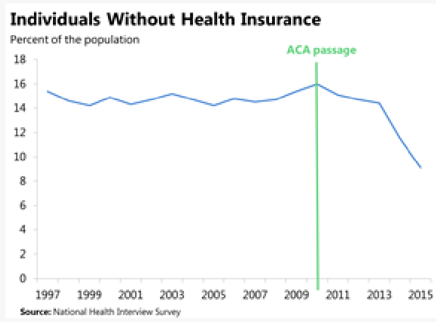
For example, as you can see in the slide, the Congressional Budget Office estimates that the lowest quintile of households saw an increase in their inflation-adjusted market incomes of 16 percent between 1979 and 2011, and those in the middle quintile saw an increase of just 9 percent. For context, aggregate real personal income per capita rose 75 percent over this period. In other words, if market incomes of the middle quintile had kept pace with overall per-capita income growth, those people's incomes would have risen 8 times as much as they actually did. While the CBO numbers end in 2011, more timely data, such as median household cash income from the Census, suggest that incomes for many households have continued to grow slowly.



What can public policy do to help? One set of appropriate policy responses aims to raise workers' productivity by increasing their skills, especially for those in the lower part of the wage distribution. We can boost community college attendance, for example, by cutting net tuitions. We can strengthen Pell grants for low-income college students, for example, by indexing them to inflation and making other reforms that would encourage completion. We can improve worker training, for example, by increasing funding for job training, grants to promote education, and programs to increase apprenticeships. And, we can increase education at younger ages by expanding high-quality preschool, for example, by increasing funding for Head Start and supporting state initiatives in this area.

Another set of appropriate policy responses is to encourage labor force participation so that more people earn wages and salaries. We can increase tax credits for working, for example, by expanding the earned income tax credit for childless workers. We can increase subsidies for childcare, for example, by boosting tax credits for childcare. We can help states to adopt paid leave policies. And, we can remove obstacles to entry into better jobs, for example, by reforming occupational licensing rules.

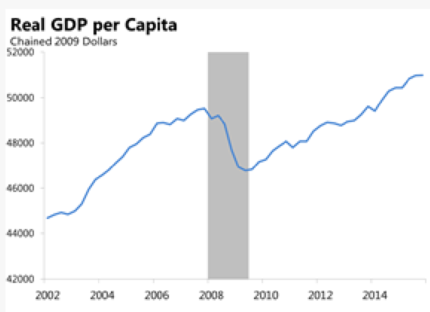
A third set of appropriate policy responses is to strengthen the safety net. It is crucial that we keep the expanded health care subsidies under the Affordable Care Act, which have reduced the number of people without health insurance so dramatically in the past few years. As you can see from the slide, that number has fallen nearly in half since the passage of the law. In addition, we must support programs with demonstrated long-term benefits for poor families. A small but growing body of high-quality research shows that children in poor families that receive certain health care subsidies, housing subsidies, food assistance, and high-quality preschool earn substantially more later in their lives. We should also increase portability of non-cash benefits of working such as pensions. Finally, we should strengthen insurance for people who are laid off—including enhancing unemployment insurance and expanding wage insurance.



Swings in Households' Use of Debt and Leverage

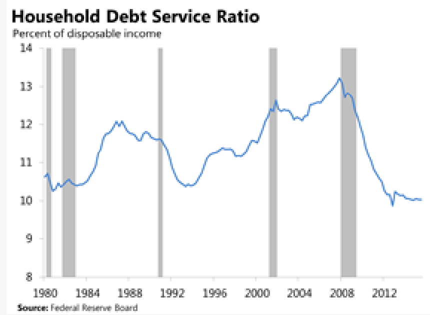
Let me turn now to households' use of debt and leverage and how that affects households' economic security. As we have seen in the past decade, excessive household debt can destabilize the economy, especially if the additional leverage is justified by erroneous assumptions about the future path of asset prices.[1] In this case, the problematic assumption was that the homes purchased with the debt would continue to see rapid price appreciation.

The consequence of this excessive debt, which you can see in the slide, was a remarkably deep decline in output, with real GDP per capita plunging 5-1/2 percent. And, the recovery that followed was unusually slow—it took 6 years for real output per capita to surpass its previous peak, a mark that had been hit in less than 2 years on average in preceding business cycles. The hardships inflicted on families by the mortgage crisis and the Great Recession were enormous. Millions of families lost their homes, job losses skyrocketed, and real wages fell for several years.

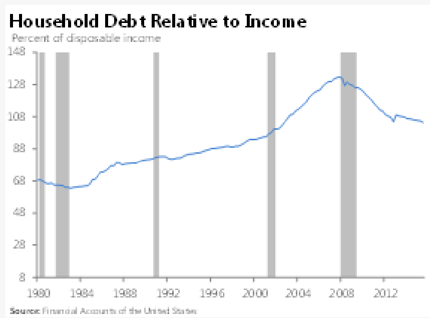


Part of the reason the downturn was so severe was that high household mortgage debt and leverage reduced not only housing investment but also consumer spending. Three years after the business cycle trough in June 2009, real consumer spending had increased only 6 percent, less than half as much as the average of preceding recoveries, held back by a variety of factors, including a debt overhang.

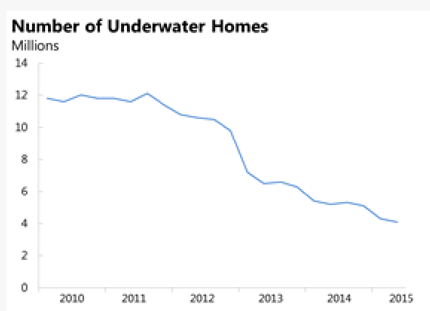
One channel through which this occurred was that high debt service reduced households' capacity to spend on other items. As you can see in the slide, the aggregate ratio of debt service to disposable personal income moved up during the housing boom, hitting a peak of more than 13 percent at the end of 2007, compared with an average of about 11 percent in the 1980s and 1990s. The figures from household-level data are even more striking—in my own research, I found that the typical highly indebted household living in a state with a big housing boom had debt service commitments that exceeded 1/3 of their *pre-tax* income in 2007—and that's before incomes were hit by the recession.[2]



A second channel through which high debt and leverage restrained household spending was by crimping households' access to additional credit. A key problem was that many mortgage borrowers who were in or close to negative equity found it difficult to refinance. This obstructed an important way in which accommodative monetary policy has traditionally boosted aggregate demand—by allowing people to refinance into lower-rate mortgages and thereby increase the amount of money that cash-constrained consumers can spend each month. This made programs such as the Administration's Home Affordable Refinance Program, which facilitated the refinancing of underwater mortgages, especially crucial.

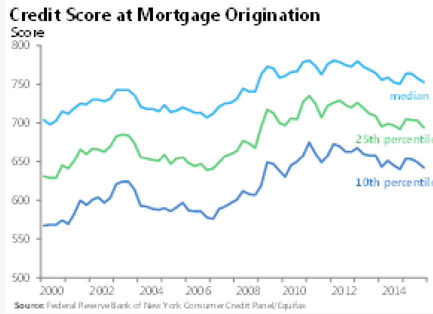


An important piece of good news is that households have made very significant progress deleveraging in the years since the crisis. As shown in the slide, household debt has fallen from a peak of 133 percent of disposable income to 104 percent of disposable income, the lowest level since 2002. As shown in the next slide, this reduction in debt, along with very low interest rates, have reduced the aggregate share of disposable income that is committed to debt service payments in recent years to their lowest levels in the 35-year history of the series. We also have seen significant progress in the risky upper tail of the leverage distribution: Reductions in mortgage debt, along with the considerable rebound in home prices, have caused the number of underwater homes to drop by 65 percent, as can be seen in this slide. This deleveraging has put households on stronger financial footing, which should be good for their own future prospects and for those of the broader economy.



All that said, it is important for us to recognize that access to household credit can be too limited as well as too loose. A reduction in the supply of credit was a natural and appropriate reaction to the excessive availability of household credit before the crisis, but the pendulum probably swung too far in the direction of limiting access to credit. Allowing for increased debt among some households would be good for them and for the overall economy.

In particular, mortgage credit availability appears to be too limited given underlying economic conditions. For example, credit scores on newly originated mortgages remain well above their pre-boom levels, as you can see in the slide. The difficulty that some creditworthy borrowers have had obtaining home loans has been one of the factors weighing on the housing sector in recent years. Even now, the level of housing starts is only about 2/3 of that in the early 2000s.



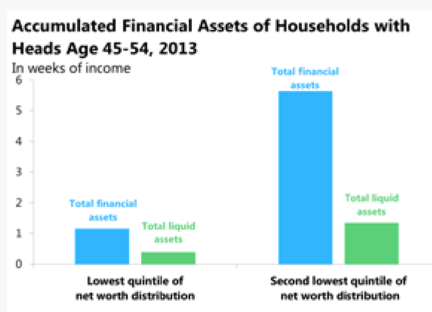
That's why the Administration has been working to draw more private capital back into the mortgage market and reduce the obstacles that may be weighing on lenders' willingness to extend loans. Under the direction of the Federal Housing Finance Agency, the GSEs reformed their buyback practices, and the Federal Housing Administration is in the process of doing the same. Treasury has also been engaged with a variety of market participants, who have been exploring the structural reforms that could help bring back the private-label mortgage securities market in a responsible way.

In addition to enabling households to benefit from the positive aspects of access to credit, we should try to reduce the exposure of households to the harmful aspects of debt use. A key step in this direction was establishing the Consumer Financial Protection Bureau under the Dodd-Frank Financial Reform Bill. The CFPB's focus on protecting borrowers will reduce the incidence of financial fraud and deception, and it will also produce rules of the road in consumer lending that will reduce the frequency with which households make decisions about credit use that they come to regret.

Large Number of Households with Low Saving

A third challenge to household economic security is the large number of households that have low saving.

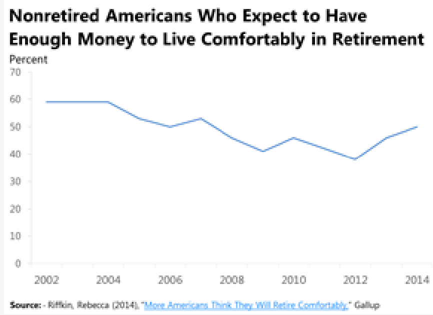
According to the 2013 Survey of Consumer Finances, only 53 percent of households reported having saved over the preceding year.[3] Low- and moderate-income households, in particular, have almost no financial assets. As you can see in the slide, among households with heads between the age of 45 and 54—by which age people should have been saving for some years—the typical household in the lowest quintile of the net worth distribution had financial assets that amounted to about one week of income and had liquid assets that amounted to only a few days of income. The typical household in the next highest quintile had 5½ weeks of income in financial assets and just over one week in liquid assets. [4]



Such low levels of saving have a number of negative consequences. First, many households are not positioned to cope with unforeseen disruptions to their income or unanticipated spending needs. The high rates of job loss and underemployment experienced as a result of the Great Recession served as a particularly painful reminder of the need for such reserves, but even before the financial crisis, household income volatility was trending up.[5] Structural changes in the labor market mean that higher volatility is likely to persist, in part through a weakening of the social compact between workers and firms. The growth of the online "gig" economy may exacerbate that problem because of the inherently irregular nature of income in this sector, or it might mitigate the problem by offering households greater opportunities to supplement their income.

A second reason to be concerned about low saving is that a lack of savings limits opportunities for households. Funds accumulated through saving can be used to pay for college tuition, to purchase big-ticket items like cars, fund start-up costs for businesses, and make downpayments on homes. Households that have little or no accumulated savings have much more difficulty in taking advantage of opportunities like these than households that have built savings.

A third reason to be concerned about low saving is that many households may not have an adequate standard of living in retirement. As you can see in the slide, in Gallup polls in recent years, only about 40 to 50 percent of respondents reported being confident that they will have enough money to live comfortably in retirement.[6] Research validates this concern and suggests, in particular, that households in the lower part of the income distribution are most likely to be squeezed: Lower-income households are much more likely to experience a material drop in their consumption at retirement than their higher-income counterparts.[7]



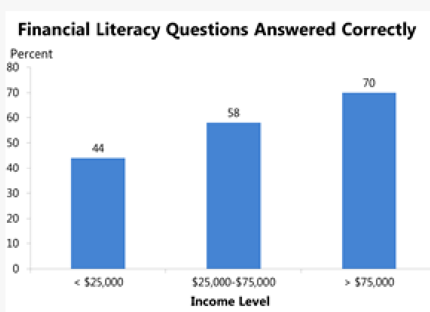
In order to design policies that address this lack of saving, we need to answer the question of why low- and moderate-income households do not save enough. To start, it is not uncommon to hear people say that they "can't afford to save." We lack research that concretely documents this phenomenon, and surely it is the case that at least some of these people are just not prioritizing saving for one reason or another. However, it does seem plausible that some households are simply stretched too thin to be putting any money aside. This consideration further justifies the policy measures aimed at supporting income growth at the lower end of the distribution that I discussed earlier.

A second challenge is that the tax incentives that have been put in place to encourage saving have fairly little effect on the return to saving by lower-income households. Households in lower tax brackets achieve smaller reductions in their tax liabilities for each dollar of saving in tax-deductible form, and households with incomes so low that they have no federal tax liability receive no benefit at all from saving tax preferences that are not refundable.

A third and broader challenge is that many people are not making the sort of rational calculations about saving that our basic models assume. Research suggests that policies that change the return on saving have a limited effect on many people's decisions. For example, in a comprehensive study, researchers examining the Danish pension system—which is very similar to ours—found that only a minority of savers responded to incentives affecting the return on saving in a way that was roughly consistent with traditional economic theory.[8] Most individuals—about 85 percent—were what the researchers termed "passive savers" who did not respond to such incentives.

What is it that blunts the response of many households to changes in the return to saving? Probably one significant factor is that people are focused on other aspects of their lives, so they use simple rules of thumb to determine their saving rather than complex calculations. These people are not necessarily irrational—making optimal decisions about saving takes time and financial sophistication, and many households may rationally decide not to spend that time or acquire that sophistication.

In addition, research has demonstrated that some households lack basic financial literacy, have particular difficulty planning, and are prone to making rudimentary financial mistakes. Indeed, a survey by FINRA found that households with income under $25,000 answered just 44 percent of basic financial literacy questions correctly.[9] The lack of financial literacy among some households is even more worrisome because of the shift over time from defined benefit pensions to defined contribution pensions, which has increased the need for personal financial responsibility.



Given these findings, how can we help people make saving decisions that will serve them better in the long run? A key step in the right direction is to make saving easier and more automatic. A large body of research documents that employer-provided retirement saving programs with automatic enrollment or default contribution rates can raise saving, particularly for low-income households.[10] The challenge is that only 60 percent of American private-sector workers currently have employers that offer 401(k)s or similar retirement savings plans.[11]

Policy changes can help a lot. First, we should adopt the "auto-IRA" proposal in the President's budget, under which firms would automatically enroll workers without access to a 401(k)-type plan in an Individual Retirement Account, and the government would provide tax credits to offset the cost. Workers would be allowed to opt out of this IRA if they chose, but many would appreciate having this opportunity to save without having to figure out the logistics themselves. In addition, we should increase the startup tax credit for firms establishing workplace savings plans, provide tax credits to firms that add auto-enrollment to existing plans, and ensure that long-term part-time workers have access to employers' retirement plans.

We should also encourage broader participation in the *my*RA program launched by Treasury last year. *my*RA is a simple, safe, no-fee starter retirement savings account designed for people without access to a retirement savings plan at work. People can arrange to have contributions made automatically every payday; the accounts stay with them if they change jobs; and there is no cost to opening or maintaining an account. The investment is backed by the U.S. Treasury and has no risk of losing money. From a tax perspective, these accounts are Roth IRAs, so contributions are made using after-tax dollars (and can therefore be withdrawn without penalty whenever one would like), and interest accrues tax-free until withdrawal.[12]

Conclusion

Let me conclude by emphasizing the importance of good public policy in improving households' economic security. The dynamism of the U.S. economy is an important strength in achieving substantial economic progress and gains in total output and income over time. However, that dynamism creates significant challenges and risks for many households. Some of those problems cannot be avoided, but good policies can improve outcomes and reduce risks. Enhancing households' economic security through such policies is crucial for ensuring that our economy works for all Americans.

Thank you.

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[1] Here, I am defining mortgage leverage as the ratio of mortgage debt to housing assets.

[2] Dynan, Karen. "Is a Household Debt Overhang Holding Back Consumption?" *Brookings Papers on Economic Activity*, Spring 2012. Highly leveraged households are defined as those in the highest quintile of debt relative to assets as of 2007. Housing boom states are defined as those in the top quartile of home price appreciation between 2000 and 2006

[3] See Bricker, Jesse, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Kevin B. Moore, John Sabelhaus, Jeffrey Thompson, and Richard A. Windle (2014), "Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin.*

[4] The figures cited are U.S. Treasury staff calculations based on data from the 2013 Survey of Consumer Finances, available at: http://www.federalreserve.gov/econresdata/scf/scfindex.htm.

[5] See Dynan, Karen, Douglas Elmendorf, and Daniel Sichel (2012), "The Evolution of Household Income Volatility," *The B.E. Journal of Economic Analysis and Policy* 12.

[6] Riffkin, Rebecca (2014), "More Americans Think They Will Retire Comfortably," Gallup.

[7] Hurst, Erik (2008), "Understanding Consumption in Retirement: Recent Developments", in *Recalibrating Retirement Spending and Saving* (eds, John Ameriks and Olivia Mitchell), Oxford University Press.

[8] Chetty, Raj, John N. Friedman, Soren Leth-Petersen, Torben Neilsen, and Tore Olsen (2014), "Active vs. Passive Decisions and Crowdout in Retirement Savings Accounts: Evidence from Denmark," *Quarterly Journal of Economics*, 129(3): 1141-1219.

[9] FINRA Investor Education Foundation (2012) "Financial Capability in the United States."

[10] See, for example, Beshears, John, James J. Choi, David Laibson, and Brigitte C. Madrian (2012), "Default Stickiness among Low-Income Individuals," Rand Corporation Working Paper.

[11] Bureau of Labor Statistics, National Compensation Survey, 2015.

[12] You can learn more about the program by visiting www.myRA.gov.