Issues in GOVERNANCE STUDIES

Number 10 September 2007

The Politics of Economic Insecurity

Elisabeth Jacobs

Recent Issues in Governance Studies

"Shaping the 44th Presidency" (August 2007)

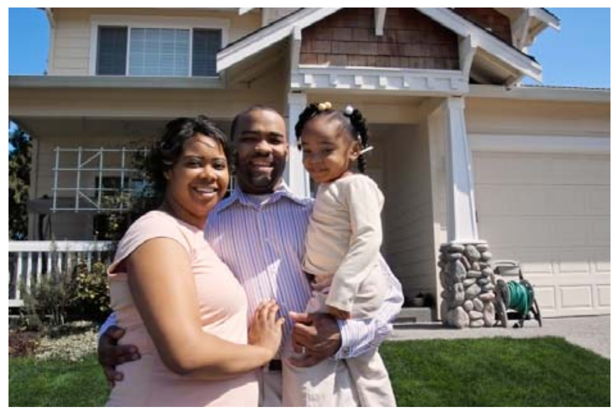
"Rediscovering Federalism" (July 2007)

"How to Pay the Piper: It's Time to Call Different Tunes for Congressional and Judicial Salaries" (April 2007)

"Judicial Independence and Judicial Accountability in the 110th Congress and Beyond" (April 2007)

The Brookings Institution
1775 Massachusetts Ave., NW
Washington, DC 20036

EXECUTIVE SUMMARY



Recent media reports suggest a rising tide of economic populism among presidential candidates and voters. In newspapers' business sections, personal finance columnists offer advice for avoiding mortgage foreclosure, managing credit card debt and navigating a job search. On the political pages, economic rhetoric aimed at winning over anxious middle-class families forms the core of the presidential campaign messages from many candidates. This paper shows, through data and analysis, that the populist message is rooted in an empirical reality.

Economic insecurity is perhaps best understood as the intersection between "perceived" and "actual" downside risk, which carry nearly equal importance in politics. Americans' assessments of their personal financial well-being play at least some part in shaping their candidate preferences. And the empirical reality reflected by household financial data should play a critical role for candidates' and elected officials' framing of policy options, particularly when faced with the challenge of efficiently targeting scarce public resources. Of course, the relationship between perceived and actual risk is an intimate one, as perceptions are often informed by, and inform, reality.

Public-opinion surveys capture Americans' perceived economic risk, suggesting that Americans feel they are under a great deal of economic pressure. Actual risk is measured by surveys of family income and consumption patterns, which reflect real and rising economic pressures on many American families. To be sure, the typical American family is not on the brink of financial collapse. Yet the probability of suffering an economic fall has grown in the past several

decades, as has the magnitude of the consequences of such a fall. Families' incomes have grown more volatile – and therefore less predictable – over the course of the last three decades. Compounded with both a cost crunch and a time crunch, families today face considerable economic pressure.

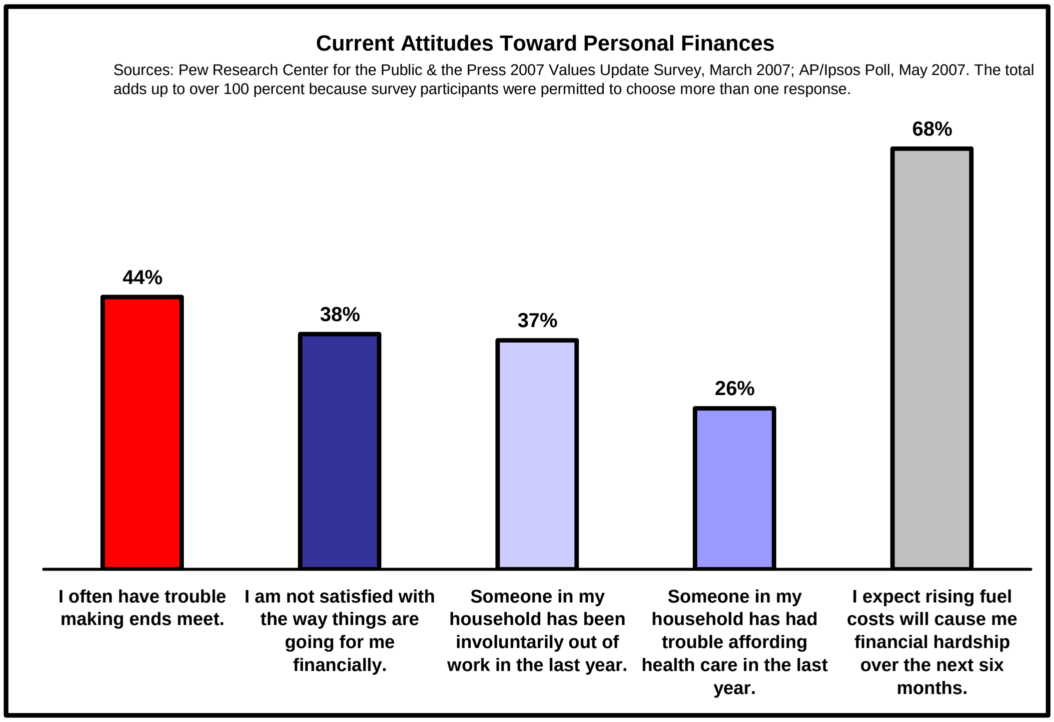
Government should play a key role in mitigating economic insecurity by creating an effective social safety net for the 21st century, but doing so will require surmounting significant public skepticism. In short, policymakers must bridge a serious accountability gap in the eyes of the public. While American families face substantial economic challenges, policymakers will not be able to create lasting solutions without a concerted effort to address the public's distrust of government's efficacy and integrity. The best proposals will combine innovative policy solutions with strong accountability and transparency measures.

Anxious America

Economic issues loom large in the mind of the American public. While analysts will continue to debate the key determinants of the 2006 midterm elections, the Democrats' congressional victory had a great deal to do with dissatisfaction with the economy. Indeed, according to CNN's exit polling, the economy trumped Iraq as an issue that was economic messaging targeted at anxious American families is likely to continue to play a critical role in candidates' campaigns. While nearly all of the Democratic candidates are crafting platforms aimed at appealing to an economically anxious America, a handful of Republicans are sounding much like their left-leaning counterparts. Perhaps most prominently, former Arkansas governor Mike Huckabee's early campaign rhetoric has a distinct populist ring, and his strong showing in the recent Iowa straw polls suggests that this message may resonate with Republican primary voters. Whether or not economic concerns will drive election results next year is a question beyond the scope of this paper. What is clear, however, is that personal economic concerns are playing a role in framing the political landscape.

Candidates' consultants are clearly paying attention to the polls. Recent public opinion data from the Pew Research Center suggest that many Americans have serious economic concerns. Nearly half of all households report that they often lack money to make ends meet. Many are dissatisfied with the financial direction their life is taking. More than a third report experiencing involuntary unemployment in the past year. A quarter says they were unable to afford health care. Most strikingly, in a May 2007 AP/Ipsos poll, over two-thirds anticipated that rising gas costs will cause financial hardship, with nearly one-half expecting that hardship to be severe.

Elisabeth Jacobs is a Special Guest in Governance Studies at Brookings



Americans' economic concerns appear even more serious when the scope of the questions widens. When pollsters ask non-specific questions, they find Americans in a dark mood. For instance, 64 percent of workers surveyed in a March 2007 Lake Research Partners poll said that the American economy was "pretty seriously off on the wrong track." On specific issues of hardship, many Americans report that someone close to them has experienced an economic disruption. When a September 2006 RBC/Ipsos poll asked whether "you or someone you know personally" will lose a job in the next six months as a result of economic conditions, 45 percent answered that this was a "likely" or "somewhat likely" possibility. Similarly, 53 percent in an April 2006 Gallup survey said they knew someone who had been laid off or lost a job in the past six months.

Uncertain Futures

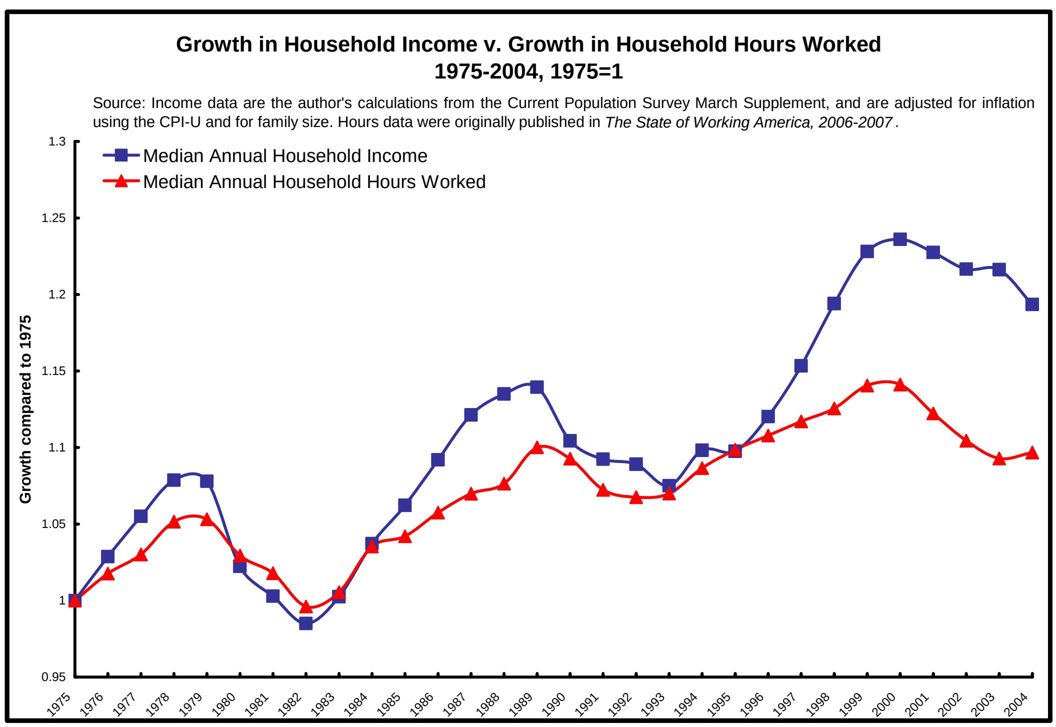
Public perceptions suggest that American families face real economic challenges. While data on family finances suggest that these anxieties are rooted in economic difficulties, they imply a more nuanced picture than the one painted in response to pollsters' questions. The typical American household does face real economic challenges, yet most families manage to avert real disaster. The anxiety projected by the public suggests that this balancing act is an exhausting and frustrating way of life. Moreover, for some – particularly the least-educated – the balancing act is not successful, and the consequences are economic hardship.

In [the] past three decades, American families have been *running to stand still*, with families putting in more hours to bring home only minimally more income.

Consider the challenges faced by the average American household.

First, while median household incomes have risen over the past three decades, that growth has largely been driven by an increase in annual hours worked. Incomes and hours grew together fairly steadily from 1975 through 1995. This isn't surprising – families put in more time at work and were rewarded with more money. However, the simultaneous growth in income and hours suggests that economic growth in the United States has not benefited the average worker. Much of the growth in family income was driven by increased work rather than rewards from a growing economy. The more rapid growth in income as compared with hours in the second half of the 1990s was likely because of the boom in both the housing and stock markets, which boosted families' asset-based income. Both income and hours have slumped during the most recent slack economic period.

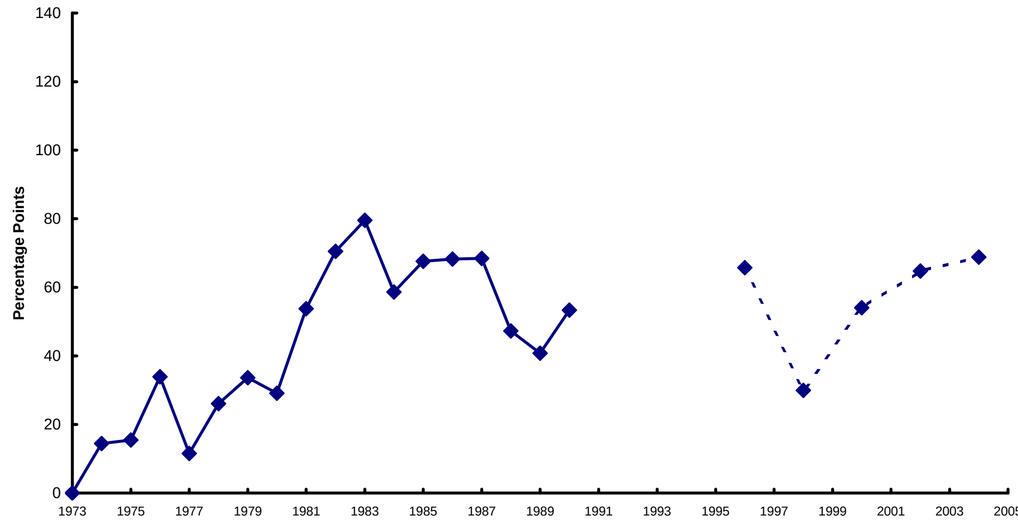
In sum, the data suggest that, in past three decades, American families have been *running to stand still*, with families putting in more hours to bring home only minimally more income. With many families sending both husband and wife to work, more household income has come at the expense of time at home, a particularly difficult trade-off for parents with young children. The "cost" of time is discussed in more detail in the following section.



Second, families' year-to-year incomes are less predictable now than they were in the past. According to my analysis of data from the University of Michigan's Panel Study of Income Dynamics (PSID) – a nationally representative sample of American families that survey administrators have been tracking since the late 1960s – household income volatility has risen substantially since the early 1970s. While results reported by political scientist Jacob Hacker in his recent book "The Great Risk Shift" may have overestimated the size of the growth, the basic facts remain consistent even after correcting for various quirks in the data.[i] If a family's income trajectory is a rollercoaster, the ride has become substantially more harrowing.

Growth in Family Income Volatility, 1973-2004

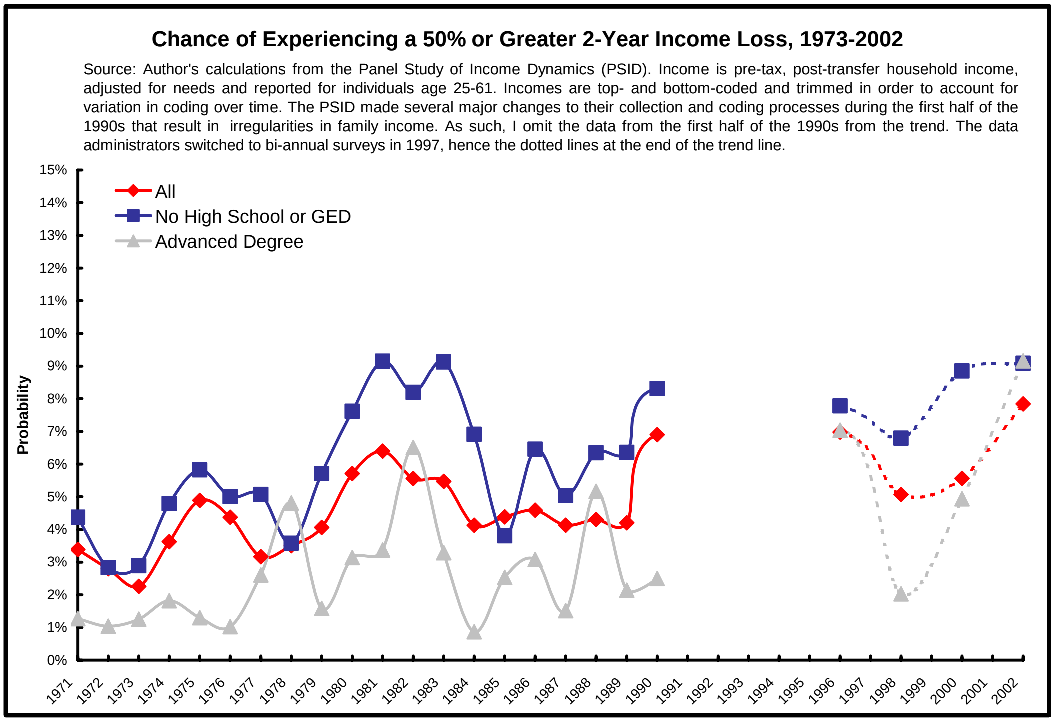
Source: Author's calculations from the Panel Study of Income Dynamics (PSID). Income is pre-tax, post-transfer household income for individuals age 25-61, excluding business owners. Income volatility is measured by subtracting the four-year covariance of logged family income from the total variance in logged family income for a given year. Incomes are top- and bottom-coded and trimmed in order to account for variation in coding over time. The PSID made several major changes to their collection and coding processes during the first half of the 1990s that result in irregularities in family income. As such, I omit the data from the first half of the 1990s from the trend. The data administrators switched to bi-annual surveys in 1997, hence the dotted lines at the end of the trend line.



Recession years have hit families harder today than they did in the early 1970s.

Recession years have hit families harder today than they did in the early 1970s. Comparing two recession years, 1973 and 1990, income volatility in the latter year was 53 percentage points greater than it was during the 1973 slump. Moreover, growth in income volatility has been fairly steady and secular, with income volatility 65 percentage points higher than its 1973 level at the peak of the business cycle in 2002.

The economic volatility metric employed above captures both the downside and upside of income swings. Yet the downside of economic volatility is the primary factor motivating economic anxiety. A second measure of volatility focuses exclusively on the risk of a large income drop. The PSID data show that the risk of incurring a large economic hit has risen sharply for the average American family. By 2002, Americans faced an 8 percent chance of losing half of their income over a given two-year period, as compared to less than half that risk in 1971. While the data show lower levels of risk than Hacker reports in "The Great Risk Shift," this analysis similarly implies that downside economic risk has increased substantially over the past three decades.[ii]



Some of this economic turbulence is undoubtedly due to voluntary decisions, such as a mother's decision to cut back on work hours to care for a child. Some of this turbulence is likely cushioned by savings, though with the savings rate at a historic low, it seems unlikely that these reserves are much help to Americans in lean times. However, much of the economic turbulence occurs among the most vulnerable families. Indeed, the risk of large income drops has more than doubled among low-income Americans, for example, who are unlikely to have the resources to choose to downshift to care for children.

Families headed by Americans without high school diplomas have long been at the greatest risk of large year-to-year economic losses, which are most likely to severely impact well-being given the precarious financial positions of many of these families. Households headed by highly educated individuals have not been immune to rising economic risk, however. By 2002, families headed by an individual with an advanced degree were just as likely to lose 50 percent of their income loss as were high school drop-outs. The fact that highly educated individuals are increasingly vulnerable to economic woes provides a clue as to why the chattering class has responded so enthusiastically to the concept of "economic security."

Beyond Income: Time and Costs

Income is only part of how Americans assess their economic well-being. Economists often focus on income as a proxy for well-being, largely because income can be measured

The entrance of women into the labor market may have driven household incomes upward, but it also introduced a major new cost for many families: child care.

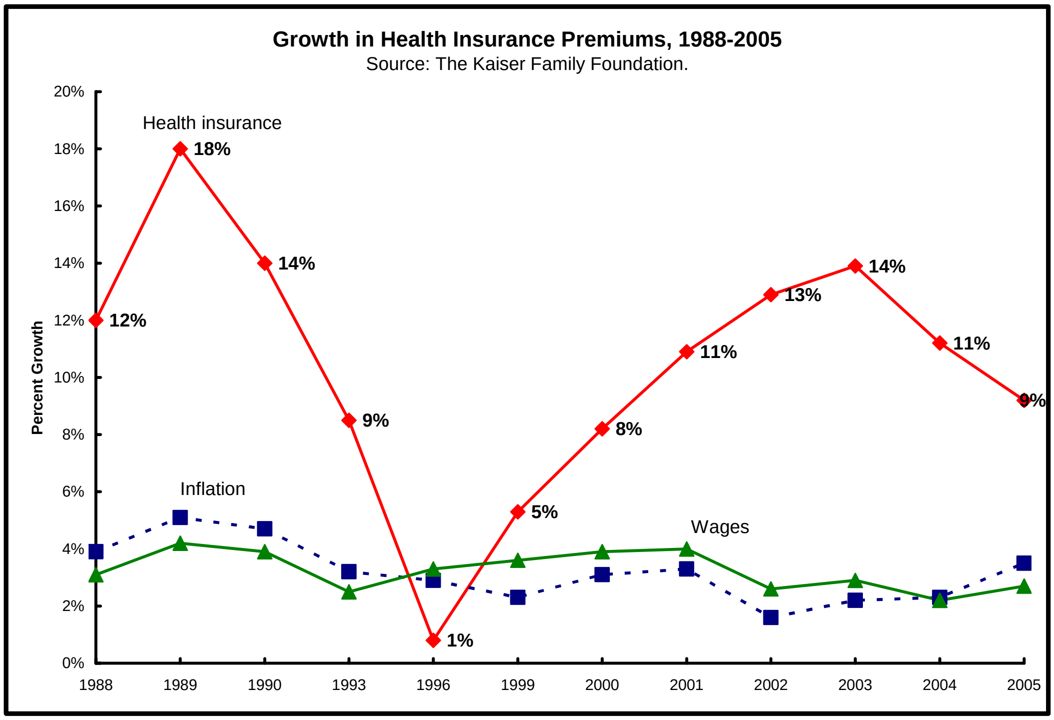
with datasets like the PSID and others. But economic anxieties that impact well-being are very likely to be caused by something more than income fluctuations. Indeed, economic stress is likely to be rooted in the interaction among multiple causes. In the following section, two additional potential drivers of public economic anxiety are discussed: time and costs.

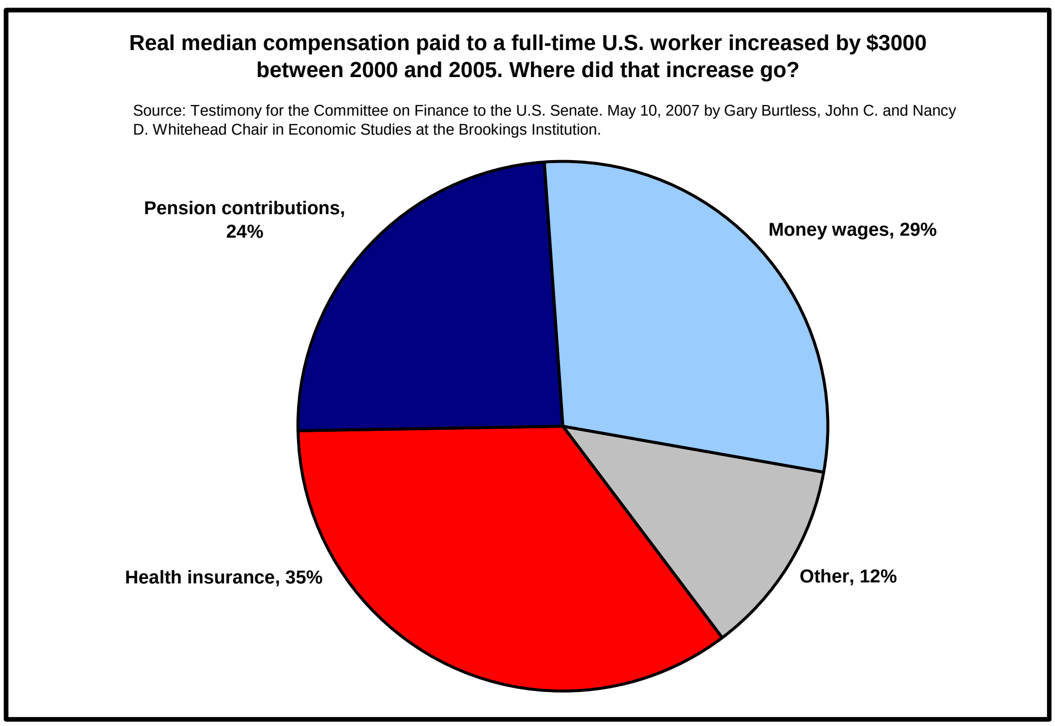
First, the comparison between income and hours growth provides one clue to a potential cause for concern: the *time crunch*. As noted above, while the median income for all households has grown in the past several decades, the majority of that growth stems from the increase in the number of hours. Karen Kornbluh, a former fellow at the New America Foundation, finds that married couples with children increased their work hours by 16 percent between 1979 and 2000. Moreover, without the increase in women's work hours, the middle fifth of American families' incomes would have risen just 5 percent, rather than 24 percent, and families in the bottom two fifths would have experienced a substantial decrease in household incomes.

Second, Americans face a serious *cost crunch*. Slow income growth and rising downside economic risk are accompanied by a host of rising costs, some of which have been created as a result of the time crunch.

The entrance of women into the labor market may have driven household incomes upward, but it also introduced a major new cost for many families: child care. A 2006 study from the National Association of Child Care Resource and Referral Agencies (NACCRRA) reports that child-care costs are remarkably high compared with other household expenses. Indeed, in 49 states, median child-care fees for two children exceed the median rent. Child care's strain on the family budget is particularly acute for lower-income families. A 2000 Urban Institute report suggests that families below the poverty line who pay for child care spend an average of 23 percent of their monthly income on child care. Moreover, a substantial majority of focus-group participants in the NACCRRA study reported sacrificing quality in exchange for cost because of the strain child-care expenses put on the family budget.

The rising cost of health care is perhaps even more critical to the typical American family. While growing numbers of Americans go without health insurance every year, even those with insurance coverage face premiums that have risen faster than inflation. Average deductibles have also risen steadily, with workers in conventional health-insurance plans paying deductibles in 2005 that were nearly six times those of 1988. According to an analysis by Brookings economist Gary Burtless, most of the American worker's compensation gains between 2000 and 2005 went to health-insurance costs. In simple terms, the growth in the cost of health insurance has outpaced the growth in take-home pay for most Americans.


Growth in Health Insurance Premiums, 1988-2005
Source: The Kaiser Family Foundation.
Percent Growth
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
Health insurance
18%
14%
12%
9%
1%
5%
8%
11%
13%
14%
11%
9%
Inflation
Wages
1988
1989
1990
1993
1996
1999
2000
2001
2002
2003
2004
2005


Real median compensation paid to a full-time U.S. worker increased by $3000 between 2000 and 2005. Where did that increase go?
Source: Testimony for the Committee on Finance to the U.S. Senate. May 10, 2007 by Gary Burtless, John C. and Nancy D. Whitehead Chair in Economic Studies at the Brookings Institution.
Pension contributions, 24%
Money wages, 29%
Health insurance, 35%
Other, 12%

Big-ticket items once considered a luxury are now considered a requirement…the most important of these big-ticket necessities is a college education.

If a middle-class breadwinner loses a job that provided health insurance, that worker's family faces potential expulsion from the insurance rolls. Because health insurance is so much more expensive than it has been in the past, the consequences of this loss are potentially far greater now than they were in the 1970s. Coupled with the increased chance of a serious income loss, it is no surprise that many Americans report substantial economic anxiety.

Moreover, working-age Americans face an uncertain retirement. According to the Kaiser Family Foundation, while 66 percent of employers offered retiree health benefits in 1988, that number slipped to just 33 percent by 2005, its lowest level since data collection began nearly two decades ago. For retirees lucky enough to still have employer-provided health benefits, the retiree share of the cost of those benefits rose dramatically in recent years. Few Americans believe Social Security will be solvent in funding their retirements, and fewer still have saved adequately for retirement.

From Luxury to Necessity

Critics of the economic insecurity argument point to rising standards of living as a reason to question economic anxiety. These critics are correct: Americans now enjoy many items that were once considered a luxury. However, while the proliferation of gadgets reflects an increase in the standard of living for many Americans, it also reflects a new potential set of pressures on Americans facing less-certain income streams.

The number of things Americans say they "can't live without" has multiplied over the past decade, according to a recent report from the Pew Research Center that compared the results from 1996 and 2006 surveys that ascertained whether various goods were rated "necessities." Many of the items included in the polls are indicative of the growing multitude of consumer goods necessary for full participation in contemporary American society. For instance, in 2006, 49 percent of those polled by Pew called the cell phone a necessity. In 1996, however, cell phones were such a novelty that they were not included in the list of items for evaluation. The additional cost of a cellular phone is relatively minor, of course, compared with the burden of paying for health insurance. But the new "necessary" commitment to yet another monthly bill may serve be a concern, perhaps more psychological than economic, for families who see economic turbulence on the horizon.

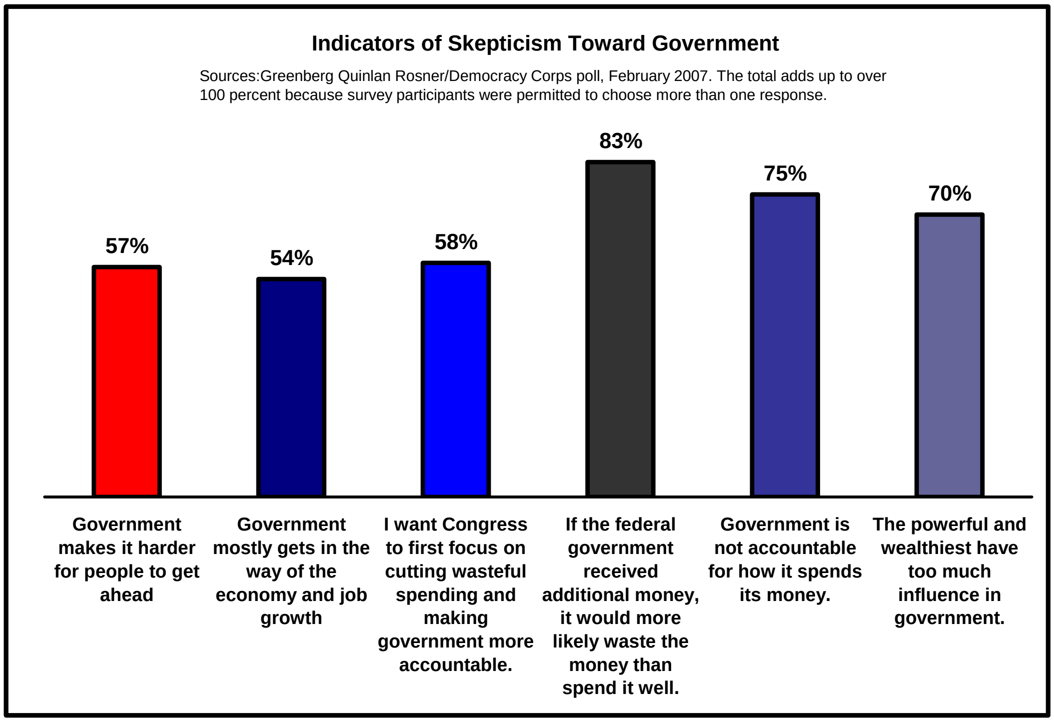
Moreover, cell phones provide just one example of the fluidity between simply consuming to "keep up with the Joneses" versus consuming to participate fully in society. In today's fluid, highly connected world, a cell phone arguably represents a necessity for effectively conducting business and social relations.

While the new necessity of the cell phone, computer and dishwasher may be relatively minor expenses, they are not the only new necessities in contemporary America. Big-ticket items once considered a luxury are now considered a requirement as well. Perhaps the most important of these big-ticket necessities is a college education. Once seen as a luxury for the children of the wealthy or the gifted, most middle-class parents now view it as a necessary credential that will allow their children to succeed. College is no longer simply for those who want to get ahead, but rather a requirement for simply getting by. Economists agree that college boosts future earnings, and myriad empirical studies concur that the income gap between those with college degrees and those without widened dramatically between the late 1970s and the 1990s. The rate of college enrollment among children of middle income families has steadily increased, meaning that more families than in the past face the financial burden of college tuition. While a college education may have long-term labor market benefits, the short-term cost is substantial, and a potential source of economic anxiety.

Bridging the Accountability Gap

Despite the economic pressure on many American families, most are getting by. Indeed, in 2002, the most recent data point available from the PSID, most families experienced very little income variation in a given year – and just as many were likely to experience a gain as were to experience a loss. The tension between stress and success is clear in public opinion polling. In the abstract, Americans are remarkably optimistic. According to a recent Lake Research survey commissioned by the union coalition Change to Win, 68 percent of workers surveyed this March were confident in their ability to achieve their vision of the American Dream, with 18 percent reporting that they "have already obtained it." Yet when pressed about specifics, Americans are more measured in their optimism. Indeed, 80 percent of households surveyed by Penn Schoen & Berland in 2006 agreed that "[t]oday, with the costs of housing, health care, education, and self-financed retirement, a middle-class life has become unaffordable for most people."

In short, Americans project mixed messages when it comes to personal economic matters. Many report a great deal of anxiety about their economic lives. At the same time, the vast majority are resoundingly optimistic about their potential to achieve their vision of the American Dream. The tension in these opinion polls suggests that policymakers must engage in a high-wire balancing act that simultaneously embraces the quintessential American optimism and acknowledges the challenges many face.



Politicians must balance optimism with a frank acknowledgment of the difficulties with which many Americans struggle, but this is not their only challenge. Indeed, policymakers face an uphill battle in convincing a skeptical public that government can and should play a role in devising effective solutions to their problems. In February, Sen. Charles E. Schumer, D-N.Y., began his chairmanship of the Joint Economic Committee with a set of hearings on economic security, telling The Washington Post that “the party that can create a model paradigm, a platform that can answer some of these questions [on economic security] will not only win in 2008 but could create a long-term majority.” That same month, Greenberg Quinlan Rosner released poll results suggesting deep-seated public distrust of government, including 83 percent of respondents agreeing that the federal government would be more likely to waste additional revenue than to spend it wisely.

These data on mistrust of government are strongly supported by interviews with workers at risk of losing their jobs. In interview after interview with employees of a local bank that had recently announced plans for major workforce reductions, workers spoke of their grave doubts in government’s ability to help people like them. Even workers facing potential economic turbulence in the near future view government’s lack of transparency, excessive bureaucracy and waste as impeding its ability to effectively expand the safety net, let alone manage a social insurance scheme such as wage insurance.

In short: If policymakers want to create politically viable solutions to the economic

Both Congress and the 2008 presidential hopefuls face a unique opportunity to bridge two major issues, economic insecurity and trust in government.

problems facing ordinary Americans, they need to combine such efforts with serious measures aimed at building public trust. A failure to do as so may jeopardize any new social safety net and social insurance program – including health-care reform – in terms of political support and public participation.

Both Congress and the 2008 presidential hopefuls face a unique opportunity to bridge two major issues, economic insecurity and trust in government, by building a modern social safety net to meet the challenges of the 21st century and beyond. The public is clearly anxious about their economic fortunes, and the empirical evidence suggests that they have good reason to be. At the same time, voters are skeptical of government's ability to meet basic challenges, and are more interested in accountable government than in new ambitious social programs.

Policy-makers should aim to meet the economic challenges faced by their constituents by developing targeted interventions, beginning with health care, a source of rising and increasingly volatile costs for ordinary families. Indeed, government has long played a critical role in helping citizens manage economic risk, and the time has come to reinvent the social insurance framework to match the challenges of the fast-moving, constantly changing global economy. However, building sustainable, long-term solutions requires acknowledging public skepticism of government and creating solutions with trust-building measures of simplicity, accountability and transparency. Without such measures, much-needed government efforts are unlikely to gain traction.

[i] For additional empirical research confirming the rise in income volatility over the past thirty years, see Dynan et al, 2007. "The Evolution of Household Income Volatility." Brookings Working Paper in Economic Studies. The main difference between the most recent analyses, including my own, and the initial findings presented by Hacker in "The Great Risk Shift" concern the treatment of very low and very high incomes. Hacker's unpublished recent revisions reflect findings nearly identical to mine.

Over the years, the Panel Study of Income Dynamics data administrators have varied the way they report the lowest and highest incomes in the data. In some years, incomes are simply coded in the data as the value reported by the individual, regardless of how high or how low. But in other years, low incomes were "bottom-coded" at a certain level and high incomes were "top-coded" at a certain level. In other words, in some years, the data administrators set a ceiling and/or a floor for income values. Because change over time is one of the key elements of the analysis of income volatility, ensuring consistent handling of income over the survey years is paramount. This consistency helps ensure that the results are driven by actual changes in household income, rather than by quirks in the data's coding. Moreover, because the metric for income volatility relies on logs, low incomes carry particular weight.

In the analysis presented in this paper, I trim the top and bottom 3 percent of the income distribution in each year, thereby eliminating most of the very low and very high incomes and standardizing the portion of the income distribution that we are examining across time. In Hacker's initial analysis, negative and zero income reports are simply set to 1, thereby introducing potential bias to both the levels of and trend in volatility.

Furthermore, substantive interpretation of the level of the income volatility metric is difficult; the measure is based on a decomposition of variance methodology developed by labor economists Robert Moffitt and Peter Gottschalk to track individual earnings volatility, and provides unit-free results that are difficult to interpret. As such, it is the trend in volatility that is of primary interest rather than the levels. Hacker and I both find that household income volatility has increased over time.

[ii] Readers familiar with the economic volatility debate likely are aware of the recent Congressional Budget Office (CBO) study of individual earnings volatility released in April. The CBO study finds that individual earnings

Governance Studies
The Brookings Institution
1775 Massachusetts Ave., NW
Washington, DC 20036
www.brookings.edu

Editor
Lisa Bonos

Production & Layout
Gladys L. Arrisueño

volatility has not risen substantially since the mid-1980s. These results are not necessarily contradictory to the PSID household income data, in that the CBO data tracks individual earnings while the PSID data reported in this study tracks household income. The two trends will not necessarily converge for a variety of reasons; more research is certainly needed to flesh out the differences between studies of income and earnings volatility.

For the purposes of this report, however, I view household income as a more important measure of economic well-being than individual earnings. First, the economic unit of interest to most policymakers is the household, not the individual. The vast majority of Americans live in household units where the combined efforts of more than one individual earner add up to total economic well-being. As such, looking solely at individual earnings gives an incomplete picture of economic welfare. Second, earnings are only one revenue stream of several that families rely upon as income. Focusing only on individual labor market earnings excludes the critical role of both public and private transfers, as well as the role of assets. Gaining a full picture of a family's economic resources requires accounting for these non-labor sources of income, which the CBO study does not aim to do.

Tell us what you think of this Issues in Governance Studies.

Email your comments to gscomments@brookings.edu.