New America Foundation

Part 6 of 6

The American Dream of Asset Ownership is Vulnerable When Bubbles Burst

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Valuable research assistance for this series provided by Benjamin Kolansky

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The Great Recession has exposed numerous flaws in our social contract – weaknesses that existed prior to the economic downturn – highlighting the need for changes in our system. This series of policy briefs explores the stresses on our social contract, and the policy changes that must be made to mend it. The six-part series includes:

- Overview: The Great Recession exposes weaknesses in the American social contract
- Economic security policies are too closely tied to employment
- The safety net for unemployed Americans is inadequate
- Problems with a state-based social welfare system
- The regressive delivery of social welfare benefits in the U.S.
- The American dream of asset ownership is vulnerable when bubbles burst

Introduction

In the last installment, we showed how the delivery of social welfare benefits through the tax code is regressive, creating a system that disproportionately benefits the wealthy and leaves lower-income families behind. In the final installment, we examine the state of Americans' retirement security, highlighting the shortcomings of our ownership society.

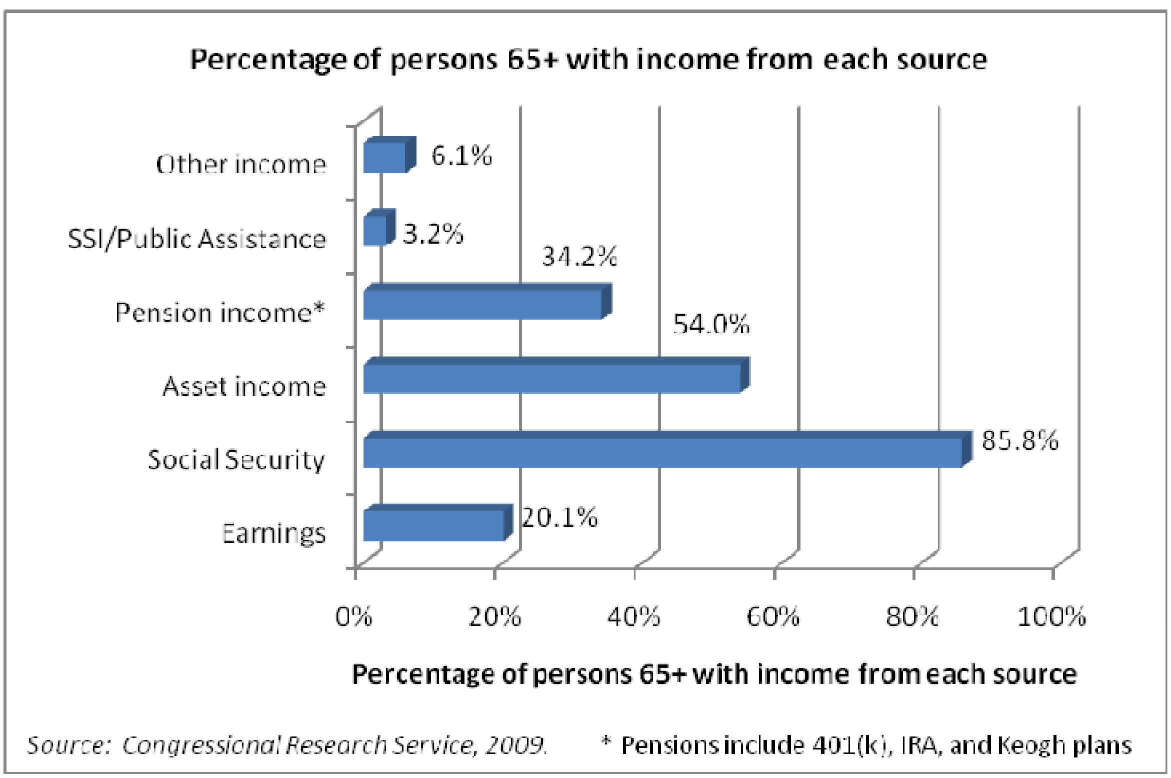
The U.S. has strongly embraced the idea of an "ownership society" for retirement security with emphasis on personal savings (largely through home ownership) and private pensions as two of the three legs of retirement security (Social Security being the third leg).

While asset prices are rising, the ownership society functions, but individuals are exposed to greater risks, which can be disastrous for them during economic downturns, as the housing crisis and the Great Recession have shown.

Although Americans' retirement security crisis has been exacerbated by the Great Recession, this insecurity was brought about by deeper structural problems in retirement savings patterns, because of a troubled transition from defined-benefit to defined-contribution plans and families relying too heavily on ever-rising home values for retirement security.

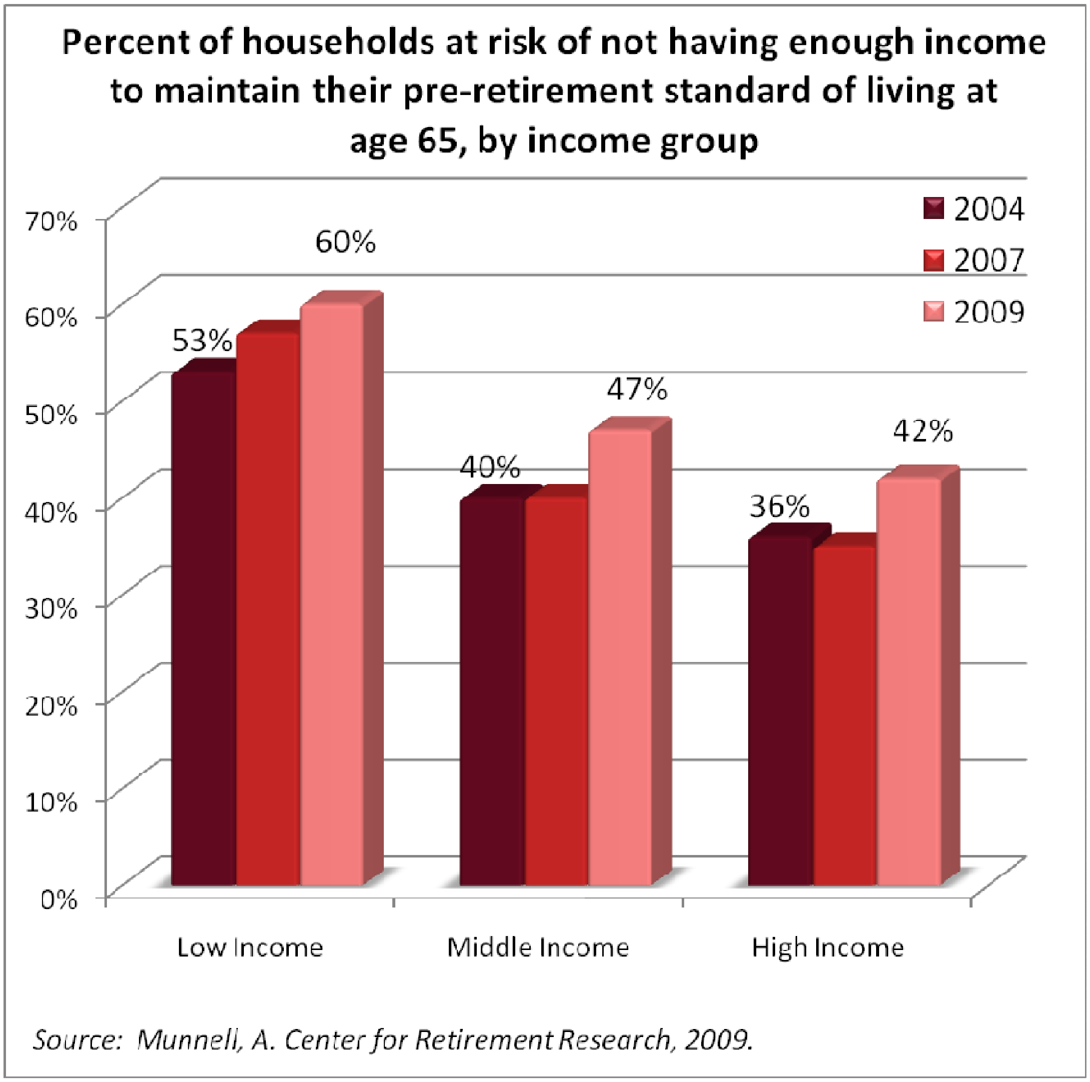
Sources of Retirement Income

Americans primarily depend upon three sources for retirement income: pensions (which include 401(k)s, Keogh plans, and IRAs), non-financial assets (usually homes), and Social Security. Pensions are the least broadly distributed asset: only 34.2 percent of Americans 65+ earn pension income, while 54 percent have income from assets and over 85 percent receive Social Security payments.[1]



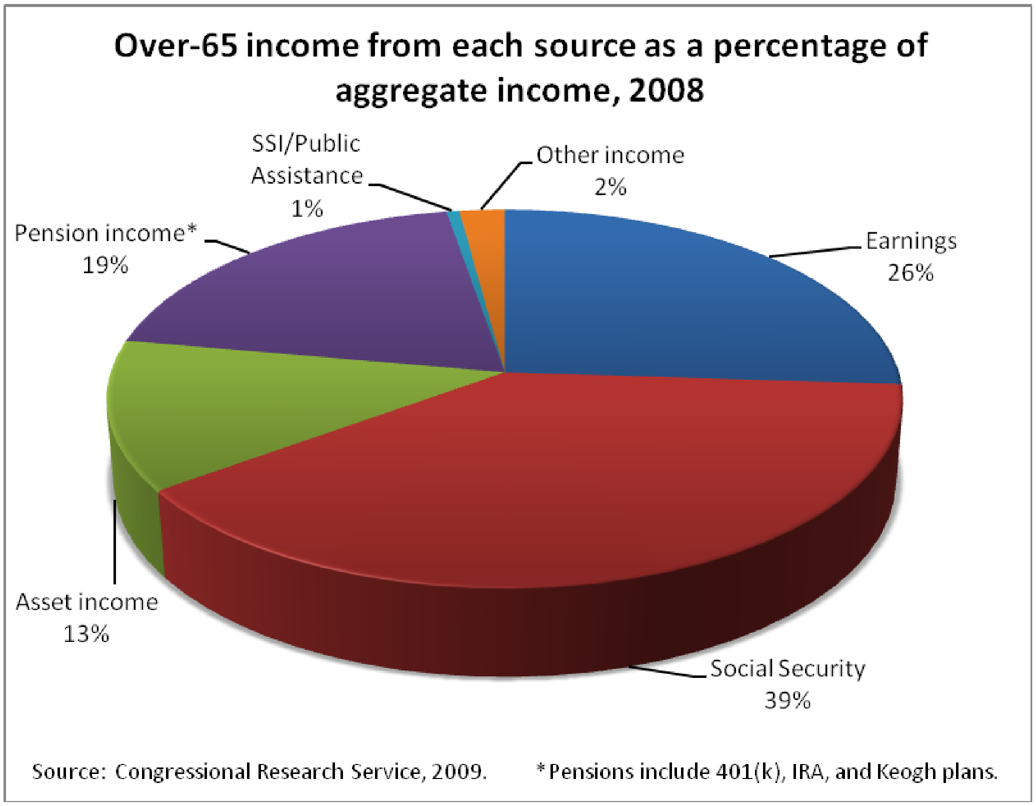
About half of all Americans are at risk of not having sufficient retirement income, largely because of reduced pension and home values. Fully 60 percent of low-income households are at risk of not having sufficient income to maintain their pre-retirement standards of living at age 65. [2]

Although the Great Recession has increased the number of Americans at risk of not having enough income to maintain their pre-retirement standard of living, over half of low-income households, and 40 percent of middle-income households, were at risk even before the financial crisis. [3]

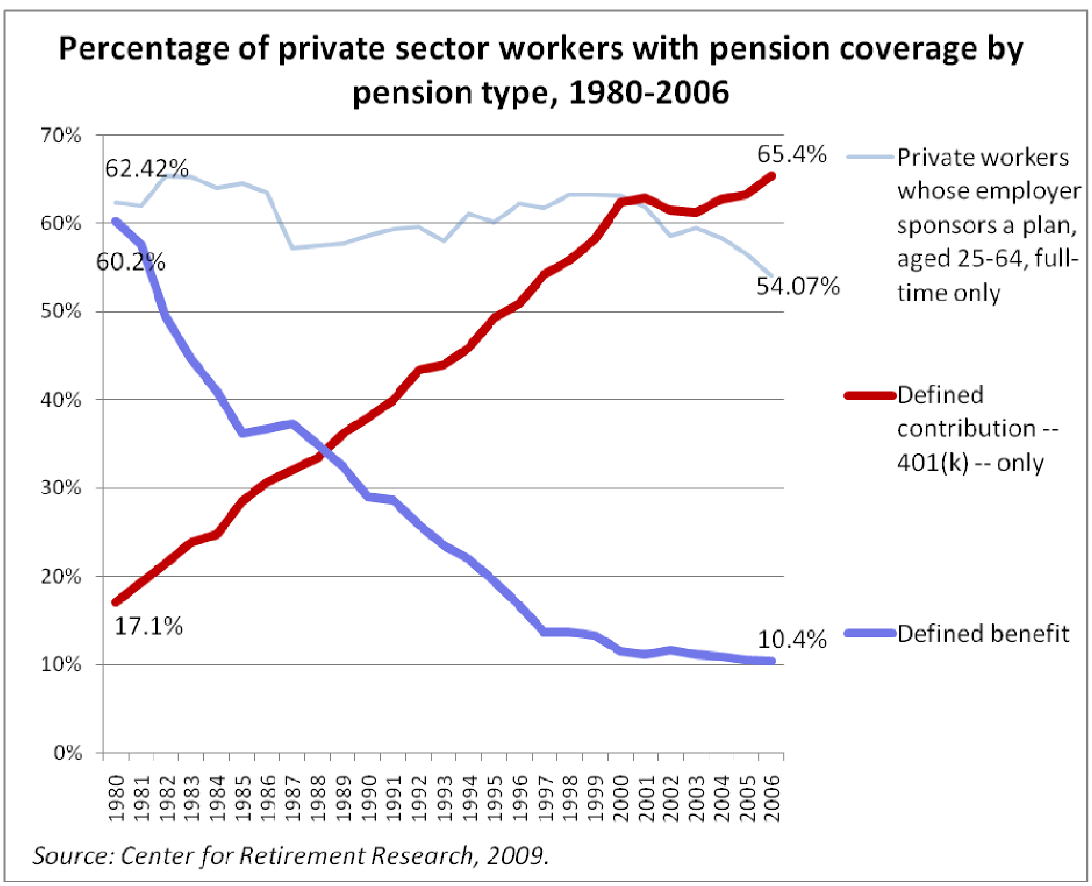


Pensions

Since the 1970s, pensions have become a more important source of income for the top two quartiles of Americans, providing over 20 percent of their income in retirement.[4]

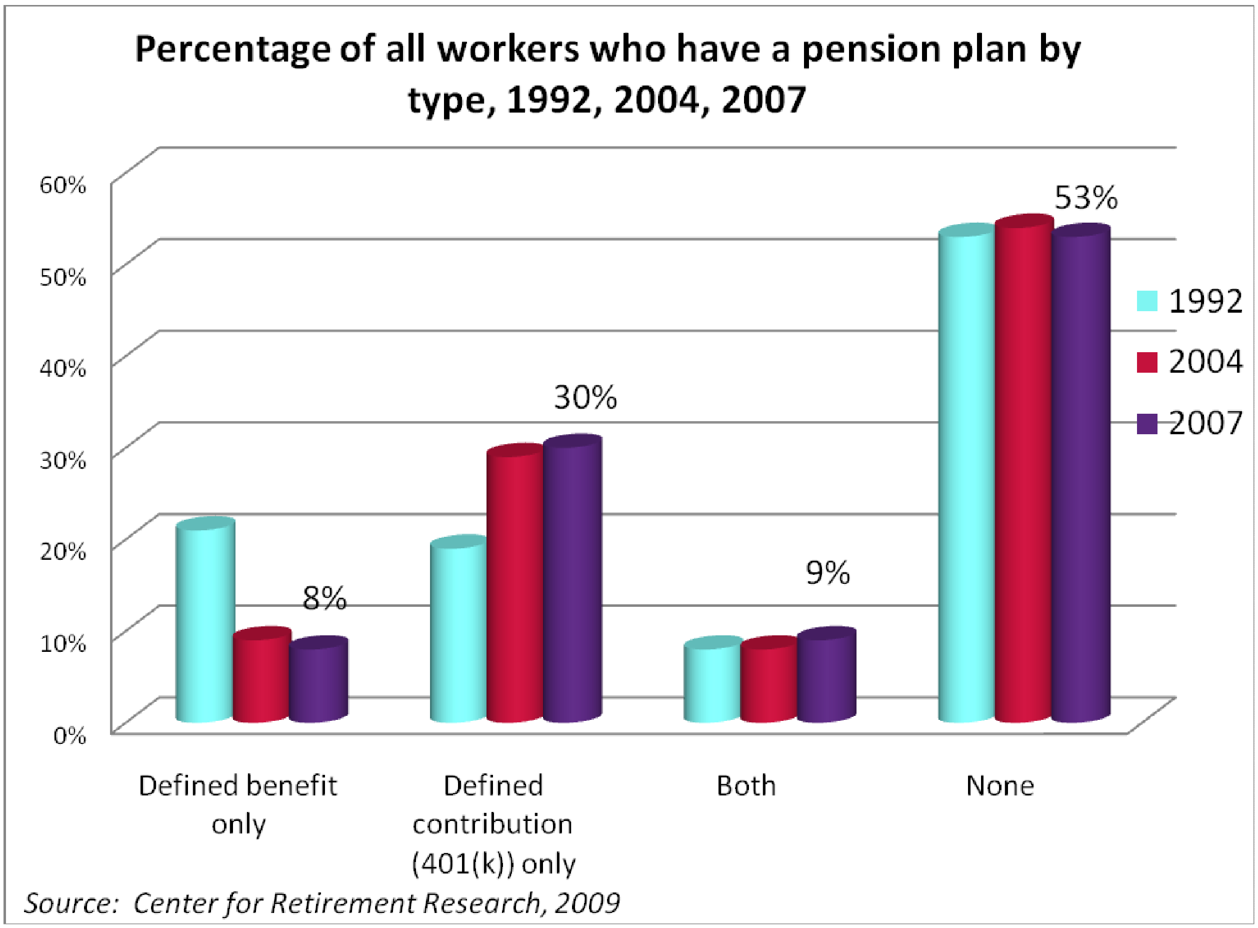


For those who have them, pensions have become an unsteady leg of retirement security. Since the early 1980s, businesses have shifted pension returns risks onto workers through a movement from defined-benefit to defined-contribution/401(k) retirement plans. Defined-benefit plans provide a specific guaranteed payout in retirement, whereas defined-contribution plans only guarantee a specific investment. In defined-contribution plans, individuals, not businesses, bear the full risk of fluctuations in stock and investment returns.

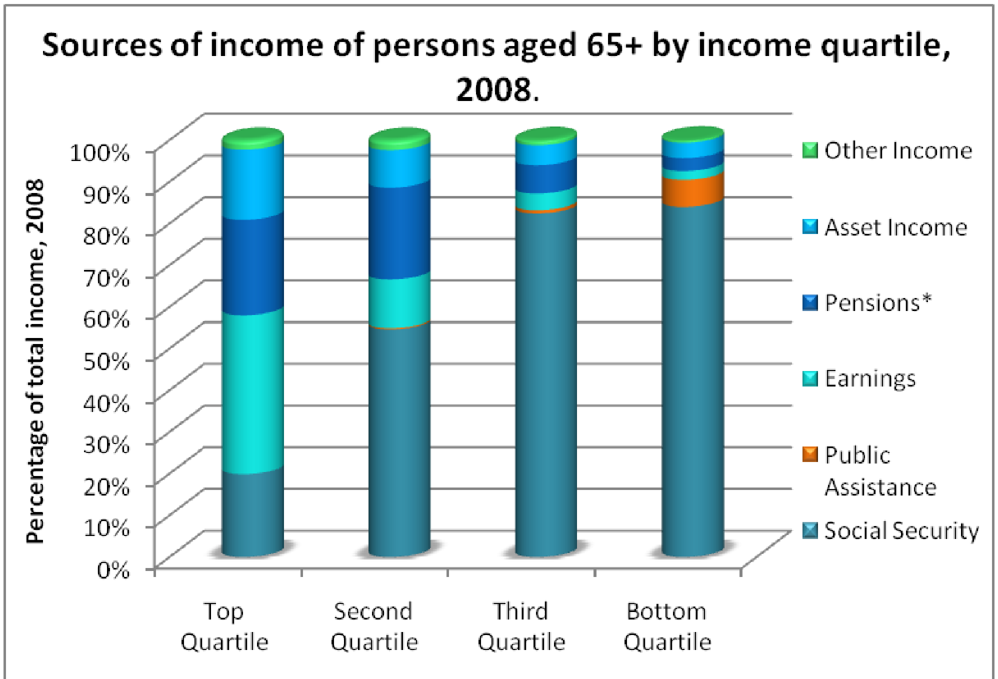


With the switch from defined-benefit to defined-contribution plans, workers with pensions find them to now be a less secure form of retirement savings. At the same time, the number of full-time private workers with employer-sponsored plans has fallen to 54 percent.[5]

The situation is still bleak when examining all American workers with pensions, not just full-time private sector workers. In 2007, less than 20 percent of all American workers enjoyed the security of a defined-benefit plan, and less than 40 percent had a defined-contribution plan. In fact, over half of all workers have no pension at all.



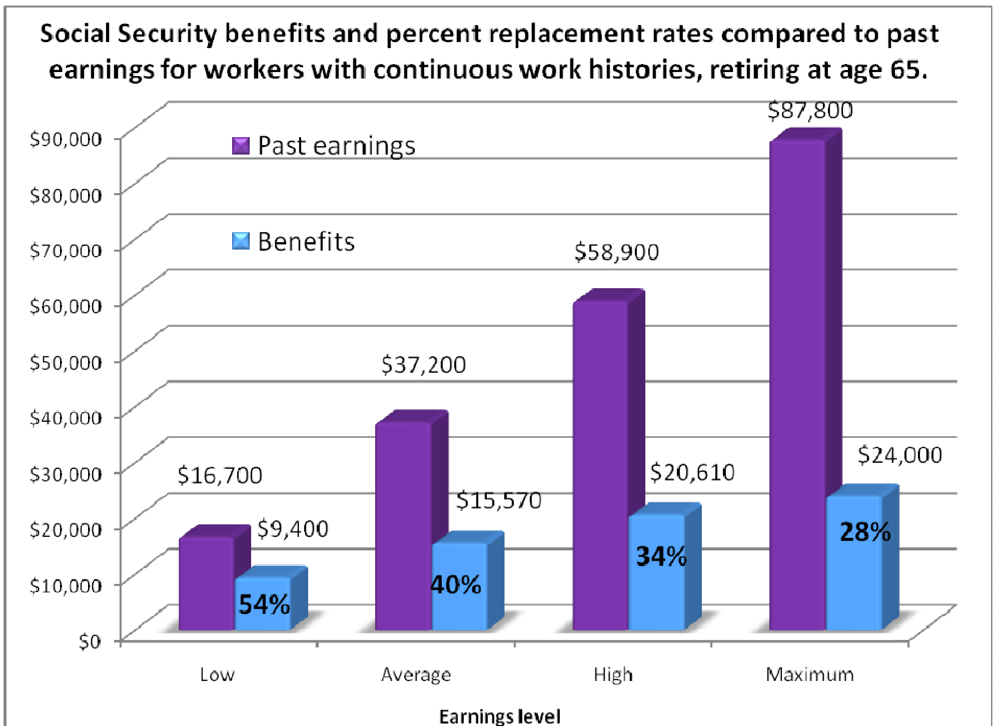
Because of narrow coverage, pension income plays a reduced role in the retirement security of most Americans, most especially in that of lower-income workers. Indeed, pensions provide only seven and three percent of retirement income for the third and fourth quartiles, respectively. Instead, the two bottom income quartiles (making less than $18,208) depend on Social Security for over 80 percent of their aged 65+ income.[6]



Source: Congressional Research Service, 2009. * Pensions include 401(k), IRA, and Keogh plans.

The second quartile still depends on Social Security for over 50 percent of its retirement income, and the program pays almost a fifth of retirement income for those in the top quartile.

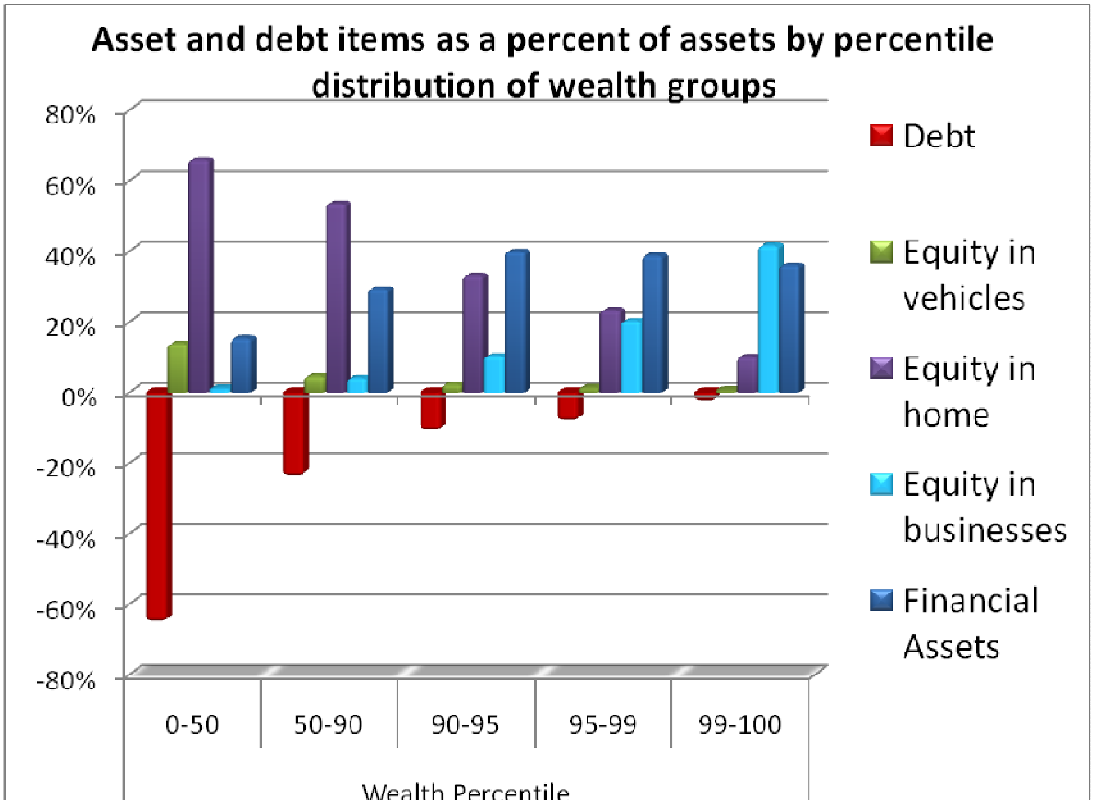
Although most Americans rely upon Social Security as their main source of retirement income, Social Security replaces less than half of pre-retirement income for the average wage earner with a continuous work history. In reality, workers do not work steadily their entire lives, and Social Security replaces only about 33 percent of their average wage from the year prior to retirement – much less than the 70-80 percent of pre-retirement income needed to maintain pre-retirement standards of living.[7]



Source: National Academy of Social Insurance, 2007.

Home Ownership

With relatively narrow coverage of pensions, and to compensate for the weakness of Social Security, Americans have invested in homes as their main source of savings for retirement. This has led to an over-reliance on rising home values for retirement security. Indeed, home ownership accounts for the largest proportion of assets for all but the richest 10 percent of the population.[8]



Source: Kennickell, A. Federal Reserve Board, 2009.

This has made Americans especially vulnerable to downturns in housing prices, and the bursting of the housing bubble has left the bottom 50 percent of Americans, who have not saved enough in secure financial assets and pensions, in a weak position for retirement.

The Federal Reserve has estimated owners' equity in household real estate decreased by $6.171 trillion from 2005 to the second quarter of 2010, a 47 percent drop.[9]

As a result, 23 percent of all U.S. homes with mortgages were underwater at the end of June 2010, representing $2.9 trillion in mortgage debt.[10] Deutsche Bank estimates that 20 million homeowners will be underwater by the end of this year, and that almost half of mortgages will be underwater before home prices stabilize in 2011.[11]

With home prices unlikely to ever recover, this loss in equity has significantly reduced the retirement security of the lower and middle classes, which have a higher proportion of their savings invested in their homes than the upper and upper middle classes, and fewer other financial assets to sustain them.

Problems of an Ownership Society

Indeed, buying into the concept of an ownership society as a means to provide retirement security has created greater financial insecurity for Americans, who are now fully exposed to volatile markets through defined-contribution pensions and unreliable home prices in the aftermath of the burst housing bubble. The Great Recession and the jobless recovery have left families vulnerable to the possibility of never being able to retire.

The Great Recession has thus dealt a double blow to many Americans: not only have they lost their jobs, but they have lost their homes and life savings as well, and Social Security is too weak to fill in the gaps. Two of the three legs of retirement – home ownership and private pensions – have failed to provide security to Americans. Social Security must be strengthened to spread market risk and provide a greater measure of retirement security for Americans.

The Great Recession and jobless recovery will scar millions of Americans, but it has highlighted changes we have long needed to make to mend our social contract. In order to support and maintain the middle class and minimize the long-term damage of structural unemployment, we must move towards a universal, citizen-based social contract that can provide counter-cyclical benefits to families and ensure a basic level of retirement security for all Americans.

[1] Purcell, P. Income of Americans aged 65 and over, 1968-2008. Congressional Research Service. November 2009.

[2] Munnell, A, Webb, A. & F. Golub-Sass. The National Retirement Risk Index: After the Crash. Center for Retirement Research at Boston College. No. 9-22. Oct. 2009.

[3] Ibid.

[4] Purcell, P. Income of Americans aged 65 and over, 1968-2008. Congressional Research Service. November 2009.

[5] Munnell, A, Webb, A. & F. Golub-Sass. The National Retirement Risk Index: After the Crash. Center for Retirement Research at Boston College. No. 9-22. Oct. 2009.

[6] Purcell, P. Income of Americans aged 65 and over, 1968-2008. Congressional Research Service. November 2009.

[7] Social Security Administration Board of Trustees. Annual report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds. Tables VI.F10, V.C.1, and III.A3. Washington, D.C. 2007.

70-80 percent replacement rate: Alford, S., Farnen, B., & M. Schachet. Affordable Retirement: light at the end of the tunnel. Benefits Quarterly. Fourth Quarter. 2004.

[8] Kennickell, A. Ponds and Streams: Wealth and Income in the U.S., 1989 to 2007. Federal Reserve Board. 2009.

[9] Federal Reserve. Z.1 Flow of Funds Accounts of the United States. Flows and Outstandings Second Quarter 2010. 17 September 2010.

[10] First American CoreLogic. June 2010.

[11] Reeves, K. Deutsche Bank. Securitization Monthly. 8 February 2010.

Weaver, K. and Shen, Y. Deutsche Bank. Securitization Monthly. August 2009.

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