The Middle Class on the Precipice

Rising financial risks for American families

by Elizabeth Warren

During the past generation, the American middle-class family that once could count on hard work and fair play to keep itself financially secure has been transformed by economic risk and new realities. Now a pink slip, a bad diagnosis, or a disappearing spouse can reduce a family from solidly middle class to newly poor in a few months.

Middle-class families have been threatened on every front. Rocked by rising prices for essentials as men's wages remained flat, both Dad *and* Mom have entered the workforce—a strategy that has left them working harder just to try to break even. Even with two paychecks, family finances are stretched so tightly that a very small misstep can leave them in crisis. As tough as life has become for married couples, single-parent families face even more financial obstacles in trying to carve out middle-class lives on a single paycheck. And at the same time that families are facing higher costs and increased risks, the old financial rules of credit have been rewritten by powerful corporate interests that see middle-class families as the spoils of political influence.

Raising Incomes the Two-Worker Way

In just one generation, millions of mothers have gone to work, transforming basic family economics. The typical middle-class household in the United States is no longer a one-earner family, with one parent in the workforce and one at home full-time. Instead, the majority of families with small children now have both parents rising at dawn to commute to jobs so they can both pull in paychecks.

Scholars, policymakers, and critics of all stripes have debated the social implications of these changes, but few have looked at their economic impact. Today the median income for a fully employed male is $41,670 per year (all numbers are inflation-adjusted to 2004 dollars)—nearly $800 *less* than his counterpart of a generation ago. The only real increase in wages for a family has come from the second paycheck earned by a working mother. With both adults in the workforce full-time, the family's combined income is $73,770—a whopping 75 percent higher than the median household income in the early 1970s. But the gain in income has an overlooked side effect: family risk has risen as well. Today's families have budgeted to the limits of their new two-paycheck status. As a result, they have lost the parachute they once had in times of financial setback—a back-up earner (usually Mom) who could go into the workforce if the primary earner got laid off or fell sick. This "added-worker effect" could buttress

the safety net offered by unemployment insurance or disability insurance to help families weather bad times. But today, a disruption to family fortunes can no longer be made up with extra income from an otherwise-stay-at-home partner.

Income risk has shifted in other ways as well. Incomes are less dependable today. Layoffs, outsourcing, and other workplace changes have trebled the odds of a significant interruption in a single generation. The shift from one income to two doubled the risks again, as both Mom and Dad face the possibility of unemployment. Of course, with two people in the workforce, the odds of income dropping to zero are lessened. But for families where every penny of both paychecks is already fully committed to mortgage, health insurance, and other payments, the loss of *either* paycheck can unleash a financial tailspin. Nor are such risks solely related to unemployment. Consider health-related exposures. Two wage-earners means either Mom or Dad could be out of work from illness or injury, losing a substantial chunk of the family income. Finally, the new everyone-in-the-workforce family faces higher risks for caregiving. When there was one stay-at-home parent, a child's serious illness or Grandma's fall down the stairs was certainly bad news, but the main economic ramification was the medical bills. Today, someone has to take off work—or hire help—in order to provide family care. At a time when hospitals are sending people home "quicker and sicker," more nursing care falls directly on the family—and someone has to be home to administer it.

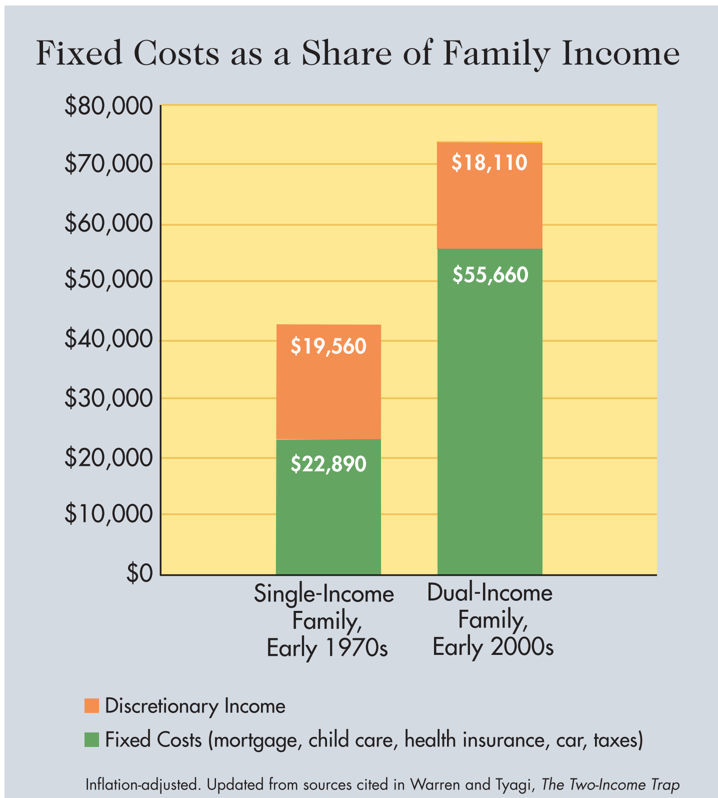
Even the economic risks of divorce have changed. A generation ago, the end of a marriage was an economic blow, but a nonwork-

Illustration by John S. Dykes

ing spouse usually took a job, bringing in new income to stay afloat. Now, whatever the two-income divorcing couple earns has to cover both their old *and* new expenses. Evidence mounts that post-divorce, both women and men are struggling to make ends meet as they try to support two households on the same combined income. A divorced woman with children, for example, is about three times more likely to file for bankruptcy than a man or woman, single or married, without children. And men who owe child support are about three times more likely to file for bankruptcy than men who don't.

The news is even worse for single parents. They face all the difficulties of dual-income families—all income is budgeted, there is no one at home to work if the primary earner loses a job or gets sick, and no one to take over if a child gets sick or an elderly parent needs help—*and* they are trying to make it on a lot less money, competing with two-income families for housing, daycare, health insurance, and all the other goods and services. As one divorced, working mother put it, "With what my ex contributes and what I earn, I can just about match what a man can make, but I can't match what a man and woman both working can make." The two-parent families are struggling to swallow the risk, but their single-parent counterparts are choking.

Does this mean that middle-class women should return to the home in order to reduce their families' risk? Before jumping to that conclusion, it is important to look at the expenses middle-class families face.



Inflation-adjusted. Updated from sources cited in Warren and Tyagi, *The Two-Income Trap*

Soaring Expenses—and Risk

Why are so many moms in the workforce? Surely, some are lured by a great job, but millions more need a paycheck, plain and simple.

It would be convenient to blame the families and say that it is their lust for stuff that has gotten them into this mess. Indeed, sociologist Robert Frank claims that this country's newfound "Luxury Fever" forces middle-class families "to finance their consumption increases largely by reduced savings and increased debt." Others echo the theme. A book titled *Affluenza* (by John De Graaf, David Wann, and Thomas H. Naylor) sums it up: "The dogged pursuit for more" accounts for Americans' "overload, debt, anxiety, and waste." If Americans are out of money, it must be because they are over-consuming—buying junk they don't really need.

Blaming the family supposes that we believe that families spend their money on things they don't really need. Over-consumption is not about medical care or basic housing; it is, in the words of Juliet Schor, about "designer clothes, a microwave, restaurant meals, home and automobile air conditioning, and, of course, Michael Jordan's ubiquitous athletic shoes, about which children and adults both display near-obsession." And it isn't about buying a few goodies with extra income; it is about going deep into debt to finance consumer purchases that sensible people could do without.

But is this argument true? If families really are blowing their paychecks on designer clothes and restaurant meals, then the household expenditure data should show them spending more on these frivolous items than ever before. But the numbers don't back up the claim.

A quick summary of the data from the Bureau of Labor Statistics' Consumer Expenditure Survey paints a very different picture of family spending. Consider what a family of four spends on clothing. Designer toddler outfits and $200 sneakers are favorite media targets, but when it is all added up, including the Tommy Hilfiger sweatshirts and Ray-Ban sunglasses, the average family of four today spends 33 percent *less* on clothing than a similar family did in the early 1970s. Overseas manufacturing and discount shopping mean that today's family is spending almost $1,200 a year *less* than their parents spent to dress themselves.

What about food? Surely, families are eating out more and buying shopping carts full of designer water and exotic fruit? In fact, today's family of four actually spends 23 percent *less* on food (at-home and restaurant eating combined) than its counterpart of a generation ago. The slimmed-down profit margins in discount supermarkets have combined with new efficiencies in farming to cut more costs for the American family.

Appliances tell the same picture. There is a lot of complaining about microwave ovens and espresso machines: *Affluenza* rails against appliances "that were deemed luxuries as recently as 1970, but are now found in well over half of U.S. homes, and thought of by a majority of Americans as necessities: dishwashers, clothes dryers, central heating and air conditioning, color and cable TV." But manufacturing costs are down, and durability is up. Today's families are spending 51 percent *less* on major appliances than their predecessors a generation ago.

This is not to say that middle-class families never fritter away money. A generation ago, big-screen televisions were a novelty reserved for the very rich, no one had cable, and DVD and TiVo were meaningless strings of letters. So how much more do families spend on "home entertainment," premium channels included? They spend 23 percent more—a whopping extra $180 annually. Computers add another $300 to the annual family budget. But even that increase looks a little different in the context of other spending. The extra money spent on cable, electronics, and computers is more than offset by families' savings on major appliances and household furnishings alone.

The same offsetting phenomena appear in other areas as well. The average family spends more on airline travel than it did a generation ago, but less on dry cleaning; more on telephone services, but less on tobacco; more on pets, but less on carpets. When we add it all up, increases in one category are offset by decreases in another.

So where did their money go? It went to the *basics*. The real increases in family spending are for the items that make a family middle class and keep them safe (housing, health insurance), that educate their children (pre-school and college), and that let them earn a living (transportation, childcare, and taxes).

The data can be summarized in a financial snapshot of two families, a typical one-earner family from the early 1970s compared with a typical two-earner family from the early 2000s. With an income of $42,450, the average family from the early 1970s covered their basic mortgage expenses of $5,820, health-insurance costs of $1,130 and car payments, maintenance, gas, and repairs of $5,640. Taxes claimed about 24 percent of their income, leaving them with $19,560 in discretionary funds. That means they had about $1,500 a month to cover food, clothing, utilities, and anything else they might need—just about half of their income.

By 2004, the family budget looks very different. As noted earlier, although a man is making nearly $800 less than his counterpart a generation ago, his wife's paycheck brings the family to a combined income that is $73,770—a 75 percent increase. But higher expenses have more than eroded that apparent financial advantage. Their annual mortgage payments are more than $10,500. If they have a child in elementary school who goes to daycare after school and in the summers, the family will spend $5,660. If their second child is a pre-schooler, the cost is even higher—$6,920 a year. With both people in the workforce, the family spends more than $8,000 a year on its two vehicles. Health insurance costs the family $1,970, and taxes now take 30 percent of its money. The bottom line: today's median-earning, median-spending middle-class family sends two people into the workforce, but at the end of the day they have about $1,500 *less* for discretionary spending than their one-income counterparts of a generation ago.

What happens to the family that tries to get by on a single income today? Their expenses would be a little lower because they can save on childcare and taxes, and, if they are lucky enough to live close to shopping and other services, perhaps they can get by without a second car. But if they tried to live a normal, middle-class life in other ways—buy an average home, send their younger child to preschool, purchase health insurance, and so forth—they would be left with only $5,500 a year to cover all their other expenses. They would have to find a way to buy food, clothing, utilities, life insurance, furniture, appliances, and so on with less than $500 a month. The modern single-earner family trying to keep up an average lifestyle faces a *72 percent* drop in discretionary income compared with its one-income counterpart of a generation ago.

Combine changes in family income and expenses, and the biggest change of all becomes evident—on the risk front. In the early 1970s, if any calamity came along, the family devoted nearly half its income to discretionary spending. Of course, people need to eat and turn on the lights, but the other expenses—clothing, furniture, appliances, restaurant meals, vacations, entertainment, and pretty much everything else—can be drastically reduced or even cut out entirely. In other words, they didn't need as much money if something went wrong. If the couple could find a way—through unemployment insurance, savings, or putting their stay-at-home parent to work—they could cover the basics on just half of their previous earnings. Given the option of a second paycheck, both could stay in the workforce for a few months once the crisis had passed, pulling the family out of their financial hole.

But the position today is very different. Fully 75 percent of family income is earmarked for recurrent monthly expenses. Even if they are able to trim around the edges, families are faced with a sobering truth: every one of those expensive items—mortgage, car payments, insurance, childcare—is a fixed cost. Families must pay them each and every month, through good times and bad; there is no way to cut back from one month to the next, as can be done with spending on clothing or food. Short of moving out of the house, withdrawing their children from preschool, or canceling the insurance policy altogether, they are stuck.

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In other words, today's family has no margin for error. There is no leeway to cut back if one earner's hours are cut or if the other gets sick. There is no room in the budget if someone needs to take off work to care for a sick child or an elderly parent. Their basic situation is far riskier than that of their parents a generation earlier. The modern American family is walking a high wire without a net.

The Rules Have Changed

The one-two punch of income vulnerability and rising costs has weakened the middle class, at the same time that the revision of the rules of financing delivers a death blow to millions of families each year. Since the early 1980s, the credit industry has rewritten the rules of lending to families. Congress has turned the industry loose to charge whatever it can get and to bury tricks and traps throughout credit agreements. Credit-card contracts that were less than a page long in the early 1980s now number 30 or more pages of small-print legalese. In the details, credit-card companies lend money at one rate, but retain the right to change the interest rate whenever it suits them. They can even raise the rate *after* the money has been borrowed—a practice once considered too shady even for a back-alley loan shark. When they think they have been cheated, customers can be forced into arbitration in locations thousands of miles from home. Some companies claim that *(please turn to page 89)*

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they can repossess *anything* a customer buys with a credit card.

Credit-card issuers are not alone in their boldness. Home-mortgage lenders are writing mortgages that are so one-sided that some of their products are known as "loan-to-own" because it is the mortgage company—not the buyer—who will end up with the house. Payday lenders are ringing military bases and setting up shop in working-class neighborhoods, offering instant cash that can eventually cost the customer more than a thousand percent interest.

For those who can stay out of debt, the rules of lending may not matter. But the economic pressures on the middle class are causing more families to turn to credit just to make ends meet. When something goes wrong the only place to turn is credit cards and mortgage refinancing. At that moment, the change in lending rules matters very much indeed. The family that might manage $2,000 of debt at 9 percent discovers that it cannot stay afloat when interest rates skyrocket to 29 percent. And the family that refinanced the home mortgage to pay off other debts suddenly faces escalating monthly payments and may find itself staring at foreclosure. Job losses or medical debts can put any family in a hole, but a credit industry that has rewritten the rules can keep that family from ever climbing back.

A Politics of Living on the Edge?

Every day, middle-class families carry higher risks that a job loss or a medical problem will push them over the edge. Although plenty of families make it, a growing number who worked just as hard and followed the rules just as carefully find themselves in a financial nightmare. The security of middle-class life has disappeared. The new reality is millions of families whose grip on the good life can be shaken loose in an instant.

Although my own work, on bankruptcy and credit, has focused on the specifics of families' household finances, I cannot help but think that their changed circumstances during the past generation have larger echoes for public policy.

During the same period, families have been asked to absorb much more risk in their retirement income. In 1985, there were 112,200 defined-benefit pension plans with employers and employer groups around the country; today their number has shrunk to 29,700 such plans, and those are melting away fast. Steelworkers, airline employees, and now those in the auto industry are joining millions of families who must worry about interest rates, stock market volatility, and the harsh reality that they may outlive their retirement money. For much of the past year, President Bush campaigned to move Social Security to a savings-account model, with retirees trading much or all of their guaranteed payments for payments contingent on investment returns. For younger families, the picture is not any better. Both the absolute cost of healthcare and the share of it borne by families have risen—and newly fashionable health-savings plans are spreading from legislative halls to Wal-Mart workers, with much higher deductibles and a large new dose of investment risk for families' future healthcare. Even demographics are working against the middle class family, as the odds of having a frail elderly parent—and all the attendant need for physical and financial assistance—have jumped eightfold in just one generation.

From the middle-class family perspective, much of this, understandably, looks far less like an opportunity to exercise more financial responsibility, and a good deal more like a frightening acceleration of the wholesale shift of financial risk onto their already overburdened shoulders. The financial fallout has begun, and the political fallout may not be far behind.

Elizabeth Warren is Gottlieb professor of law and faculty director of the Judicial Education Program. This article is based in part on "Rewriting the Rules: Families, Money, and Risk," a paper written for the nonprofit Social Science Research Council (see http://privatizationofrisk.ssrc.org/Warren/). Warren and her daughter, Amelia Warren Tyagi, are the authors of The Two-Income Trap: Why Middle-Class Mothers and Fathers Are Going Broke *(see "The Middle-Class Trapdoor," January-February 2004, page 10) and* All Your Worth: The Ultimate Lifetime Money Plan.