

Income Diversification as Insurance in an Increasingly Risky World: Identifying Policy Goals

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I. Introduction

Labor market risk exposure – the possibility of being harmed by high unemployment and earnings fluctuations – has grown for households over the past three decades, while labor market risks – the actual market ups and downs – have also increased. Households historically could rely on social insurance systems, mainly Social Security and unemployment insurance, and on private protections such as defined-benefit (DB) pensions and unions to partially insulate them from the vagaries of the market. But, these cash income protections have weakened over time just as risks have increased.

Both trends – greater market volatility and fewer protections – have been driven by the same underlying factor. The financial sectors' relentless pressure on companies to pursue short-term profits and the increasingly widespread focus on companies on their short profitability¹ has contributed to greater earnings volatility and higher levels of long-term unemployment. Companies have sought to reduce their risks and long-term liabilities as well as their costs. This risk and cost shifting has translated into fewer publicly and privately provided benefits and a shifting of economic risks onto individuals, who now face greater earnings fluctuations, fewer benefits and more long-term unemployment.

Households are generally risk averse and the loss of social and private insurance should lead them to seek out additional insurance elsewhere, e.g. by saving more, and to lower their risk exposure elsewhere, e.g. by diversifying their income. Greater economic uncertainty should lead households to save more on their own, although the evidence indicates that households do not fully compensate for the greater risk exposure with additional savings (Browning and Lusardi, 1996; Weller, 2010).

This leaves households with more risk exposure than in the past. Households could experience more economic insecurity during recessions, exacerbating economic downturns due to declines in consumption, for instance. The increase in economic insecurity may be particularly large among communities of color, single women and those with less education where risk exposure is especially pronounced (Weller, 2013; Weller and Bernardo, 2014a, 2014b), such that wealth inequality may also rise, exacerbating economic downturns.

Growing household labor market uncertainty increases the need for ways to address increasing risk exposures, e.g. through income diversification. Left unaddressed, rising risk exposure can feed back into more widespread economic insecurity and slower economic growth. Lowering households' risk exposure requires a multipronged approach that could include more opportunities for income diversification so that household incomes fall less during downturns as would be the case with less diversified incomes.² Households could diversify their incomes by drawing down savings³ and through employment-related income diversification. Two spouses, for example, could work in separate employment arrangements or

¹ There are some countervailing forces to this trend towards greater short-term profit orientation among U.S. companies and globally operating companies abroad, e.g. in Germany, but they only serve to slow not change the direction of this trend (Doerre, 2015; Lazonick, 2015). Factors such as collective bargaining agreements and internal conflicts between managers and corporate owners appear to occasionally slow the prioritization of short-term profits over other corporate goals (Doerre, 2015; Lazonick, 2015).

² Public insurance strategies can include Social Security and unemployment insurance reforms as well as greater access to public health insurance. We focus only on income diversification in this chapter to illustrate the potential and limits of this approach.

³ Savings refers to any store of wealth that household could access when employment-related incomes decline. Private unemployment and disability insurance in addition to retirement savings would hence fall under this standard savings definition as would home equity (Wolff, 2015).

individuals could combine part-time employment arrangements as salary and wage employees, independent contractors and entrepreneurs.

There is also the possibility that greater income diversification could create a virtuous cycle of economic security for some households. Households with more diversified incomes could take a longer term view of their future, save more, invest more for the long-term, starting a business and pursue different job opportunities than would be the case for households with less diversified incomes. These follow-on effects from income diversification could create new sources of future income diversification. Policy interventions to help households diversify their incomes may be efficient because of this virtuous cycle, assuming that policy can indeed help households diversify their incomes.

This is a strong assumption. Diversification strategies – relying on savings, working in separate employment arrangements and receiving annuities – are after all fraught with substantial challenges. Being able to draw down savings when other income sources decline requires that households accumulate sufficient funds before their income declines and that the savings are accessible without restrictions. The evidence suggests that households in fact save less than they otherwise would in non-housing savings because of complex restrictions tied to federal savings incentives (Weller and Ungar, 2014), leaving households with limited savings to diversify their income streams during a downturn, and with savings that are not fully accessible when incomes decline. Households may also encounter substantial transaction costs and liquidity constraints if they want to draw on the equity in their houses to diversify their income. And, households may face institutional obstacles when trying to work less than full-time in separate employment arrangements, e.g. a requirement to work full-time for one employer to maintain health insurance coverage. Finally, annuity incomes such as Social Security and defined benefit (DB) pension benefits are generally only available to households above a certain age.

We argue in this chapter that income diversification deserves policy attention as a response to the growing labor market risks that households face as a consequence of increased financialization – the growing prioritization of short-term profits to satisfy financial investors and lenders. We further argue that past policy efforts hold lessons for future policy targets to help households diversify their incomes. First, past policy efforts related to public transfer payments have increased the importance of these income streams as part of income diversification among wage and salary earners. And, past policy changes have made it potentially more difficult for households to use withdrawals from private savings as income diversification. Households need more income diversification and policy can make it easier for households to diversify their incomes. There appears to be an especially large space for policy to intervene with respect to private income sources.

This chapter develops the background and the policy goals for policymakers to consider in their efforts to help households diversify their income. We summarize the theoretical and empirical literature on income diversification and present some data on existing household income diversification and on the potential economic benefits for households from such income diversification. We then discuss possible obstacles to household income diversification in the labor market and through other means, e.g. through more capital, business and annuity income. The chapter concludes with drawing out some policy goals to remove these obstacles to greater income diversification.

II. Literature review

U.S. corporations have increasingly emphasized short-term profits over other goals during the past few decades (Weller, 2014). This short-term profit prioritization has meant that, among other things, corporations have cut back on wages, benefits, and training (Lazonick, 2007; 2015) and slowed hiring during expansions (Bivens and Weller, 2006). As a result, households have faced increasing labor market risks -- both unemployment risk and compensation risk, i.e. the volatility of labor income – over the past three decades. Long-term unemployment, for instance, has been on the rise since the 1970s (Rothstein,

2011), earnings volatility has grown as well (Hacker, 2006; Dynan, Elmendorf, and Sichel, 2007) and the share of jobs with employer-sponsored health insurance and retirement plans has eroded over time (Census, 2013; Copeland, 2013; EBRI, 2010; Schmitt, 2007).⁴ Changes in corporate priorities in the name of shareholder value creation are one key factor driving growing labor market risks.

Labor market risks tend to correlate with demographic characteristics, such that the rise in labor market risks has contributed to growing income inequality. African-Americans and Latinos tend to experience higher unemployment rates, greater incidences of long-term unemployment, higher earnings fluctuations and lower employer-sponsored benefit receipts than is the case for whites (Weller and Ahmad, 2013; Hoynes, 1999; Stratton, 1993). And, there is some evidence that women typically have had higher earnings fluctuations than men (Hoynes, 1999; XXXX), while their unemployment fluctuations have increased over time to match those of men (Goodman et al., 1993; Abraham and Shimer, 2001). Finally, labor market risks have also grown for older workers as they have seen sharper increases in long-term unemployment than was the case for younger workers (Rix, 2011, 2012).

Income diversification would help to stabilize household incomes, especially when labor market risks are high. Diversifying household income so that households receive income from uncorrelated sources should theoretically result in more stable incomes. That is, a household that receives income from wages, dividends and interest income from savings from a patent and from Social Security should experience fewer and smaller income fluctuations than a household that solely relies on wages, even if the average income is the same.

Income diversification then requires households to find income sources in addition to their primary source of income, typically wages and salary. One key argument of optimal portfolio strategies is that diversification requires that households invest in financial assets that have returns that are not correlated with each other, i.e. investing in two technology stocks is not diversification, but investing in stocks and in bonds is. Translated to labor market experiences, this implies that households can only diversify labor market risks within limits by taking another job. The part-time jobs a person can qualify for may all be in the same industry or occupation and thus offer earnings that are somewhat or are highly correlated. Households hence can theoretically only address labor market risks within limits by working several part-time jobs and thus need to consider diversifying their incomes with income from non-wage and salary sources, such as business income, capital income and public assistance.

More stable household incomes should, all else equal, offer households some additional benefits that could improve their economic security. Stability may result in lower internal discount rates and this may have a number of potential benefits. First, it would increase human capital and business investment. Second by stabilizing income and lowering internal discount rates households would have longer planning horizons, which tend to be positively related to more savings and a greater chance of successful entrepreneurship.

Income diversification through separate employment arrangements

Most pre-retirement age adults receive the overwhelming majority of their income from work, however work-related incomes – wages and benefits – have become increasingly volatile in recent business cycles (Dynan, Elmendorf and Sichel, 2007). Wage and salary employment can also severely compromise households' incomes in recessions as adverse business cycle fluctuations may be more severe for some wage and salary employees than for entrepreneurs and independent contractors (Baker and Nelson, 2005; Bradley et al., 2011; Hipple, 2004).

⁴ The health insurance data ignore the declining quality of health insurance coverage. The insured face growing co-pays for health care services as well as rising shares of health insurance premiums (KFF, 2013).

Self-employment, in comparison, may lead to smaller income losses during an economic downturn (Baker and Nelson, 2005; Bradley, Aldrich, Shepherd and Wiklund, 2011; Hipple 2004). Independent contractors can diversify their income by working for several clients across economic sectors. Likewise, successful entrepreneurs may have the personal ingenuity and financial reserves to develop new offerings that can weather economic downturns, in contrast to those who are dependent on their employer's decisions and finances. It is thus possible that households could stabilize their incomes in part through engaging in separate employment arrangements.

This rosy scenario downplays entrepreneurial risk: self-employment also holds substantial income risks compared to wage and salary employment. Independent contractors and entrepreneurs may see substantial income fluctuations during a downturn if they have to cover the costs of maintaining office space, for instance, or of keeping employees and subcontractors. Secondly, a diversified strategy may mean it is unlikely to experience catastrophic reductions in income. But, it may make it more probable that *some* reduction in income is likely. Wage and salary workers who keep their jobs may be wholly unaffected by a recession, but they may lose all of their income during a layoff, while those with diversified incomes may only see part of their incomes disappear either from job loss or other income reductions during a recession. This suggests that combining separate employment arrangements – wage and salary employment, independent contracting and entrepreneurship – could stabilize incomes. Rather than choosing one employment form over another workers may be best served by combining multiple employment/entrepreneurial arrangements.

Households that can diversify their income sources within their primary employment arrangement should see less volatility. A household may simultaneously receive income from working for somebody else, from entrepreneurship and from independent contracts. One or more people in the household may split their time between these options. That is, households with more diversified income sources should face less household income volatility.⁵

One fundamental difficulty of this diversification technique, aside from the aforementioned correlation between one person's part-time jobs, is time, specifically the fact that time is limited. Workers cannot be expected to hold one-and-a-half to two full-time jobs in order to attain income diversification. To make this option more feasible, high quality part-time jobs need to be available. However, most part-time jobs are not high-paying and benefits-providing; these jobs tend to be focused in relatively low paying occupations: cashiers, waiters, and sales clerks. Secondly, while the most recent recovery businesses have generated an unprecedented number of part-time jobs, unpredictable scheduling makes it nearly impossible for many part-time workers to diversify their income through multiple jobholding. Pressure is now mounting to provide more normalized schedules for these part-time workers so that they may combine part-time work with other ways of earning income^{6,7}.

Public policy can play some role in determining when and how households receive business income. Policy, for instance, can require employers to provide at least two weeks notice of a worker's schedule. Policy can also encourage entrepreneurship through an array of measures that target, for instance, the availability of financial capital for a start-up or ongoing business venture, the education of entrepreneurs and the market for a business' products, e.g. through procurement rules for government purchases. Tax policy can also influence whether business owners reinvest their earnings into their business or take distributions from their earnings.

⁵ The literature on households in developing countries discusses families diversifying income sources to decrease risk and increase stability. See, for instance, Reardon, T., Berdegue, J., Barrett, C., and Stamoulis, H. (2006).

⁶ See <http://www.nytimes.com/2014/07/16/business/a-push-to-give-steadier-shifts-to-part-timers.html> (accessed July 21, 2014)

⁷ See <http://www.nytimes.com/2014/07/19/business/part-time-schedules-full-time-headaches.html> (accessed July 21, 2014)

Income diversification through withdrawal from savings

Receiving income from savings could also allow households to diversify their current income – if workers had significant savings. Working age households could receive realized capital gains from all non-retirement savings as well as dividends and interest payments from non-retirement, non-housing savings. However, given the small percentage of households that have capital gains income, this method is infeasible for the vast majority of households. More commonly households have capital gains, interest, and dividend income in restricted savings, such as retirement savings accounts. This capital income can only help households diversify their income when they withdraw money from these accounts. Since these monies are typically earmarked for retirement, very few working age households withdraw money from these accounts (Argento, Bryant and Sabelhaus, 2013). Consequently, we ignore retirement account withdrawals as a separate income diversification strategy in this discussion, it is likely that ignoring this income will have little influence on our overall conclusions.⁸

Households could also tap into their home equity through reverse mortgages, or home equity lines of credit, but very few households of any age do so in large part because of high transaction costs and other restrictions (AARP, 2010; Redfoot, 2011; Twomey and Jurgens, 2009).

Finally, most non-housing forms of savings face severe restrictions on withdrawals, limiting households' ability to use them as income diversification measures when other forms of income decline. Households can use retirement savings, for instance, for a limited number of purposes other than retirement such as a down payment on a first residence, medical emergencies, and education, without incurring penalties. That is, households will incur penalties if they withdraw money from their retirement savings as an income diversification strategy when these accepted reasons for pre-retirement withdrawals do not exist.

Income diversification through annuity income

Older households seeking to diversify their incomes may rely increasingly on Social Security as buffer since earnings tests were reduced and eventually eliminated⁹, allowing older households to earn money without any penalties while also receiving Social Security benefits. The earnings limits for full-benefit Social Security recipients were removed in early 2000 (Burke 2000). This may have potentially incentivized older entrepreneurs to collect Social Security benefits earlier than they otherwise would have to grow and expand their businesses (Burke, 2000). Again, public policy can play a direct role in determining when and how much income from a source other than wages and salaries households can receive.

Older households may have access to annuity income a defined benefit pension, and to a lesser degree from their defined contribution plans (e.g. 401(k), 403(b), 457). Households may receive annuity benefits, while also continuing to receive some employment based income, depending on their age and the details of their annuity benefits. Fry et al. (2011) suggest that older adults may be economically advantaged relative to younger households by having inflation-indexed Social Security as the anchor of their annual income streams. Likewise, pensions and retirement accounts may have generated higher retirement incomes due to the strength of the financial market after 1983 (Phelps et al. 2001).

Obstacles to income diversification

Income diversification offers potential economic benefits to many households that have experienced labor market uncertainty, but households face serious obstacles employing income diversification strategies discussed above – savings withdrawals, combining employment arrangements, and annuity income.

⁸ We use data on withdrawals from IRAs as supplementary materials in our empirical discussion.

⁹ For a complete history of Social Security earnings tests see <http://www.ssa.gov/oact/cola/rteahistory.html>

First, households need to have any savings before they can use capital income as a diversification strategy. Many households have few liquid assets that they can use in an emergency (Brooks et al., 2014) and thus have few opportunities to diversify their income with income from their liquid savings. Communities of color, single women and younger households will be less likely than whites, single men and older households to have substantial savings (Brooks et al., 2014; Wolff, 2015). Shapiro (2004) notes that in 1984 an African-American household had between 5¢ and 10¢ in wealth for every dollar of wealth held by a white household. More recently Shapiro et al. (2014: 105) find that following a representative sample of households over time (using the Panel Study of Income Dynamics) working age, African-American households had a median wealth – net of home equity - of \$6,500 compared to \$113,000 for white households.

Second, households need to be able to access savings with relative ease when they have them. Households can only access their savings in retirement accounts without restrictions once they reach age 59-½ years. Otherwise, they can withdraw funds only within some limits or pay excise taxes on their withdrawals (Argento, Bryant and Sabelhaus, 2013). Under certain circumstances, households can borrow against their retirement savings accounts at attractive interest rates. However, penalties and marginal tax rates apply in the case of default, and in the event of job separation (voluntary or involuntary) the loan is payable in full. This “feature” of DB loans effectively increases the risk associated with the job by bundling full repayment of the loan upon separation from the job (Wenger and Weller 2014)

Third, households may be locked into full-time wage and salary employment if they desire and need access to certain employment based benefits. Typically only full-time jobs offer employer-sponsored group health insurance, DB pensions, matches to retirement savings accounts and disability insurance. Because most employers only offer such benefits to full-time employees and part-time employees may be locked out of these markets as a result. Purchasing these benefits on their own can be cost prohibitive. Often households will diversify by holding different work arrangements where one household member’s job provides health insurance and other benefits (Reynolds and Wenger 2009). Communities of color, single women and younger households will be less likely than whites, single men and older households to have employment based benefits and thus be less likely to be locked into their current jobs. Importantly for lower income households, the Affordable Care Act is providing significantly expanded access to health insurance and consequently health care. The ACA is doing this in two important ways. First, it allows for continued household health insurance coverage for young adults (up to age 25) via parents. Second, it is providing subsidies for insurance coverage and health care marketplaces with competitive pricing for low income households.

By partially decoupling health insurance access from employment the ACA will foster opportunities for workers to diversify employment into work arrangements that have not typically provided health insurance, such as self-employment, independent contracting, and part-time hours (Blumberg, Corlette and Lucia, 2013). Health insurance is only one employer-sponsored benefit that is tax advantaged. Pensions and disability insurance will still make full time work an attractive option.

Fourth, households need to be at least 62 year old to receive annuities from Social Security and 59-½ to receive penalty-free annuities from DB pensions. Occasionally annuitants need to meet certain other requirements - such as not working for their previous employer - if they want to use annuity income from Social Security and DB pensions as an income diversification strategy in addition to employment-based income. The vast majority of households have access to Social Security as they get older, but communities of color, single women and more recent cohorts will be less likely than whites, single men and older cohorts to have access to DB pensions (Wolff, 2015).

III. Empirical Analysis

We now investigate the prevalence of household income diversification, and examine which households pursue this strategy and which avoid it. We also examine the method and circumstances of income diversification, and find that private savings and self-employment have played a declining role in income diversification. Public transfers and Social Security have gained in importance in creating diversified annual income streams for wage and salary earners – especially as labor income overall has become less stable. This implies a special role for policy in facilitating income diversification for wage and salary earners during a time of rising labor market risks.

Data

We use the Federal Reserve’s triennial Survey of Consumer Finances (SCF) as our data source. The SCF is the main nationally representative household survey on household wealth, detailing substantial information on all types and amounts of household assets and debt (Bricker et al. 2012) in addition to household income.

The SCF allows us to study household income diversification in greater detail than many other publicly available data sources. We define income diversification by a household’s reliance on more than one substantial source of income. A household has a substantial source of income by our definition if it receives \$5,000 or more from that source in any given year. Households can report income from several sources in the SCF, which we combine into six separate sources for easier presentation: 1) wage and salary income, 2) capital income (capital gains, dividend and interest income), 3) Social Security and other retirement annuities, 4) business and farm income, 5) public transfers (unemployment insurance and worker’s compensation, SSI, TANF and SNAP), 6) other income such as alimony payments and rental income from investment properties.

Our main two interests in this chapter are to understand the potential for income diversification for salary earners and to draw policy implications to improve the prospects for future income diversification. We note that extreme care must be used in drawing conclusions from a heterogeneous category of income such as government transfers. Normatively, receiving low-income transfers represents a shortcoming of the labor market to provide wages sufficient to maintaining an adequate standard of living and is not a measure of successful income diversification.

Capital income, Social Security and retirement annuities, business income and public transfers are more or less directly subject to policy interventions. This is not the case for other incomes, which include alimony payments, income from personal trusts, charitable donations, family gifts and rental income from investment properties¹⁰ – although tax policy plays an important role in many of these.

The SCF also includes detailed data on households’ economic situations, specifically on their sources and total amount of income, their income sources and their employment status. The SCF allows us to classify households as being dependently employed or self-employed, because it distinguishes between being formally employed, being self-employed by holding multiple jobs, or whether the self-employed have a significant financial interest in their business, i.e. they are entrepreneurs. And, the SCF includes a range of household demographic characteristics such as age, marital status, household size, education, ethnicity and race. Most SCF variables are available on a consistent basis dating back to 1989 and the most recent survey data is available for 2010.

¹⁰ Our treatment of rental income as other income requires additional explanation. Policy can encourage the purchase of investment properties, although this is the case only for particular circumstances, e.g. to encourage investment in low-income housing, in the United States. We hence treat rental income as non-policy relevant income source.

We focus on younger and older households in our analysis by splitting the sample at age 50, so that households headed by somebody younger than 50 years are included in the younger household group and everybody else is included in the older household group. We include retirees and non-retirees in in order to investigate how households diversify their income sources over the life-cycle, if at all. Many households self-identify as retired but continue receiving income from wage and salary employment and from self-employment. Including retiree households allows us to better understand the diversification strategies of older households. Our conclusions are generally not influenced by our sample definition.

Finally, we combine a number of years in our analysis to study income diversification over time. We combine years from 1989 to 1998 and denote them “early” years ; the years from 2001 to 2010 are denoted as “later” years. The recession of 2001 marked a break in labor market risks as longer term trends in long-term unemployment, wage uncertainty, and benefit cuts accelerated after the recession (Bivens and Weller, 2006). That is, labor market risks were higher in the later years than in the early years.

Income diversification and potential beneficial economic outcomes

Table 1 summarizes the link between income diversification and potentially beneficial economic outcomes for wage and salary earners. We consider specifically the link between income diversification and the probability of self-identifying as savers, median household wealth, the chance of a household self-identifying as having a planning horizon of five years or more and the probability of being an entrepreneur. These data are only suggestive of the possible benefits of income diversification since the causality between these economic outcomes and income diversification likely runs in both directions, e.g. income diversification makes it easier for households to be successful entrepreneurs and successful entrepreneurship increases households’ access to income diversification tools. That is, income diversification could result in a virtuous circle of household income stability and growth, but only if households can initially diversify their incomes. Public policy can help to provide households with some income diversification and such policy interventions could be efficient if they jump start a virtuous cycle.

Our summary data here highlight two economic channels by which households such virtuous cycle could emerge. First, income diversification may lead households to save more and better plan for the long-term, thus increasing household wealth that then could be used for future income diversification. Second, income diversification may improve households’ long term planning horizon, which is generally considered a key factor in helping households better manage their finances – save more, invest to avoid excessive risk taking and building successful small businesses.

*** INSERT TABLE 1 ABOUT HERE ***

Table 1 shows that income diversification correlates with a number of positive economic outcomes for households with substantial wage and salary earnings. Households with more diversified incomes tend to be more likely to self-identify as savers, have substantially more wealth, have longer planning horizons and are a lot more likely to be entrepreneurs than households with less diversified incomes. These results hold for younger and older households (Table 1). 60.7 percent of older households with two substantial income sources, for instance, self-identify as savers of, compared to only 55.1 percent for older households with only one or no substantial source of income. Older households with two substantial income sources also have almost seven times the median wealth -- \$696,5000 compared to \$107,200 – as older households with less income diversification. And, older households with two substantial income sources have a 52.9 percent chance of having a planning horizon of five years or longer as compared to a 47.2 percent chance for older households with less income diversification. Finally, older households with two substantial income sources have a probability of being an entrepreneur of 12.9 percent compared to only 7.0 percent for older households with less income diversification (Table 1). The summary data

indicate that income diversification may be associated with some peace of mind in the present as those with diversified incomes take a longer planning horizon and in the future as those households with diversified incomes are more likely to save, have more wealth and are more likely to build a successful business than those without diversified incomes.

Income diversification trends by age and year

Considering the potential benefits from income diversification, the next question then is whether we can see a growing trend towards more income diversification as the wage and salary employment has become more precarious in an age of increased financialization. The absence of a clear trend towards more income diversification could give rise to future policy interventions to make it easier for households to diversify their increasingly risky wage and salary incomes.

Table 2 summarizes the income diversification trends by year and by age for households with substantial wage and salary income. We separate households into two groups, those who are 50 years and older and those who are younger, and consider the number of substantial income sources that households on average had in any survey year from 1989 to 2010.

*** INSERT TABLE 2 ABOUT HERE ***

Table 2 illustrates two important facts. First, income diversification substantially increases with wealth and wealth typically increases with age. More than half of older households typically have two or more substantial sources of income, while the share of younger households with two or more substantial income sources generally is at or below 25 percent. Older households, in particular, are generally more than three times as likely as younger households to have three or more substantial income sources (Table 2).¹¹

Second, there is no clear trend towards more income diversification over time, even though labor market uncertainty has grown. The share of older households with more than one substantial income source has bounced between 49 percent and 55 percent from 1989 to 2010, while the comparable share of younger households fluctuated between 21 percent and 26 percent, but there was no clear upward trend towards increasing diversification (Table 2). The absence of a trend towards more income diversification among wage and salary earners may suggest that households encounter problems diversifying their incomes, even as wage and salary incomes have become less stable. This may give rise to policy interventions to stabilize household incomes through income diversification.

Combining the years from 1989 to 1998 and the years from 2001 to 2010 facilitates the presentation of summary statistics and it ensures that we have sufficient sample sizes in all of our subsequent calculations. The absence of a trend towards more income diversification further justifies combining these data years.

¹¹ We checked to make sure that this is not just a spurious correlation between age and wealth. Specifically, we calculated the chance of having two or three and more substantial income sources by age and wealth levels. We still find lower probabilities of having more than one substantial source of income for younger households than among older households, even after controlling for wealth levels. For instance, 39.1 percent of younger households with wealth in the top third of all wealth holders had two or more substantial sources of income in the later years from 2001 to 2010, compared to 52.2 percent of older households. The conclusion that a larger share of older households had more substantial sources of income than was the case for younger households holds for all wealth levels in both the early and the later time periods. Calculations are not shown here, but are available from the authors upon request.

Table 3 shows the income diversification by demographic characteristics, age and time period to highlight differences in income diversification across households. We specifically consider race, family status and educational attainment as key household characteristics. We combine the data into two income diversification categories – one substantial source of income and more than one – to preserve observations and to facilitate the presentation. Remember that we only include data for households with wage and salary income, so that households in the “one substantial source of income” all have substantial wage and salary incomes. We consequently report the share of households with substantial income in addition to wage and salary income in Table 3, broken down by race, family status and education in addition to age and time period.

*** INSERT TABLE 3 ABOUT HERE ***

Three broad factors stand out from the data in Table 3. First, older households again tend to have more income diversification than younger households. And second, we again see no trend towards more income diversification over time. Third, there are substantial differences in income diversification by age, mainly in expected ways. Whites, married couples and households with college education have more income diversification than communities of color, single men and single women and households with less education.¹² The bottom line, though, is that groups of households that generally experience greater labor market uncertainty and for who labor market risks have especially grown tend to have less income diversification than their counterparts. That is, policies to increase income diversification should ideally target population groups that generally face higher labor market risks than their counterparts.

Distribution of income sources for households with diversified incomes

Table 4 highlights the importance of particular income sources for households with diversified incomes beyond wages and salaries.¹³ We specifically report the shares of households with substantial income from capital income, business and self-employment income, Social Security and pension income, public transfer income and other income in addition to wage and salary income.

*** INSERT TABLE 4 ABOUT HERE ***

Our summary data in Table 4 show widespread use of at least three additional sources of substantial incomes for working households. More than one-fifth of young households and more than one-fourth of older households had substantial capital income (Table 4). Similarly, conditional on having employment income, more than one-third of young households and more than one-fourth of older households had substantial business and farm income. And finally, close to one-fifth of younger households reported substantial transfer incomes, while more than half of older households indicated substantial Social Security and pension income (Table 3). Households diversify beyond wage and salary incomes through a number of private and public sources. The use of private sources is comparable by age, but the use of public sources predictably varies with age with older households relying more heavily than younger households on Social Security and younger households relying more heavily than older ones on public transfer programs.

¹² We should note that single women have a higher likelihood than single men to have diversified incomes, which may be due to a greater chance of receiving public assistance from programs that lend particular support to single mothers such as TANF, as we discuss below.

¹³ We calculate that households with substantial wage and salary income are 2-3 times as likely to have diversified incomes as households without substantial wage and salary income, regardless of age and time period. Details available from the authors upon request.

Our data also show a few noteworthy and substantial changes from the early to the later years in Table 4. Capital income declines in importance over time for younger and older households, Social Security and pension incomes gain in importance for older households and public transfers gain in importance for younger households (Table 4). These changes are all connected to policy changes as we discuss in the next section.

We note that business and farm income fell slightly from the early to the later years. Starting a business is a comparatively easier way for households to diversify their incomes than relying, for instance, on savings withdrawals and public programs. Savings take time to build up and income from public sources requires households to meet specific eligibility thresholds. Households wanting and needing to diversify their incomes amid rising labor market uncertainty should have turned increasingly to self-employment. The stable to declining importance of self-employment income then suggests that generating substantial self-employment income has not become easier for households over time. Policy changes may make it easier for households to become self-employed and thus diversify their incomes.

IV. Drawing policy implications from the data

Table 4 shows three key changes in the receipt of substantial income beyond wages and salaries: falling capital income for younger and older households, rising Social Security income for older households and rising public transfer incomes for younger households. We discuss potential causes for these three changes to show that all of them are in part related to past policy changes. We also note that while diversifying income sources can be a way to stabilize income and consumption, some forms of diversification are unambiguously bad. Diversifying income by receiving SNAP (food stamps), TANF (welfare) or other means tested programs is an indication that the workers and firms cannot jointly provide adequate income for maintaining consumption. Other non means-tested programs such as unemployment insurance also indicate a failure in the labor market – either a short-term friction or a long term structural problem. Again, this form of income diversification should not be considered a “healthy” form of diversifying.

Other forms of diversification are more ambiguous. Realized capital income has become less relevant over time in part because of growing incentives to save in tax advantaged savings vehicles such as 401(k)s and IRAs. These accounts restrict access to capital income until money is actually withdrawn from these accounts, typically upon retirement. Thus, a policy-induced increase of savings incentives has limited the possibility for income diversification increasing the “lockbox” nature of retirement savings and providing an added hurdle to the temptation of utilizing retirement savings for some other purpose.

Table 5 summarizes data on withdrawals from IRA/Keogh retirement accounts relative to capital income. Households can usually withdraw funds from their IRA/Keoghs at age 59-½ years without penalty. We anticipate fewer withdrawals among younger households, and a nontrivial share of households withdrawing funds in the later period. The SCF contains information on such withdrawals only for the years from 2004 to 2010. Adding withdrawals to capital income shows only minor changes the share of younger households with expanded capital income compared to just capital income (see Table 4). But, expanding the definition of capital income to include withdrawals raises the share of older households with capital income by about three percentage points compared to the narrower definition (Table 5). This is nontrivial increase in income diversification among older households. Restricting access to savings, in this case by limiting pre-retirement withdrawals, reduces households’ use of capital income as income diversification tool.

*** INSERT TABLE 5 ABOUT HERE ***

Second, the growing reliance on Social Security and pensions among older wage and salary households is also not surprising. The gradual elimination of earnings limits for full retirees and the increases in earnings limits for early retirees have made it easier for older households to receive Social Security benefits in addition to wage and salary earnings. That is, older households have been able to diversify their incomes as a direct result of a policy change.

Third, the growth of public transfers income – UI, TANF, SSI and SNAP – among younger households requires some additional explanation. The share of wage and salary households with substantial public transfers has grown particularly fast for younger single men from 12.3 percent in the early years to 26.4 percent in the later years – an increase of 14.1 percentage points.¹⁴ The comparable share for married couples has grown by 4.6 percentage points from 16.2 percent to 20.8 and by 8.3 percentage points for younger single women from 14.8 percent to 23.1 percent.

Table 6 shows that the growth of public transfers among younger single men is highly correlated with unemployment insurance receipt. The SCF reports annual incomes, i.e. single men could have substantial earnings during part of the year and receive substantial UI benefits during the rest of the years. The calculations show that more than sixty percent of younger households, who had substantial wage and salary income and substantial transfer income, also had substantial unemployment insurance benefits in the early years. This share jumped to 85.8 percent in the later years (Table 6). At the same time, the respective shares for married couples and single women declined. That is, the increase in public transfer income among younger men likely reflects growing labor market uncertainty especially for this population.

This is not surprising. Men have suffered from more long-term unemployment than women in the aftermath of the two most recent recessions. And, men often do not qualify for other cash transfer programs such as Supplemental Social Insurance (SSI) and Transitional Assistance for Needy Families (TANF).

One conclusion then is that unemployment insurance offered households access to income diversification, when they needed it most, e.g. when the probability of becoming unemployed and the chance of being out of work for long periods of time increased.

Fourth, the small decline in business and farm income partly reflects the growth of single households. The share of married wage and salary households with substantial business income was much larger than among single households. And, among older households, for instance, the respective share remained relatively stable over time with 31.8 percent in the early years and 31.6 percent in the later years, although this share decreased from 43.7 percent to 40.9 percent for younger households.¹⁵ Put differently, there appear to be severe obstacles for single households to splitting their time between wage and salary employment and self-employment.

These obstacles such as the tight linkages between full-time employment and benefit receipt could become fruitful policy targets by making it easier for households to access key benefits when they are working less than full-time for a single employer.

V. Parameters of possible policy reforms

Our discussion shows the need for, the possible benefits of, and the reality of income diversification. We conclude that private savings have played a declining role and self-employment has not increased, while

¹⁴ Authors' calculations.

¹⁵ Authors' calculations.

public transfers and Social Security have gained in importance in creating diversified annual income streams for wage and salary earners as wage and salary income has become less stable. All of the changes in the relative importance of specific income streams for wage and salary earners can be traced to specific policy changes or lack thereof, as we discussed in the preceding section. We now present a few basic parameters for future policy development to either strengthen or reverse existing trends, so that wage and salary earners can better diversify their household incomes in an era of growing uncertainty.

Private savings

We note two important goals with respect to private savings: 1) a need for broad-based savings for lower and middle-income households, and 2) a need to gain easier access to savings for households that have some.

Policy experts have long proposed a number of measures to increase household savings. These measures include automatic enrollment of participants into employer-sponsored retirement plans, automatic payroll deductions into Individual Retirement Accounts, promoting low-cost, low-risk savings vehicles and streamlining and more efficiently targeting federal savings incentives (Weller and Ungar, 2014).

Similarly, public policy already facilitates reverse mortgages and such efforts could be expanded. Making it easier for households to access their savings when they need them, e.g. by streamlining savings incentives could help households diversify their incomes with capital income.

Self-employment

A critical obstacle to self-employment as an income diversification strategy is that many households work full-time in order to secure crucial benefits such as health insurance, long-term disability and employer-sponsored retirement savings. Public policy can make it easier for people to access these benefits in an affordable way, even if people do not work full-time for an employer. The Affordable Care Act of 2009 is one policy example whereby policy efforts have made it possible to decouple benefit receipt from full-time employment (Blumberg, Corlette and Lucia, 2013). Employees who no longer receive health insurance benefits from their employers because they no longer work full-time for their employer can now purchase health insurance at terms similar to employer-sponsored insurance plans. Policymakers could theoretically model other publicly sponsored risk pools to make it easier for households to access affordable and critical benefits without working full-time for an employer.

It is possible, however, that faced with increasing quasi-fixed costs of employment more employers may opt for creating part-time jobs (rather than full-time). The ACA has put in place a relatively low standard for full time work (30 hours) and counts employees on a full-time equivalent basis – that is, two 15-hour per week employees constitute a full-time worker. It is unlikely that the firms have much of an incentive due to the ACA to create part-time work. It may be that workers are accepting part-time jobs and utilizing the health care exchanges from the ACA to purchase group coverage. Current research is mixed on why part-time employment has increased in this recovery, but it seems clear that the ACA will be a boon for those who opt for self-employment.

Public transfer payments

Public transfer payments, especially unemployment insurance, have gained in importance as employment relations have become more precarious. But, many workers in vulnerable employment arrangements, e.g. involuntary part-time workers, low-wage workers and workers with frequent bouts of unemployment, do not necessarily qualify for unemployment insurance benefits. States differences in UI application rates vary dramatically, and there is little systematic research investigating this phenomenon. Policies that

facilitated application, provided valuable job-search assistance, along with wage subsidies for workers who accept new jobs with significantly lower wages would reduce the labor market volatility experienced by some workers.

Social Security

Past policy changes have made it easier for older workers to receive benefits, while still earning a paycheck. Public policy can build on these efforts. It is possible, for example, to also make it easier for younger workers to access Social Security benefits, at least temporarily, e.g. when a caregiving situation arises (Glynn and Farrell, 2013). And, Social Security modernization could improve benefits for vulnerable populations (Weller, 2010b).

VI. Conclusion

Income diversification as conceptualized in this chapter provides an important mechanism for households to maintain income and consumption during periods of economic hardship. Our conceptualization of income diversity differs from commonly accepted notions of diversification such as those employed in portfolio management. Diversification here implies income from any and all sources, including those that are contingent - such as transfer programs and social insurance. While it seems clear that having these forms of income available to workers is beneficial, it is also the case that utilizing them is indicative labor markets gone awry. We analyze data from the Survey of Consumer Finance to show where public policy could intervene to improve income diversification for struggling workers. In theory there is room for policymakers to build mechanisms that could make it easier for households to gain access to multiple substantial forms of income.

The data show that policy could make an important difference in helping households diversify their incomes. Public income sources already often serve as tools for income diversification either because people want to use them to stabilize their incomes or because they have to increasingly rely on public assistance in more volatile labor markets. Whether by choice or out of necessity, public transfer programs play a growing role in income diversification. One policy goal then is to give households more access to public transfer programs during periods of economic hardship, as long as well-known moral hazard problems with expanded social insurance access are addressed.

Moreover, the data show that policy has made it more difficult, or at least failed to facilitate, the use of private income diversification strategies, e.g. by restricting access to household savings. Calls for increased private savings are ubiquitous, while effective public policies have been few and far between. The U.S. continues to have historically, and internationally, low personal saving rates. And, retirement savings policy has effectively "bottled up" a considerable portion of the upper-middle-classes' assets, making them difficult and costly to access. In our analysis we fully anticipated that entrepreneurs and the self-employed would play an important role in income diversification. It is the case that entrepreneurship and self-employment are important sources of income diversification, but they have not increased during the ensuing periods increasing in income insecurity. The second policy goal then would be to make it easier for household to save and use their savings for income diversification when households so desire.

Improving opportunities for households to diversify their incomes could create a virtuous cycle of income stability over time. Much of our analysis investigates the relationship between income diversification and household wealth; however, it is unclear which way the causal arrow points. It seems intuitive that older, wealthier households would have income from a broad range of sources. Less clear is the effect of having multiple sources of income leading to wealthier households, though we should not undersell this causal direction. Having the resources to maintain consumption, pay bills, and avoid credit card default, and continue paying the mortgage may lead to higher overall wealth. So too will the managerial skills necessary for financial management that come from entrepreneurial activity. It seems likely that having a

diverse income portfolio may lead to increases in wealth. Put more positively, income diversification could create a virtuous cycle, so that more diversified incomes result in more income stability and wealth over time and more income stability and wealth result in more income diversification.

Diversifying risk, especially in a world of growing risks, through appropriate private sector and public policy tools is one of modern finance's most important contributions to economic well-being. Applying the lessons of diversification to a household's income can be an important tool in developing a more stable and healthier middle class amid rising labor market risks.

The mechanisms necessary for increasing income diversification are difficult but not impossible to build. Public policy can make important differences on the margins, often having the largest impacts on households who need assistance the most. Much work has already been done to show both the need and the potential for policy to more economic security over time with greater income diversification.

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Tables

Table 1: Correlation between income diversification and economic outcomes for wage and salary earners

	Wage and salary earners		
	Only one substantial income source	Two substantial income sources	More than two substantial income sources
<i>Households younger than 50 years old</i>			
Probability of self-identifying as saver	47.8%	48.2%	61.0%
Median wealth	\$ 18,620	\$ 58,500	\$ 260,300
Probability of self-identifying as having a planning horizon of 5 years or more	37.8%	43.0%	52.6%
Probability of being an entrepreneur	5.1%	19.0%	34.8%
<i>Households 50 years old and older</i>			
Probability of self-identifying as saver	55.1%	53.5%	60.7%
Median wealth	\$ 106,200	\$ 162,780	\$ 696,650
Probability of self-identifying as having a planning horizon of 5 years or more	47.2%	45.1%	52.9%
Probability of being an entrepreneur	7.0%	12.9%	32.9%

Notes: Authors' calculations based on Board of Governors, Federal Reserve System. Various years. Survey of Consumer Finances. Washington, DC: BOG. Inflation-adjustments are based on the Bureau of Labor Statistics. (2012). Consumer Price Index for Urban Consumers, Research Series (CPI-U-RS). Washington, DC: BLS. All dollars are in 2010 dollars. Income can come from five different sources: wages, Social Security and other retirement income, capital income, business and farm income, and transfer payments and other income. We define substantial income as income greater than \$5,000 (in 2010 dollars) from any of these five sources. Savers are those who indicate the save irregular or regular amounts. Entrepreneurs are households, who own and manage their own business and the business is worth at least \$5,000 (in 2010 dollars). Sample includes all households with substantial wage and salary income.

Table 2: Income Diversification Trends by Year and Age

Year	Households younger than 50 years			Households 50 years old and older		
	Not more than one substantial income source	Two substantial income sources	Three or more substantial income sources	Not more than one substantial income source	Two substantial income sources	Three or more substantial income sources
1989	74.0%	19.2%	6.8%	46.0%	34.4%	19.6%
1992	77.9%	16.0%	6.1%	48.3%	34.4%	17.3%
1995	78.3%	17.9%	3.8%	48.0%	34.1%	17.9%
1998	78.0%	16.9%	5.2%	53.5%	32.7%	13.8%
2001	79.3%	16.1%	4.5%	49.9%	33.6%	16.5%
2004	78.2%	17.0%	4.8%	49.1%	36.6%	14.3%
2007	75.6%	18.2%	6.2%	50.6%	33.7%	15.7%
2010	74.2%	19.7%	6.1%	45.5%	37.3%	17.2%

Notes: Authors' calculations based on Board of Governors, Federal Reserve System. Various years. Survey of Consumer Finances. Washington, DC: BOG. Inflation-adjustments are based on the Bureau of Labor Statistics. (2012). Consumer Price Index for Urban Consumers, Research Series (CPI-U-RS). Washington, DC: BLS. All dollars are in 2010 dollars. Income can come from five different sources: wages, Social Security and other retirement income, capital gains and interest and dividend income, business and farm income, and transfer payments and other income. We define substantial income as income greater than \$5,000 (in 2010 dollars) from any of these five sources. The trends do not change if we put the threshold for substantial income at \$3,000 (in 2010 dollars). Shares calculated for respective populations of households, broken down by age. Sample includes only households with substantial wage and salary income.

Table 3: Income diversification† by household demographics, age and time period

	Households younger than 50 years		Households 50 years old and older	
	Early years (1989-1998)	Later years (2001-2010)	Early years (1989-1998)	Later years (2001-2010)
White	24.7%	25.1%	54.3%	54.9%
African-Americans	18.9%	20.3%	35.6%	36.0%
Hispanics	13.0%	16.2%	31.8%	38.6%
Other	20.4%	22.6%	43.5%	42.4%
Married couples	24.4%	24.8%	53.8%	55.8%
Single men	16.6%	16.4%	48.6%	42.0%
Single women	22.6%	22.5%	41.7%	41.0%
Less than h.s./GED	18.5%	16.7%	48.7%	47.0%
High school/GED	19.1%	21.6%	44.7%	48.9%
Some college	23.7%	20.9%	51.5%	47.0%
At least college	26.9%	27.1%	57.6%	55.9%

†Diversification indicates income in at least one category outside wage and salary income.

Notes: Authors' calculations based on Board of Governors, Federal Reserve System. Various years. Survey of Consumer Finances. Washington, DC: BOG. Inflation-adjustments are based on the Bureau of Labor Statistics. (2012). Consumer Price Index for Urban Consumers, Research Series (CPI-U-RS). Washington, DC: BLS. All dollars are in 2010 dollars. Income can come from five different sources: wages, Social Security and other retirement income, capital gains and interest and dividend income, business and farm income, and transfer payments and other income. We define substantial income as income greater than \$5,000 (in 2010 dollars) from any of these five sources. The trends do not change if we put the threshold for substantial income at \$3,000 (in 2010 dollars). Shares calculated for respective populations of households, broken down by age. Sample includes only households with substantial wage and salary income.

Table 4: Substantial income sources for households with diversified income and substantial wage and salary income, by age and time period

	Households younger than 50 years		Households 50 years old and older	
	Early years (1989-1998)	Later years (2001-2010)	Early years (1989-1998)	Later years (2001-2010)
Capital income	28.3%	21.2%	36.7%	27.2%
Business income	38.1%	35.7%	28.8%	28.2%
Social Security and pension income	14.1%	13.2%	55.3%	60.2%
Public transfer income	15.5%	21.8%	5.2%	8.1%
Other income	32.4%	35.5%	20.7%	20.9%

Notes: Authors' calculations based on Board of Governors, Federal Reserve System. Various years. Survey of Consumer Finances. Washington, DC: BOG. Inflation-adjustments are based on the Bureau of Labor Statistics. (2012). Consumer Price Index for Urban Consumers, Research Series (CPI-U-RS). Washington, DC: BLS. All dollars are in 2010 dollars. Income can come from five different sources: wages, Social Security and other retirement income, capital gains and interest and dividend income, business and farm income, and transfer payments and other income. We define substantial income as income greater than \$5,000 (in 2010 dollars) from any of these five sources. The trends do not change if we put the threshold for substantial income at \$3,000 (in 2010 dollars). Shares calculated for respective populations of households, broken down by age. The numbers add up to more than 100 percent since households can report more than one additional source of substantial income in addition to substantial wage and salary income.

Table 5: The effect of IRA withdrawals on substantial income

	Households younger than 50 years			Households 50 years old and older		
	With substantial capital income	With substantial capital income and IRA withdrawals	Difference	With substantial capital income	With substantial capital income and IRA withdrawals	Difference
2004	17.9%	18.3%	0.4%	26.5%	28.7%	2.3%
2007	21.6%	22.2%	0.7%	27.4%	31.8%	4.4%
2010	12.3%	13.0%	0.7%	21.1%	23.7%	2.6%

Notes: Authors' calculations based on Board of Governors, Federal Reserve System. Various years. Survey of Consumer Finances. Washington, DC: BOG. Inflation-adjustments are based on the Bureau of Labor Statistics. (2012). Consumer Price Index for Urban Consumers, Research Series (CPI-U-RS). Washington, DC: BLS. All dollars are in 2010 dollars. We define substantial income as income greater than \$5,000 (in 2010 dollars) from any of these five sources. Shares calculated for respective populations of households, broken down by age. Capital income refers to capital gains and dividend and interest income and IRA withdrawals refer to withdrawals from Individual Retirement Accounts and Keogh plans.

Table 6: Share of households with substantial unemployment insurance benefits among households who had substantial wage and salary income and substantial public transfer income, by period, age and family status

	Households younger than 50 years		Households 50 years old and older	
	Early years (1989-1998)	Later years (2001-2010)	Early years (1989-1998)	Later years (2001-2010)
Married couples	71.2%	62.1%	82.9%	81.0%
Single men	63.5%	85.8%	61.0%	88.0%
Single women	39.6%	33.3%	39.8%	59.0%

Notes: Authors' calculations based on Board of Governors, Federal Reserve System. Various years. Survey of Consumer Finances. Washington, DC: BOG. Inflation-adjustments are based on the Bureau of Labor Statistics. (2012). Consumer Price Index for Urban Consumers, Research Series (CPI-U-RS). Washington, DC: BLS. All dollars are in 2010 dollars. We define substantial income as income greater than \$5,000 (in 2010 dollars) from any of these five sources. Shares calculated for respective populations of households, broken down by age, period and family status.