MARKLE

Rebalancing Investment in Business and Consumer Debt

By Louis Hyman, Cornell University | January 2014

This paper was prepared for the Markle Economic Future Initiative.

Personal debt has always existed in the American economy, but it hasn't always been a way to make profits. The business of America was in making things, not in financing consumption. Lending, especially at the retail level, was small-scale and unprofitable. Stores lent money to their customers as a way to grow their business, profiting on the merchandizing but not on the loans. Manufacturers did not concern themselves with lending to customers because there was so much profit to be had in making things. Today, however, securitization has made consumer debt an easy, safe, and profitable alternative—for both corporations and banks--to investing in businesses. As consumer debt has become a profitable site of investment, it has displaced investment in real economic growth.

In our economics courses we worry about government lending crowding out business lending. The reality is that we should be concerned about consumer lending crowding out business lending. Banks and other financial institutions are making decisions that shift capital away from business investment into personal debt. Personal debt may drive short-term demand, but it cannot result in long-term growth. Every dollar invested in a credit card securitization is a dollar that is not invested in a new factory.

For borrowers, this capital shift is dangerous because whereas in the postwar United States, the 99% got paid rising wages, now they are just lent rising debt. For business owners, financial institutions' preference to lend to consumers makes it harder for them to grow or to start their firms, constraining American entrepreneurialism. Investors in the global 1% happily poured capital into American consumer debt because it was seen as safe and having a good yield. The virtuous postwar cycle of rising wages and economic growth has become a self-reinforcing cycle of inequality.

Some technologies have abetted this shift, like office software and manufacturing robots that have replaced office and manufacturing workers. Maturing industries replaced workers with machines, as has been the case since the industrial revolution, but unlike in earlier eras no new industries have been created. Our "newest things" like the Internet and the transistor are still based on postwar inventions and postwar science. The shift in capital away from businesses to consumers has not only put Americans in greater debt than ever before, it has also made technological progress more timid and incremental. This resulting shift in capital investment is dangerous not only to the particular borrowers and lenders involved, but to the future of the entire American economy as a whole.

Current Status of Personal Debt in the United States

Since the Great Recession, the ultimate source of funds for consumer borrowing has continued to be capital markets, but the originators of those bonds have shifted from investment banks to the federal government. While the official statistics kept by the Federal Reserve show a drop in securitization, even the Fed acknowledges that "the shift of consumer credit from pools of securitized assets to other categories is largely due to financial institutions' implementation of the FAS 166/167 accounting rules."[1] These numbers reveal more about accounting magic than economic science. These accounting changes, like the legal reforms surrounding the financial crisis, are superficial. Borrowing has rebounded, though it is more focused on secured loans—like houses and cars—than on credit cards. The difference now is that the government is at the center of the securitization rather than private banks, which are now sitting on piles of unlent cash.

The interconnected, underlying causes of the Great Recession—wage inequality, technological stagnation, and securitization of consumer debt—remain unchanged. As a nation, we have focused on a narrow set of tricksters and frauds, pretending that the underlying system works, and ignored the deeper structures of finance. Ideally we should be thinking about how to tip the balance of investment away from consumer debt back into business debt. To accomplish that goal we need to 1) fund basic scientific research so as to discover new industries in which to invest large amounts of capital to produce large numbers of jobs, and 2) create a mechanism to invest capital in small- and medium-sized businesses.

While we debated the wealthy 1%, we ignored the meager 1%, that is the roughly 1% of the federal budget in the United States that goes for non-military scientific research. The exact numbers vary by who is doing the calculation, but that extremely small amount of the discretionary budget accounts for all National Science Foundation and National Institutes of Health funding, which in turn support all basic scientific research. Basic science—the kind that make possible disruptive new technologies in which to invest—is necessary for long-run economic growth. We live in an age of apparent technological change but the underlying technologies are not new. Today there is no new industry based on a disruptive technology that employs as many people or invests as much capital as the postwar industries like electronics and aerospace. Computer technology has succeeded in eliminating jobs, but without new research, no new fields have opened up to employ the displaced workers.

Basic science research has historically come from either university labs or corporate labs. The university labs have seen their budgets cut drastically over the past two decades, and the kinds of projects that receive approval today are more incrementalist than radical. Corporate labs, in contrast, can only flourish when firms focus on the long-term and enjoy monopolistic profits. AT&T and Xerox created all the foundational technologies that we enjoy today. While postwar R&D was widespread among big companies, few of today's firms, Google being the most prominent exception, pursue basic research. More common are the short-run research practices of firms like Microsoft, which squandered its billions on useless updates to operating systems and office software. Even Google, however, is limited by its research agenda to the kinds of computer-driven innovations like autonomous cars that, while holding great promise, are also limited. We need basic research in areas like chemistry and physics to have the big scientific breakthroughs like electricity or nuclear power. Simply doubling the federal budget for scientific research would produce disproportionately huge results. Our current world of growing debt and stagnating wages are deeply connected to this question of scientific funding, because it is the

[1] See the Federal Reserve's G.19 Consumer Credit data at http://www.federalreserve.gov/releases/g19/Current/#table3

lack of capital- and labor-intensive new industries that is making consumer debt so appealing relative to business loans for commercial banks.

At the same time, we must not neglect the importance of small- and medium-sized businesses in the economy. One of the main roadblocks to small business growth is a lack of capital. It is easier for banks to lend to consumers than to businesses, so securitization and secondary markets in consumer debt have successfully channeled capital away from business to consumers. Setting up a mechanism for the easy securitization of small business loans, on the same scale as home mortgages, would be a godsend for the economy. Sexy tech firms have venture capital, but a solid plumbing supply company, or even a growing cheesemonger, does not have access to the same kinds of capital.[2] Moreover, the kinds of firms that have access to venture capital do not actually employ that many Americans, even as they produce great investment returns. We cannot rely on niche high-tech firms to employ Americans. More than six times as many people work at Sears as work at Google. Google, while fabulous for providing free services and innovative products, does not produce normal jobs for average Americans. Only by growing the capital access of small business can we produce the necessary jobs to maintain the American way of life.

Like houses, each business is different of course. To securitize these loans would require simplifying how banks made business loans. Instead of the deep analysis currently conducted, we would need to set up a few criteria. During the Great Depression, the FHA did this for houses by creating national FHA standards. These standards for houses allowed mortgages to be treated like interchangeable commodities. If such a scheme could work for houses, it can work for businesses, since we already have, in accounting, a common language to describe firms. These loans, initially, would need to be for steady firms, just like the FHA mortgages were for the middle-class salaryman. Start-ups need not apply, but small- and mid-size companies with good histories could apply for loans and expand their businesses.

Creating channels of business loan securitization, like those for consumer assets, would not increase economic volatility but instead reduce it. Fears of securitization should be understood as fears of consumer asset securitization. Expanding the opportunities for capital investment in business would drain away capital from investment in consumer assets, making it harder for marginal consumers to borrow. Instead, the easier access to business loans would, at the same time, expand hiring and give those marginal consumers access to better wages, which is what, in the end, they really need.

Borrowers

The basic truth of lending today is that creditors expect some percentage of their borrowers to default, and they simply set their interest rates high enough to cover it. For creditors this decision is good business, but for borrowers, at least for that defaulting percentage of borrowers, the debt ruins their lives.

The balance of power between creditors and debtors in the United States is unique in the world. We have, on the one hand, the most liberal bankruptcy laws in the world, and on the other, the

[2] See Louis Hyman, “Securitizing Cheese: How the Surge in Consumer Lending has Squeezed Small Businesses Dry,” The Atlantic/National Journal special issue The Next Economy, October, 2011.

most aggressive debt-peddlers in the world. As Elizabeth Warren showed in her legal sociology work in the 1980s and 90s, Americans attempt to repay their debts even when they know that they will never be able to complete their payments.[3] The debt relation, from the borrowers' point of view, is frequently a moral rather than a business relationship. For lenders, though the moralistic language is used to enforce repayment, the lending decision is based on expected profits. Borrowers tend to think that if someone will lend them money, that lender believes that they can repay the debt. In reality, lenders expect some percentage of borrowers to default. This expectation of default has not always been a part of American consumer lending culture. In the postwar, credit managers bragged about their low default rates. What makes the profitability amidst default possible today is individualized interest rates pegged to statistically-based risk profiles.

Instead of clumsily restricting lending, we should instead have a policy that limits the expected default percentage to a lower number. Of course, those risk models proved overly optimistic during the subprime crisis.[4] Some restriction is better than no restriction.

A better solution, however, would be to encourage a rebalancing of investment demand from consumer debt to business debt. Carrots are always preferable policy solutions to sticks. The willingness of lenders to take on these risks is made possible by the structured finance that underpins consumer lending. Creating a parallel set of instruments for business lending would drain off demand. If lenders want to take on greater risk in business lending, the consequences would be less than ruining consumers' lives. Bankruptcy for a firm is not the same as for a family.

Final Thoughts

If we do not rebalance the ease of investing between business and consumer debt, then we will continue to have the same underlying economic problems going forward. We need to restore the virtuous cycle of capitalist investment by which savings produce real investment which leads to real growth. The compact that underlies capitalism is that inequality produces savings which in turn produce jobs. Today that compact is broken. Finance needs to serve the real economy but the relative success of finance is as much the failure of industry as the innovation of Wall Street.

There is no single magic bullet to righting the economy, but making it easier to invest in business growth that produces jobs seems to be an important part of returning to the postwar prosperity. Our policies need to enable the growth of both start-ups as well as existing small- and mid-sized firms. We also need to push for more scientific progress to create new leading sectors worthy of investment. To accomplish this goal we need to:

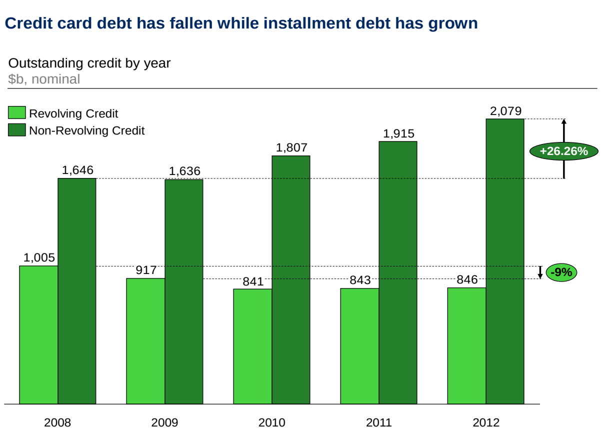
- Rebalance the ease of investing in business debt relative to consumer debt: Whether through a quasi-public corporation or through government laws, we need to set up a system of standards so that loans to small- and medium-size businesses (not start-ups) can be easily securitized and resold on a secondary market. The SBA would seem to be the natural agency to accomplish this goal. In my book Borrow, I lay out an extensive

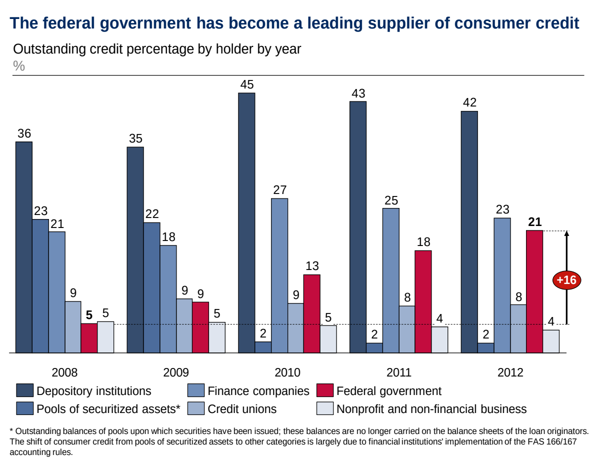
[3] Warren, Elizabeth et al, *The Fragile Middle Class: Americans in Debt*. New Haven: Yale University Press, 2000; *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America*. New York: Oxford University Press, 1989.

[4] Indeed the underlying data used to estimate the models of the 2000s relied on only a few years, and it turns out that the estimators vary widely from year to year. See for instance An, Xudong, Yongheng Deng, Eric Rosenblatt, and Vincent W. Yao. "Model stability and the subprime mortgage crisis." *The Journal of Real Estate Finance and Economics* 45, no. 3 (2012): 545-568.

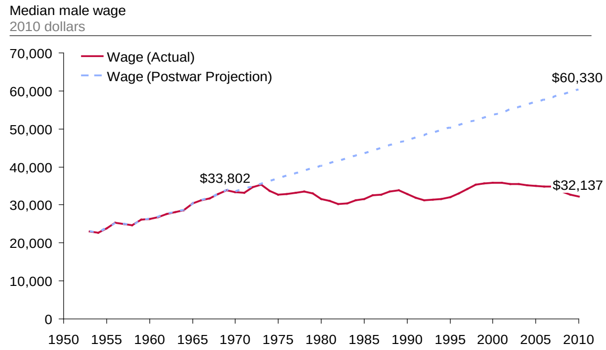
plan for an independent agency, akin to the FHA, that would do this that I called Bobby Mac.

- Spur investment in basic scientific research: We need to fund more science, both through government grants and through tax breaks for corporate R&D. While there will continue to be a brain drain from science to finance because of higher salaries, we can offset much of this loss by providing young researchers with easier access to grant money.
- Ease start-up investment: We should reduce capital gains taxes on start-up investment to further increase investment in new, risky enterprises.
- Limit lending risk: Expected default risk should be limited by law, not markets. Consumers are too prone to thinking that if they can borrow then they will be able to repay their debts. No amount of consumer education has changed this belief, though attempts have been made for the last century.
- Reform credit rating agencies: The credit rating agencies responsible for overseeing the safety of the capital markets are still private and unreformed. We have historically trusted in firm competition to maintain the honesty of these firms, but the competition of bond-rating agencies promoted bad information. Instead of investors paying for the ratings, bond issuers paid for the ratings. This perverse system incentivized bond rating companies to please their customers—the bond issuers. We could create a law prohibiting bond-rating agencies from accepting money from bond issuers, but probably we need to create either a public company that doesn't have to worry about profits, or even a regulated monopoly. In some areas of the economy, we cannot rely on market competition to produce good outcomes. The core of capitalism, like energy and finance, needs to be stable not innovative. The essential trust of these core areas of the economy make possible the innovation in the rest of the economy—which is what really matters in the end.

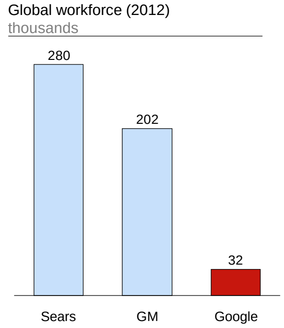




If wages had continued to grow, the median wage would have doubled, reducing the demand for consumer borrowing



Our fastest growing sectors require very little in capital (relative to their profits) and most importantly do not create good jobs for regular people



Internet and finance create an unequal economy