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When Easy Credit Replaces Wage Increases, Prosperity is Fragile and America's Middle Class Suffers

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The American middle class has been in trouble for decades, but this was not obvious until the recession of 2008 because consumer purchases held up. How was that possible? The simple answer is that financiers devised ways to loan money that severed the link between profits and middle-class wellbeing. Reckless trading in mortgage-backed securities and other asset-backed instruments allowed the issuers of credit to make record profits, regardless of whether consumers could pay off their debts. When millions became unable to pay back loosely regulated loans, the United States plunged into financial crisis. To put recovery on sound footing, policymakers must boost middle-class incomes and block the reemergence of reckless credit practices.

An Earlier Virtuous Cycle of Consumption and Earnings

Prior to the deregulation of banks and consumer credit in the 1980s and 1990s, creditors were obligated to evaluate the credit-worthiness of borrowers, creating a tight link between borrowers' income and the profits creditors reaped from making loans.

- For consumers, borrowing money meant you had to prove you could pay it back. Jobs, earnings, and educations had to be verified, and lenders "sized up" would-be borrowers in face-to-face interviews. Creditors' reputations depended on making well-grounded loans.
- Profits for U.S. companies depended on consumer spending tied to middle-class earnings, and borrowing rested on solid earnings prospects. All roads to profits and prosperity ran through the paychecks of millions of Americans.
- Economic recessions occurred if credit became too tight or wages did not keep pace with rising economic productivity. Consumer spending went down and profits suffered.

During the era of the virtuous cycle, profits, productivity, and earnings rose together. To keep the cycle functioning, U.S. government policies until the early 1980s curbed financial excesses by banks, investors, and lenders. Government also aimed to stimulate aggregate demand among the middle class and the poor, because their spending power fuelled the entire economy.

Severing Consumption from Middle Class Earnings

Starting with the Reagan administration in the 1980s, U.S. government policy switched from promoting middle-class earnings and purchasing power toward inflating the fortunes of the rich.

- Financial markets were deregulated, and lines between consumer lenders and investment firms blurred. Deregulation encouraged consolidations creating huge banks and financial firms, and lending became much looser as interest rate caps disappeared and reserve rules and fiduciary requirements were gutted.
- U.S. taxes were also changed to levy much lower rates on investment income than on wages and salaries. Many companies and individuals benefitted from both financial deregulation and the tax changes. Financial lobbyists gained enormous leverage in Washington DC and dictated further changes to enrich their clients.
- Organized markets for consumer debt were created that turned bundles of credit card debt, auto loans, and mortgage loans into tradable investment instruments. Because U.S. lenders could offload the

liabilities of their loans and credit card offers onto the global investment market, they had reduced incentives to evaluate the credit-worthiness of borrowers.

These changes unleashed a tortuous cycle. The unprecedented expansion of consumer credit coincided with the stagnation of middle-class earnings from jobs. Seemingly overnight hard-pressed consumers could lease cars rather than buy them, secure mortgages for no money down, and receive credit card offers for thousands of dollars' worth of credit through the mail without filling out an application.

It is tempting to suppose that relaxed credit rules and stagnant earnings became connected by more than mere chance. Before the 1980s, steadily rising earnings for the middle class were widely understood as a "public good," the basis for rising profits and prosperity for all. But just when corporate chieftains and investors started taking more of the gains from increased economic productivity, deregulated credit and financial markets allowed mass consumption to continue for a time. Employers and government were off the hook for providing steady jobs with rising wages. Why pay workers good wages when you can make additional profits by giving them loans instead? For investors and their political friends, what's not to like?

After the Recession, Can the Virtuous Cycle be Reestablished?

The 2008 recession was partly the result of the collapse of confidence in markets for consumer debt – and the aftermath gives Americans a chance to correct the perverse policies and incentives that paved the way for the collapse. Corporate profits are at an all-time high, while wages and salaries are at an all-time low. Many in the financial establishment want to turn the credit spigot back on. But there is a better way that involves taking new steps to link consumption and lending to the earnings of masses of actual workers

- Re-regulate the financial sector so that creditors have to hold onto a fixed percentage of the loans they make until they mature, creating an incentive for cautious lending.

- Legislate tax incentives for the creation of steady jobs with decent wages.

- Tie capital gains tax rates to middle-class earnings. If earnings rise for typical workers, capital gains taxes go down; but if earnings fall or stagnate, capital gains taxes would rise.

Here in America we're fond of saying that we respond to financial incentives. It's time to give corporations and investors new incentives to create improved middle-class jobs and earnings.

Read more in Kevin T. Leicht and Scott T. Fitzgerald, *Post-Industrial Peasants: The Illusion of Middle Class Prosperity* (Worth Publishers, 2008).