Financial Reforms Alone Cannot Reduce Household Debts for Americans Facing Low Wages and Insecure Jobs

Sara M. Bernardo, University of Massachusetts Boston

From 1980 until the start of the financial crisis of 2007 and 2008, U.S. households accumulated debt at an unprecedented pace. Back in the 1960s and 1970s, the ratio of total debt to disposable income – a measure that reveals households' ability to service their debts out of current income – hovered around 70 percent. Thereafter it rose, increasing to 90 percent by 1995 and peaking at 135 percent in 2007, before declining to 110 percent in 2013.

The financial meltdown brought new attention to the debt loads facing American households, in part because many analysts fingered defaults on subprime mortgages as a chief cause of the crisis. But policy responses have focused too narrowly on financial market reforms. Certainly it makes sense to curb the unfair and fraudulent lending practices that have proliferated over the past few decades, yet new financial regulation alone won't make most working families more economically secure. For that, we must understand and address the intertwined social, political and economic trends that have created insecure labor markets and heightened debt risks.

The Debt Problem and Pervasive Economic Insecurity

Since the 1970s, financial products and incentives have become increasingly central to the U.S. economy as a whole. As part of this process, household debt growth has grown in response to both supply and demand dynamics:

- *On the supply side*, looser regulations encouraged banks to make profits from interest and fees collected from individual households. Investment funds flooded into banking to profit from new credit market instruments that were bundled and resold on financial markets.

- *On the demand side*, spreading job insecurity left more and more families needing to borrow to maintain living standards and pay for education, health care, and housing. After World War II, a substantially unionized working class won wage increases and middle-class living standards until the mid-1970s. But after that, firms weakened by a combination of international competition, slow economic growth and high inflation turned to strategies designed to reduce labor costs. Firms pushed for policies to weaken unions and labor market regulations. Real wages and incomes stagnated, income inequality rose, and masses of working Americans faced increasing unemployment, underemployment and job insecurity. At the same time, working families had to pay more and more for many standard goods and services, such as education, health care, housing and transportation. Inflation-adjusted prices of these goods grew faster than the real wages of the majority of U.S. workers, and the public sector stop subsidizing these essential services as generously as in the past.

Most American households get by on employment income, so the downward pressure on wages and other job-linked benefits made it harder and harder for people to maintain their standard of living. Banks were there to offer what appeared to be a way out for many working middle class families, as many turned to credit cards and borrowing to maintain consumption levels in the face of stagnant or declining wages. That is how the supply of new forms of credit met rising demand from struggling workers, pushing upward the ratio of debt to overall household worth. After the 1970s, the whole process fed on itself, as financial considerations spurred firms to keep reducing labor costs – leading to ever more insecurity and incentives for workers to borrow.

Why Rising Debt Hurts Workers in the Labor Market

Working people struggling to handle high levels of debt find it harder to move around in search of better jobs and wages – and when workers cannot quit undesirable jobs and pursue better ones, overall economic inefficiency results.

Debt service burden indicates the percentage of current disposable income that is devoted to making principle and interest payments on outstanding debts. Households with higher burdens are economically fragile, because any drop or disruption in income can lead to economic catastrophe. These households are essentially using their current income to pay off past expenditures, so if income drops or is disrupted by a period of unemployment, it is more difficult for the household with a high debt service burden to continue to meet economic obligations than it would be for another household with similar income but lower debts. Workers in highly indebted households simply cannot afford to lose or quit their jobs. They cannot go without wages and they may also be locked into such vital benefits such as employer health insurance.

Labor market efficiency depends partly on optimal employment matches – that is, employers need to be able to attract the most suitable workers, and workers need to be able to find positions in which they can be most productive and earn good wages and benefits. But the rapid growth of household indebtedness in the United States has made voluntary moves from job to job harder. Not just workers and their families, but also businesses and other employers, suffer from the resulting labor market inefficiencies.

The Way Forward

The growth of financial industries in the U.S. economy has unleashed a reinforcing cycle of rising labor market insecurity and indebtedness, making the economy less efficient and more uncertain for most Americans. This reinforcing cycle of labor market insecurity and exposure to heightened financial risk must be addressed by policymakers who hope to deal with spreading household debt. Cracking down on fraudulent or unfair lending practices will not be enough. The more fundamental issues of insufficient wages and benefits and growing labor market insecurities and inefficiencies must be addressed head on.

An adequate reform program must, at a minimum, including efforts to boost wages and enhance access to affordable health care, transportation, housing, and health care. In addition, the unemployed must have income replacement and support for their efforts to find new jobs. More fundamentally, we should look for ways to help families build savings and avoid credit traps. Despite considerable popular support for such measures, they have been hard to pass or sustain politically in recent times. Nevertheless, addressing the roots of mass economic insecurity is the only effective way to break the cycle of rising household debt in America.

Read more in Sara M. Bernardo, "Debt Lock-In: Household Debt Burdens and Voluntary Quits," in *Financial Market Development and Labor Relations* (edited by Christian E. Weller) (ILR Press, forthcoming).