

# Lecture 24: The Democratization of Finance: Consumer Finance

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# Social (Governmental) Insurance

- Progressive Taxes (US 1913)
- Free public education and services
- Social Security: OASDI, Old Age, Survivors and Disability Insurance (US 1935)
- Health Insurance: Medicare, Medicaid (US, both 1965) US is only major developed country without comprehensive health insurance.
- Workers Compensation (US before 1920)

# Origins of Social Insurance

- German social thinkers in 1870s: Lujo Brentano, Gustav Schmoller, Adolph Wagner. Stressed insurance principles.
- Otto von Bismarck's government: instituted sickness insurance (Krankenversicherung) 1883, accident insurance (Unfallversicherung) 1884, old-age insurance (Invaliden und Altersversicherung), 1889.
- Unemployment insurance, UK, Lloyd George, 1911.

# Government Insurance, continued

- Aid to Families with Dependent Children (1935) abolished 1996, in reaction to accelerating “moral hazard” problem.
- Unemployment insurance (US 1935)
- Survivors Insurance (US 1939)

# Radical Financial Innovation

## Example II: Social Security

- Germany, 1889 first national pension plan
- Financial theory: concept of insurance (*Versicherung*), large risks, Lujo Brentano, Gustav Schmoller
- Psychological theory: overconfidence, wishful thinking, hyperbolic discounting *Schriften des Vereins für Sozialpolitik*
- Information technology making this possible: paper, typewriters, filing cabinets, German bureaucracy, pasting 11 million stamps on cards
- Invention copied around the world, same social security principles in U. S. today

# Welfare Reform Act of 1996

- Republican bill, Clinton signed it because of pledge to “end welfare as we know it,” after vetoing two earlier bills
- Ended Roosevelt’s “New Deal” after 60 years
- Lifetime 5-year lifetime limit on welfare
- Denies aid to immigrants who are not citizens
- Unemployed childless adults limited to 3 months food stamps out of 36 months, immigrants get none. Hungry people helped by churches, charity

# Early US Bankruptcy History

- Reacting to what they regarded as lenient state bankruptcy laws in colonies, US constitution, Article I, Section 10, prohibits states from “impairing the obligation of contracts.”
- 1800, 1841, 1867, 1898 acts followed financial crisis that rescued multitudes of failed debtors. In 1840, there were half a million failed debtors.
- 1841 law had a discharge provision, after surrendering all one’s assets, one could have a “fresh start.”

# Bankruptcy Reform Act, 1978

- First major revision of bankruptcy law since 1938
- Lowered stigma of bankruptcy, relabeled “bankrupts” as “debtors.”
- Allowed people to keep more
- Made repayment schemes more attractive
- Launched a boom in personal bankruptcies.
- Bankruptcies have increased five-fold since 1985.



# Personal Bankruptcies

- US Personal bankruptcies reached 1.4 million in 1998, a record. Declined to 1.3 million in 1999 and 1.2 million in 2000, rose to 1.45 million in 2001, new record.
- More bankruptcies than divorces. (1.2 million divorces in 1996)
- With 104 million households in US in 1999, more than 1% of households declare bankruptcy each year.
- Cumulative effect as years go by.

# Chapter 7 Bankruptcy

- This is the liquidation form.
- Debtors turn over all nonexempt property to trustee and are discharged from most debt.
- Alimony, taxes, educational loans not discharged.
- Can't declare bankruptcy again for 6 years.
- To read Chapter 7 (or others), go to Title 11 (Bankruptcy) of United States Code, <http://www4.law.cornell.edu/uscode/11/>

# Chapter 11—Reorganization

- Primarily for businesses
- Some individuals running small businesses may use Chapter 11

# Chapter 13—Adjustment of Debts of an Individual with Regular Income

- Chapter 13 is a vehicle to repay part or all of debts over time, supervised by court-appointed trustee.
- Keep all of property and receive a discharge of portion of debt

# 2005 Consumer Protection and Bankruptcy Abuse Act

- Clinton vetoed 2000 bill as too harsh.
- Harsh new bills passed both houses March 2001, Bush indicated he would sign.
- Reconciliation conference was scheduled for September 12, 2001, cancelled.
- Pres. Bush signed final bill April 2005, prompting last minute rush to file for bankruptcy
- Took effect October 17, 2005, foreclosure rates jump immediately
- Time between bankruptcies raised to eight years from six
- Chapter 7 now available only for households with incomes below their state median

# Informal Bankruptcy

- Only 40% of credit card charge-offs are due to bankruptcies. (Amanda Dawsey, L. Ausubel)
- Going bankrupt requires some planning, one has to save \$1000 before lawyer will represent you. Down-and-outs don't do it. Creditors may just give up— not worth it.
- State laws allow creditors to garnish your wages, even if you never declared bankruptcy.

# Causes of Bankruptcies

- Personal bankruptcies tend to be spurred by job loss, health problems, divorce.
- Americans run up debts they can pay only if nothing goes wrong.
- Many bankruptcies are by people who are “drowning in mortgage debt,” having bought too big a house.
  - Sullivan, Warren & Westbrook *The Fragile Middle Class* YUP 2000

# Bailouts without Bankruptcy

- Home Owners' Loan Corporation 1933. If you couldn't afford to pay your mortgage, but were still dependable, you go to HOLC.
- HOLC goes to your lender, and seeks a reduction of your balance, say from \$8000 to \$6000.
- HOLC would swap the lender \$6000 of govt bonds for the new mortgage
- Demanded a 15-year mortgage



# Dodd-Frank Bill Pending in Congress

- FHA would insure mortgages up to 90% of value of home
- Private sector would do new loans at 90%, have FHA guarantee loans
- Swapping debt for equity, equity that will stay with FHA realized upon resale of house.
- Future of this bill is uncertain

# Continuous-Workout Mortgages

- The mortgage workouts in Dodd-Frank bill could be done continuously (every month) for all home owners.
- Automatically adjust mortgage for changes in home prices, incomes, economic conditions
- Dodd-Frank bill is in trouble because it smacks of bailout; my proposal is not a bailout
- CWM proposal is in my forthcoming *Subprime Solution: How Today's Global Financial Crisis Happened and What to Do about It*

# Concluding Thoughts for Course

- Democratization of finance will dramatically extend realm of financial technology to everyone, improving human welfare
- This democratization is part of a long trend toward greater economic development
- Financial careers have a good claim for social purpose, youthful idealism
- Peter Unger's *Living High and Letting Die* reveals complex moral dilemmas for *all* careers, dilemmas that all of us must confront, each in our own way.