The Trade-Off between Social Insurance and Financialization: Is There a Better Way?

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Introduction

The more a government spends on social insurance, the less likely households are to fall into debt. Social insurance includes pensions, health care, family allowances and parental leave, job training, income support, unemployment spending, and other such policies. Spending on these policies enables households to build up assets and reduce debt.

Figure 1 shows this relationship for the years 2007 to 2018 using data from the Organization for Economic Cooperation and Development. On the x-axis is the OECD’s measure of social expenditure (socx) and on the y-axis is the OECD’s household indebtedness ratio (hir), which is households’ debt as a proportion of their assets. Each dot represents one country for one year, and the overall picture is clear: as social expenditure goes up, household indebtedness goes down.
Analysts have been pointing to this trade-off between credit and social insurance for decades. In an important early examination, Teresa Sullivan, Elizabeth Warren, and Jay Westbrook noted that consumer credit is more easily available in the United States, and bankruptcy law is also more lenient to debtors, which serves as a counterbalance to the less extensive social safety net: “The United States offers families more sanctuary in bankruptcy — at the same time that it permits a wide-open consumer credit economy coupled with less protection from the economic consequences of other problems such as job losses, medical problems, accidents, and family breakups. ... The European and Canadian approaches, by contrast, make the game safer — but less competitive” by making credit access and bankruptcy more difficult, but by providing extensive social safety nets.¹

Figure 1: Household Indebtedness vs. Social Expenditure

All systems do something for families that are struggling to make ends meet: European systems subsidize them more through the social insurance system, while the United States allows them to borrow money and declare bankruptcy more easily. This relationship between credit and the welfare state can be seen in data for the longer period from 1980 to 2005 as well, and it holds even if we control for other factors that influence credit and the development of welfare states, such as economic growth, inflation, unemployment, demographic factors, and the level of interest rates.²

This picture of a trade-off is bolstered when we examine what Americans are actually spending their money on. In the United States, the stereotypical picture of why and how Americans fall into debt blames consumers purchasing flat-screen TVs that they cannot afford; an only slightly less stereotypical picture blames greedy bankers offering subprime mortgages. But over the last decades, Americans have not increased their purchases of luxury goods or housing as a proportion of total consumer spending. Rather, what Americans are spending more money on is health care (Figure 2). Housing is the single most significant item in consumers’ budgets, but this has been the case for decades, as we will discuss further below. Health spending, on the other hand, has risen from less than 8 percent of personal consumption in 1970 to over 17 percent today. Government spending on health care has been steadily rising in the U.S., and particularly since the passage of the Affordable Care Act, public health spending is not particularly low in the U.S. compared to other countries. The main reason American households are nevertheless spending more on health care is because prices are so much higher in the American health care sector. Equivalent amounts of public health spending thus purchase less health in the U.S. than other countries; even private systems of health provision cannot make up the shortfall, and households are left paying out of pocket, to a greater extent than in previous decades, and to a greater extent than in other countries.

Not all countries over all time periods exhibit a trade–off between credit and welfare. For example, in recent years Denmark, Norway, and to some extent Sweden, which all have extensive welfare states, have also seen rising indebtedness as a result of an unusual rise in housing prices alongside low interest rates. Moreover, over the last several decades the United States has become less unusual, as its levels of social insurance have risen and its levels of household indebtedness have fallen, trends that are particularly noticeable under the administration of Barack Obama. But overall, and particularly if we
control for other factors that affect credit and welfare, easy credit emerges as an alternative form of the welfare state.

How We Got Here

Nobody explicitly chose the American model of easy credit and a weaker welfare state. It arose out of a century of struggle and partial solutions to other problems. To understand why Europe went one way and America another, we have to go back to where the countries stood at the end of World War II. Parts of Europe were destroyed, physically and economically, while America emerged as the undisputed hegemon of the world, having displayed both its military and economic might. This was not unexpected — America had been growing at rates that had shocked European observers for decades, prompting a flurry of concern about the “American danger” at the turn of the century. But the end of the war ended any thought of maintaining hegemony that European powers might have had, and inaugurated the regime of American dominance.

In this context, the overwhelming European concern was to rebuild the economy. Moreover, the desperation of the times in many European countries forced erstwhile enemies to sit down as partners: business and government, labor and capital. What emerged from this crucible was a pattern of economy in which everyone got something, and everyone gave up something. Surprisingly, Europe emerged with a political economy that was in many ways more favorable to capital than the United States. For example, taxes on capital and the wealthy were surprisingly low, and remained so for decades. Instead, broad-based taxes, including payroll taxes and value-added taxes that hit the middle classes harder than the wealthy, played a larger role. The concern on all sides was to regenerate the economic system, which meant avoiding burdening capital with taxes or regulations. At the same time, those payroll taxes and value-added taxes were used to finance ever-increasing levels of social spending, which brought acceptance of the new economic model from citizens. And in an effort to channel available funds towards investment, European policymakers did all they could to promote savings.

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3 Much of the material in this section is from Prasad, The Land of Too Much.
Meanwhile, America had its own problems, but they were problems of an entirely different nature. A widespread strain of thought had concluded that the Great Depression in America had been a problem of producing too much. Diligent American farmers had raised their productivity, and the consequence was a glut of agricultural products on the markets. Prices for those products fell; when prices fell, farmers could not repay the debts they had taken out to invest in their farms; when they could not repay those debts, banks collapsed; and when banks collapsed, the entire economic system shook. Productivity gains had led to worse economic outcomes. Where Europeans were faced with scarcity and the need to rebuild, America was faced with what many thought was overabundance.

The work of economic historians has since suggested that the real problem was an excessively tight monetary regime given the rates of American productivity. But at the time, the mere fact of a sequence that could start with everyone doing everything right and end in catastrophe seemed to prove that something was deeply wrong with the system. Observers from across the political spectrum eventually decided that if the problem was too much productivity, the solution was that American consumers simply needed to consume more. This decision launched the American consumer regime. American politics — from business leaders to labor-union leaders, politicians to journalists to academic economists — became focused on trying to increase levels of consumption.

The result was that over the next few decades, consumption actually declined in Europe in terms of its importance in the economy, as policymakers focused on increasing savings that could be channeled to reconstruction and building up export markets, while consumption increased dramatically in the United States. For example, data from the Penn World Tables show that household consumption as a share of GDP fell in 22 OECD countries from 65 percent in 1950 to 55 percent in 2014, as many European countries channeled their efforts to investment and exports; in the United States, on the other hand, consumption rose from 67 percent of GDP to 72 percent over the same period.6

American policymakers experimented with many different ways to increase consumption. They eventually decided that one of the best ways to increase consumption was to increase credit.

The United States has not always been a land of easy credit. The earliest comparative data we have show that in 1913 credit was unusually low in relation to GDP in the United States in comparison to Denmark, France, Germany, Switzerland, and the U.K. Even the flowering of consumer lending in the 1920s, which saw the rise of installment payments for sewing machines, refrigerators, and automobiles, was not unusual in comparative perspective. America’s distinctive dependence on easy credit came later.

The real shift began during the New Deal, when everyone was focused on trying to get Americans to consume more. The history of this time abounds in fascinating and cockamamie plans, like trying to create paper out of surplus cotton, or regulate overproduction, or subsidize prices. Eventually, several strands of thinking converged on the idea that rescuing the economy required rescuing home construction. As the chairman of the Federal Reserve Board described President Franklin Roosevelt’s thinking at the time, “almost a third of the unemployed were to be found in the building trades, and housing was by far the most important part of that trade. A program of new home construction, launched on an adequate scale, not only would gradually help put those men back to work but would act as the wheel within the wheel to move the whole economic engine. It would affect everyone, from the manufacturer of lace curtains to the manufacturer of lumber, bricks, furniture, cement, and electrical appliances. The mere shipment of these supplies would affect the railroads, which in turn would need the produce of steel mills for rails, freight cars, and so on.” Americans would consume more homes, and the government would help them do it; the construction industry, which had collapsed during the Great Depression, and which was so centrally tied to the rest of the economy, would pull the rest of the economy out of the doldrums. Constructing homes would create a stock of affordable housing for the middle classes, and it would revive the economy based on the construction that housing would require.

The particular genius of the program was to borrow from the more prosperous future that this scheme would generate in order to bring the scheme and that future about. The key innovation was the rise and rapid spread of the home mortgage.

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Home mortgages may seem like a simple invention, but a lot had to be done to figure out the mechanics of paying off a loan in the context of residential housing. The Roosevelt administration experimented with several other programs before finally developing the Federal Housing Administration and the Federal National Mortgage Association, the twin pillars of the American credit-based economy. The legislation that developed these policies was neither statist — it did not provide directly to distressed or poor people, for example — nor laissez-faire, as it did not leave the market to fend for itself. Instead, the policy approach that emerged used government to jump-start the market, by subsidizing private financial institutions that offered home mortgages according to regulated terms. In a process of policymaking that other scholars have found familiar in the United States, government operated in the background. Other countries also had government programs to facilitate homeownership, but these were often focused on helping aspiring homeowners save enough to afford large down payments.

The result was a sharp uptick in mortgage-financed homeownership in America. Homeownership rates increased from 45 percent before these innovations to 65 percent afterwards, and have not fallen much below that level ever since. Careful studies attribute about half of this rise to the invention of the fixed-rate mortgage. Housing starts increased enormously from the depths of the Depression, growing from 93,000 in 1933 to 332,000 in 1937.

The long-term, declining-balance mortgage as we know it today was a brilliant technological innovation. It brought the purchase of high-quality housing within the reach of young households. No longer did couples have to scrimp and save before moving into a house — they may have had to scrimp to pay off the debt after moving into the house, but this still meant several additional decades of homeownership, and children growing up in suburban yards. The house became the largest single purchase that most families would ever make, and lives and careers were oriented towards saving up for the down payment and then paying off the mortgage. At a macro level, the entire economy was

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premised on the continued consumption of single-family homes, a situation that continued after the war.

In other countries where the housing sector had been severely hit, such as Germany, similar innovations did not become widespread. Instead of an economy financed by government-subsidized mortgages, Germany focused on increasing private savings to aid production for export markets. These different decisions are explained by the different contexts — the need to revive export markets in Germany, compared with the attempts to deal with “excessive” production in the United States by getting people to consume. It is after World War II that the quantitative series first show the United States edging ahead of other countries in consumption as well as in measures of financialization.

This credit-based economy underlay the economic prosperity of the postwar decades in America. It is therefore not surprising that in the 1960s and the 1970s, American progressives began focusing their attention on trying to make credit more easily available for those who had been left out of economic growth: The main problem with the American vision was that it was mostly white children running around those suburban yards. Increasingly, progressive activists began to notice that in a credit-oriented economy, African-Americans who were denied credit were unable to participate in the dream of American mobility, and credit access for African-Americans became a central element of the American fight for justice. Practices such as redlining homebuyers into racially segregated neighborhoods, as well as restricting access to credit for African-Americans, directly contributed to residential segregation, and therefore to widening the wealth gap. Moreover, as the average age of first marriage rose and the divorce rate spiked during the 1960s and 1970s, restricted credit access for women kept many women out of full participation in the economy as well. Without access to credit on the same terms as white men, African-Americans faced severe constraints on their ability to prosper, and women suffered hardships in trying to live independently. And so progressives were led, for their own distinctively egalitarian reasons, to expand America’s easy-credit system.

11 Prasad, The Land of Too Much, 207–12.
12 On consumption, see Robert Inklaar, Robert C. Feenstra, “Penn World Table 9.1” (Groningen Growth and Development Centre, 2019) and Prasad, Starving the Beast, 172–76, 191–96; on financialization, see discussion in Prasad, The Land of Too Much, 197.
By the time the Great Inflation of the 1970s took off, America had already developed its model of easy credit and low spending on social insurance. Policymakers then doubled down on this model in response to the crisis. In particular, interest rate caps in a time of inflation meant that bank depositors were often receiving negative real interest rates, leading to calls for deregulation of interest rates. The deregulatory momentum continued throughout the 1980s and 1990s, with branching restrictions on banks removed and then the Depression-era Glass–Steagall regulations unwound. Financialization shot up, as all elements of the political spectrum now agreed on the goal of improved credit access — the left for egalitarian reasons, the right for pro-market ones.

Meanwhile, raising welfare spending required more of a fight. In the 1980s Ronald Reagan won two sweeping electoral victories, and helped the Republicans regain control of the Senate for the first time in decades, by pushing a program to roll back government. Although Reagan and his successors did not manage to decrease the size of the state, they did succeed in slowing further increases. Financialization became the political path of least resistance for addressing citizens’ social needs.¹⁴ Such was the status quo until the financial crisis of 2007 broke the logjam long enough to allow a major addition to the welfare state in the form of the Affordable Care Act.

This brief history shows how the American political world — even American progressives — came to rely on credit expansion rather than social insurance as the motor of the American economy, and as the organizing principle of American economic lives. But is this a good way to arrange our economy?

Analyzing the Costs and Benefits

Because this model of political economy emerged over time through many steps that were not part of a grand plan, we have never had a national debate on whether our economy should be organized around credit to the extent that it is. There has been plenty of discussion over the years about whether government spending is good or bad, and whether the growth of finance has been good or bad, but virtually no discussion of how the two are interrelated. In particular, there has been almost no recognition of the fact that the price of lower

¹⁴ Krippner, Capitalizing on Crisis.
government spending is increased indebtedness for households and bigger profits for bankers.

Without a doubt, the easy-credit model offered key political advantages — which explains why it won out over rival approaches. Conservatives were able to defend “small government” — at least in terms of visible taxing and spending — while creating an alternative mechanism for addressing social needs. Progressives were able to secure benefits for disadvantaged groups without triggering voters’ easily roused suspicions of government overreach.

But did these political advantages translate into sound, effective policies? Experience has revealed some important problems with the model. The first is the volatility and fragility of a credit-based economy. As we saw during the financial crisis of 2007–8, if credit is a large proportion of GDP, then credit crises can rock the broader economy. Because mortgages are such a large market, there was intense interest in developing ways to make money off the massive financial flows that mortgages represent, and many financial innovations arose claiming to be able to do that, particularly mortgage-backed securities. As it happens, the models for reducing risk were not very good, and rising levels of foreclosure threatened the entire system; because all financial institutions were exposed to these securities, and because it was not clear which financial institutions would therefore remain creditworthy, the crisis brought the whole system to the brink of collapse. Regulations can prevent a repeat of this scenario, but the demand for easy credit access that is built into the heart of the American economy ensures that there will always be constituencies arguing for less regulation.

A second issue is what debt does to individuals.\(^5\) Holding debt has been found to delay marriage and childbearing as well as retirement and to lead to postponement of health care.\(^6\) Debt is associated with worse mental health among less advantaged groups, and the unsecured debt of parents is associated with emotional problems in children.\(^7\) While tertiary education is either free or


\(^7\) Randy Hodson, Rachel E. Dwyer, and Lisa A. Neilson, “Credit Card Blues: The Middle Class and the Hidden Costs of Easy Credit,” *The Sociological Quarterly* 55, no. 2 (May 1, 2014): 315–40; Lawrence M. Berger, J. Michael Collins, and Laura Cuesta, “Household Debt and Adult Depressive Symptoms in the United States,” *Journal of Family and Economic Issues* 37, no. 1 (March 1,
heavily subsidized in other countries, taking on debt to go to college is the norm in the United States. This regime has an unfortunate outcome, in that it harms the least advantaged the most: Students who take on debt to attend college but do not graduate, who are most likely to come from disadvantaged populations, are left having to pay off loans without much labor-market benefit from their education.\(^\text{18}\) Even the availability of easy credit to tide families over during difficult economic times is a mixed blessing, as it can lead to negative economic spirals that end in bankruptcy.\(^\text{19}\) And despite this country’s relatively more lenient bankruptcy terms, bankruptcy is nevertheless still associated with reduced job prospects and social stigma.\(^\text{20}\)

Although an economy based on credit and an economy based on social insurance can both provide stable and fulfilling lives to a large segment of the population, a credit-based economy does less for the poor. This is because there is an irreducible problem with extending credit to the poor: Many of them will not be able to pay it back, because of irregular and low earnings. Financial institutions that lend to the poor thus ask for very high rates of interest, to make up for the fact that a disproportionately larger share of the poor will default on their loans. These high interest rates in turn make default more likely. We can pass laws to force financial institutions to lend at lower interest rates, but that means that when the banks get into trouble, taxpayers will eventually pay the costs. The only way around it is, once again, to raise taxes, so that we can subsidize banks that lend to the poor. There is no particular consensus for doing that — programs that help the poor are never as popular as social insurance programs that help everyone — which is why American poverty rates remain so high in comparative perspective.

While a credit-based economy underserves the poor, it also overserves the rich. Financialization ensures that a larger proportion of income is captured by the financial sector and its well-paid workers. Between 1980 and 2006, the financial sector’s share of GDP rose from 4.9 percent to 8.3 percent.\(^\text{21}\) Over this
same period, compensation in finance surged ahead of other sectors: In 1980, finance professionals earned roughly the same as equivalently skilled peers in other industries, but by 2006 financiers were earning 50 percent more. By underserving the poor and overserving the rich, financialization has exacerbated inequality. 

A Better Way: To Reduce Financialization, Increase Social Insurance

The main response to the financial crisis of 2007–8 was more regulation of financial firms. The discussion in this paper suggests that trying to restrict financialization solely by restricting the supply of credit, by passing laws and regulations to control financial firms, is counterproductive, politically difficult, and addresses only the symptoms of the problem. It’s counterproductive because it does nothing for the truly poor, whose access to credit will be further restricted by these regulations, and restricting credit when health care costs are rising means that many households will have more difficulties making ends meet. It’s politically difficult because activists and policymakers from all across the political spectrum want to enable economic mobility, which in America today means being able to borrow substantial sums for a house in a good school district. And laws to restrict finance address only the symptoms because they do not examine why Americans want credit in the first place. Regulation may be part of the answer, but unless we address the underlying factors that lead Americans — and therefore their policymakers — to want to make credit access easier, we are sure to see further pressure for financial deregulation from the left as well as the right.

A better path forward is to address the demand for easy credit. Americans borrow to purchase housing, and in recent decades they have had to borrow to manage their health care costs. Thus, a better way to reduce financialization would be to increase and improve social insurance. Increasing levels of social insurance would directly address Americans’ needs to borrow for health care.

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costs and would also indirectly begin to dismantle the regime of debt–financed homeownership that places credit at the heart of American political economy. Americans search for the most expensive house they can afford because doing so provides them assets for retirement and protection against economic reversals caused by unemployment, divorce, or other unexpected costs. In short, homeownership is economic security — which means, perversely, that indebtedness feels like the best path to economic security. Detaching homeownership from economic security by increasing social insurance is the most promising step forward in countering financialization.

About the Author

Monica Prasad is a professor of sociology and faculty fellow in the Institute for Policy Research at Northwestern University, and a senior fellow at the Niskanen Center. She is the author of The Land of Too Much: American Abundance and the Paradox of Poverty (2012) and most recently of Starving the Beast: Ronald Reagan and the Tax Cut Revolution (2018).