Perspectives from Social Economics

CONSEQUENCES OF ECONOMIC DOWNTURN

BEYOND THE USUAL ECONOMICS

EDITED BY MARTHA A. STARR

CONSEQUENCES OF ECONOMIC DOWNTURN

Perspectives from Social Economics

Series Editor:
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The Perspectives from Social Economics series incorporates an explicit ethical component into contemporary economic discussion of important policy and social issues, drawing on the approaches used by social economists around the world. It also allows social economists to develop their own frameworks and paradigms by exploring the philosophy and methodology of social economics in relation to orthodox and other heterodox approaches to economics. By furthering these goals, this series will expose a wider readership to the scholarship produced by social economists, and thereby promote more inclusive viewpoints, especially as they concern ethical analyses of economic issues and methods.

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Beyond the Usual Economics

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Chapter 1

Beyond the Usual Economics

Martha A. Starr

The economic downturn of 2007–09 inflicted considerable economic hardship on the U.S. population.[1] Following years of extraordinary increases in home prices in many metropolitan areas, housing prices started falling in 2006, and home construction ground to a halt. As mortgage delinquencies and defaults rose, the balance sheets of financial institutions deteriorated, with full-scale financial crisis erupting in fall 2008. This confluence of factors propelled the U.S. economy into the longest downturn since the Great Depression, with unemployment reaching double digits for the first time in 25 years (see Figure 1.1). Almost all socioeconomic indicators show evidence of painful deterioration. The ranks of the unemployed swelled by almost 8 million between December 2007 and October 2009, with an additional 4.6 million people shifting involuntarily into part-time jobs. Nationally, about 1 in every 135 homes was in foreclosure in the third quarter of 2009, with hard-hit states such as Arizona, California, Florida, and Nevada registering rates on the order of 1 per 52–4 homes. An additional 2.6 million persons fell below the poverty line between 2007 and 2008, while the number covered by private health insurance fell by 1 million.[2]

Both in academia and in policy-making circles, discussions of the financial crisis and economic downturn have largely focused on the "usual economics" of money, banking, and finance. Here debate has centered on questions of what caused the financial system to malfunction so badly, especially in the second half of 2008 when major financial institutions seemed to be toppling like dominoes. The list of possible culprits is long and complex, but most reasonable people would agree that it should feature: the role of securitization in contributing to the erosion of mortgage lending standards and the inevitable rise in financial distress; shortcomings in regulation of banks

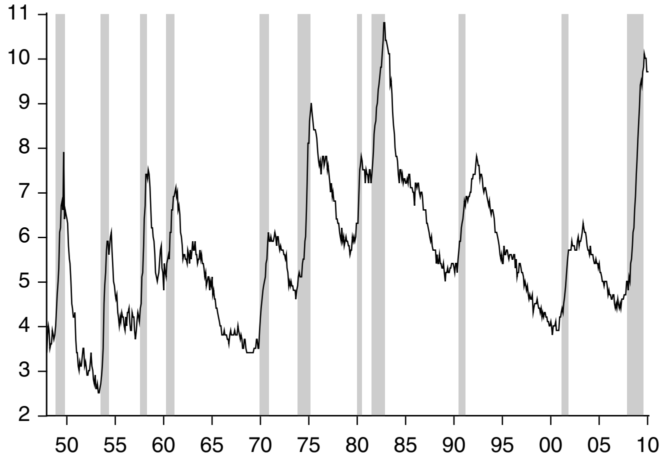

Figure 1.1 National unemployment rate (percent)

Source: U.S. Bureau of Labor Statistics. Gray bars show recessions as dated by the National Bureau of Economic Research. The NBER has not yet declared the official end-date of the most recent recession, though current thinking is that it ended in the third quarter of 2009 (Reddy 2010).

and other financial institutions that reduced their incentives to manage risk prudently and created the problem of "too big to fail"; and the possibility that monetary policy was too lax in the years before the crisis, contributing to the housing-price bubble.[3]

But as much as it is important to understand and tackle problems in these domains, analyzing *only* these aspects obscures equally, if not more, important questions raised by the crisis and economic downturn—about how well the U.S. economic and financial system is functioning in terms of its ability to provide widespread and secure access to decent living standards, enabling people to build and maintain lives they have reason to value (Sen 1999, Nussbaum 1999). Standard economic thinking frames the primary objective of macroeconomic policy as promoting maximum sustainable growth of output, meaning that it neither kicks up inflation nor leaves people who are willing and able to work without jobs. This, in turn, is understood to require a financial system that works effectively in channeling loanable funds from governments, businesses and people who spend less than they earn ("savers"), to governments, businesses, and people who would like to spend more than they earn ("borrowers"). While these objectives are hard to argue with in general terms, this standard thinking has the disadvantage of embedding a strong assumption about what best promotes social welfare: growth of aggregate output. On one hand, an ample body of research shows that, in already-wealthy societies such as the United States, further growth in per-capita income does not correlate closely with broad-based improvements in social well-being (Easterlin 1974, 1995). Rather, a multiplicity of other factors seem to affect the level and distribution of social well-being, such as how well-distributed the "economic pie" is; people's sense of inclusion and control in their economic, social and political lives; their levels of economic and personal security; their sense of the fairness of the laws and institutions that impinge upon their lives; and other considerations (Diener et al. 1999; Frey and Stutzer 2001; Jowell and Eva 2008; Wilkinson and Picket 2010). On the other hand, as the rapidly expanding literature associated with the human capabilities approaches of Sen (1999) and Nussbaum (1999) emphasizes, understanding social well-being as multifaceted does not simply imply that policymakers' "objective functions" have to be expanded to ensure that they are maximizing the right things. On the contrary, if essential ingredients of social well-being are that people can exercise agency in their own lives and can themselves work to construct lives they have reason to value, then social well-being is not something to be delivered *by* policymakers *to* the population. Instead it shifts policymakers into a different role of establishing and maintaining preconditions for human flourishing, rather than trying to be its engineers.

Thought of in this way, the downturn poses three sets of questions beyond the usual monetary, financial and banking domains. Addressing these questions is important if we are to properly conceptualize what happened, identify what changes need to be made to reduce risks of major downturns like this from happening again, and promote shifts in policy goals to prioritize social well-being rather than growth *per se*. The first set of questions concerns how we should understand who bears responsibility for the financial crisis and economic downturn, and the extent to which considerations of *social responsibility* need to be introduced into financial and monetary-policy decisions. When the financial crisis first hit, some initially framed it as a "perfect storm," so unique in the pathways of its development that no one could have seen it coming. But after much public discourse in its aftermath, it is clear that decisions were made all up and down the line—by everyone from Fed chairman Alan Greenspan, to bank regulators, to numbers-crunchers at hedge funds, to pension-fund managers who bought mortgage-backed securities, to mortgage brokers pushing option ARMs, to those who used Alt-A mortgages to buy and flip homes—that in effect entailed a good amount of downside risk which would not necessarily be borne by the decision-maker. Soaring home prices and hot financial markets, combined with unduly positive expectations, made it easy not to think about who might be left holding the bag if one's decisions didn't work out. But it was not impossible to foresee downside risks and how they would be distributed; people just felt no sense of obligation to think about them or minimize their effects on others. Thus, a problem is that, no matter how well we might patch up the financial system to reduce odds of malfunction of the type just experienced, if we fail to get policymakers, financial decision makers, and even ordinary consumers to become more mindful of the consequences of their decisions and avoid courses of action that throw downside risks onto others, there is really no assurance that things will work out any differently in the future, as continued evolution of the financial system will continue to produce new opportunities of the same kind (Kane 1997, 2010).

Second, whereas traditional money, banking and finance analyses emphasize aggregate measures of economic and financial performance, the financial crisis and economic downturn point to the importance of understanding how the benefits and costs of aggregate fluctuations are distributed within the population. Popular narratives of the crisis and recession emphasize issues of fairness and the public's sense that government actions and taxpayer resources were used to help the wealthy and powerful over ordinary people (the "Wall Street versus Main Street" contrast). Large financial institutions were bailed out, yet struggling homeowners received little protection from foreclosure. Taxpayer funds were transferred to troubled financial firms, which then paid handsome bonuses to top employees. Banks deemed 'too big to fail' received capital injections that enabled them to stay afloat, while dozens of smaller banks had to close their doors. Economists have tended to regard discontent over these issues as matters of the public not understanding how important it is to keep the "lifeblood" of the economy, credit, pumping through its veins, justifying the "whatever it takes" approach that Fed chairman Ben Bernanke and Treasury Secretary Hank Paulson took in the midst of the 2008 financial panic (Wessel 2009). Yet if the primary concern of economic policy should be widespread access to social well-being, and not GDP *per se*, it actually does matter quite a lot to think about how alternative courses of policy action affect different social groups, aiming to ensure that distributional properties of courses of action taken are consistent with considerations of fairness and transparency and do not favor well-off groups.

The third set of questions posed by the downturn concerns the proper locus of collective actions to address social and economic problems. The traditional economic paradigm understands governments as responsible for fixing divergences between free-market outcomes and those which maximize social welfare. This posits an inherent and stark difference between government and business, framing the former as concerned only about the public interest and the latter only about profit. However, real-world economies are much more complicated than this. For one, nonprofit organizations, community groups, religious organizations, and other collectivities also organize activities that aim to tackle social and economic problems that concern them. While many of these organizations are small, some operate on a national scale, such as the anti-hunger group Feeding America, which distributed 1.3 million tons of emergency food supplies in 2008–09. For another, businesses are increasingly adopting codes of social responsibility to their stakeholders, which may involve engagement in projects to benefit the communities in which they work. Recognizing that efforts to solve problems of mutual concern are not the exclusive domain of government, Nobel Prize winner Elinor Ostrom (2010) argues that economic governance should be understood as "polycentric": often there are multiple loci of efforts to shape economic activity for common benefit, and these may interrelate in complex ways. From the point of view of the economic downturn, an important question concerns the extent to which collectivities other than government have stepped forward to mitigate adverse consequences of the recession for people's livelihoods and/or help devise and implement strategies for reducing people's vulnerabilities to aggregate shocks in the years ahead. Thus, for example, while unemployment insurance and food stamps have helped people cover basic consumption needs in hard times, so too have food banks, food pantries, soup kitchens, and community clinics serving the uninsured.

In the remainder of this introduction, I describe the chapters contained in this book, which collectively aim to help move our understanding of the causes and consequences of the economic downturn beyond the usual money, banking and finance. They are organized into three sections that respectively address the questions outlined above about social responsibility, distributional effects, and the social economy.

Ethics, Social Responsibility, and Economic Policy

The financial crisis has provoked important debate among economists about the extent to which the knowledge practices of our profession may have helped cause the crisis and related economic downturn.[4]

Some well-known people were warning about accumulating risks of financial distress in the years before the crisis erupted, including Robert Shiller, Nouriel Roubini, Dean Baker, and Edward Gramlich. But, in general, the profession seemed too wedded to analytical frameworks that interpreted the developments of the period as posing no special risks of major financial and economic troubles. This led people to discount warning signs that housing prices had run up above fundamental levels, that mortgage lending standards had been imprudently relaxed, that moderate-income households were taking on debts that could well become difficult to service, that mathematical models used to price derivatives were systematically understating risks and overstating returns, and so forth. While it is easy to see *ex post* that mounting risks were being ignored, the question going forward is what would need to be done differently so that *ex ante* such brewing risks could be correctly recognized and addressed, before they became systemic problems.

Chapter 2 by George DeMartino provides a clear and compelling answer to this: a new field of professional ethics for economists. Unlike many other professions and academic disciplines, economists do not have a code of ethics requiring them to consider the consequences of their professional activities and avoid courses of action that could adversely affect others. Yet economists' work—the ideas they promote in their scholarly research, the policy advice they give, the macro-econometric models they build, and so forth—can be highly consequential insofar as they shape policy discussions and business decisions, in ways that broadly affect the economic livelihoods and security of others. In some sense, the lack of concern for ethics comes from economists' view that the environment in which they work is inherently all about identifying "right" or superior ideas and approaches over "wrong" or inferior ones: if the selection mechanisms governing what ideas take hold widely within the profession operate sufficiently vigorously and effectively (e.g., peer review at journals; promotions to influential positions in academia, government, or the private sector; invitations to testify before Congress, etc.), then we might expect state-of-the-art knowledge to always be converging to that set of ideas which would provide the best possible guidance for action. The problem is that, in a complex, ever-evolving economic system like that of the United States, there always remains substantial uncertainty about the extent to which any given interpretation of the data is in fact "right," as opposed to just seemingly better than alternatives, given what else is known. Thus, for example, early on in the development of subprime lending, it was not at all clear that the extension of credit to subprime borrowers was a time bomb waiting to go off. On the contrary, at least initially it looked like it could be a good thing, given that traditional methods of making mortgage loans were said to ration moderate-income borrowers out of credit markets and limit their ability to become homeowners (see, e.g., Holmes 1999).

How then should economists contend with the fact that many of the trends we are called upon to interpret have the proverbial "on the one hand... on the other" character? As DeMartino's chapter discusses, many other professions have ethical guidelines intended to circumscribe how people evaluate uncertainties and avoid courses of action that could impose unacceptable costs on others, such as the physician's oath to *first do no harm*. DeMartino argues that reasonable concern for the well-being of others—especially vulnerable groups lacking the wherewithal to deal with a period of significant economic and financial distress—would have impelled economists to think more squarely about the risks inherent in the constellation of developments in the years before the financial crisis (the housing price bubble, rise of subprime lending, proliferation of collateralized debt obligations, etc.). This, in turn, would have clarified their social responsibility to try to stop practices that were contributing to these risks, and/or advocate policies that would tamp them down. DeMartino's chapter outlines general principles that should enter into an appropriate professional ethics for economists, which are discussed at greater length in his book on this subject (DeMartino 2010). Making this book required reading for economists could go a long way toward reducing odds of such constellations of risk developing again.

Chapter 3 by Robert Prasch discusses an important instance of disconnect between economic theory and economic reality which caused a collective blind spot as to what was brewing in the run-up to the financial crisis. A core tenet of financial economics is that above-average returns cannot be had from safe investments; if risk and return are positively correlated, as standard theory assumes, then above-average returns can only be had by investing in risky assets. Assuming that investors are rational and take this trade-off into consideration, we would expect them to stay away from assets for which risks are high relative to expected returns. Working this logic backwards is what got former Fed Chairman Alan Greenspan into so much trouble: he assumed that risks associated with assets such as mortgage-backed securities could not have been "too high," as shrewdly calculating investors would not have been buying them had that been the case. This bred a complacency for which many later had to pay.

But as Prasch argues, a key flaw in this reasoning is that risk and return are not actually very closely linked in contemporary U.S. capitalism, because a variety of important laws, practices, and institutions enable those who control large corporations and financial institutions to earn abnormally high returns without taking on commensurate risks. An important concept here is limited liability, which implies that corporate shareholders and executives do not have to bear full responsibility for losses resulting from their actions; if the firm's finances deteriorate catastrophically, its creditors can demand that its assets be sold, but except in cases of gross negligence, any wealth accumulated by the firm's principals as a result of their past bad actions (e.g., outsized bonuses, realized capital gains) can remain safely in their bank accounts. Similarly, problems of asymmetric information enable parties selling financial assets to portray them as having better risk/return profiles than they actually do. In principle, securities law prevents financial-market participants from deliberately misleading investors; in practice, there are many things they can do to get around this burden, and anyway financial regulators are often too short on resources to ensure compliance with rules. In many cases, then, principals of large corporations and financial institutions are able to wriggle out from under downside risks, shifting them instead to unsuspecting bystanders who did not share in the returns. In the context of the 2008 financial crisis, the boom in financial services driven by the housing-price bubble enabled bankers and financiers to amass extraordinary financial gains in the years before the crisis broke, but then when the inevitable eventual losses started showing up on their books, the federal government stepped in and managed them in the interest of keeping the financial system afloat; the taxpayer bore the risks of the bailout operation. In the meantime, the costs of the economic contraction that accompanied the financial crisis fell on people ill-prepared to carry them: average workers, homeowners, retirees, and so forth, who lost jobs, homes, home equity, and retirement savings. Prasch notes that this "divorce of risk and return" in American capitalism both contributes to and exacerbates the problem of rising inequality in the United States, and also worsens problems of economic insecurity among average people.[5]

The next two papers investigate the role of rising inequality in contributing to the financial crisis and economic downturn, and the extent to which failure to address it could continue to drag down economic performance and social welfare in the years ahead. As is well known, household incomes have been flat or slipping in inflation-adjusted terms for the majority of households since the early 1980s;

only for households toward the upper end of the income distribution have real incomes been improving (see Figure 1.2). Although it is frequently suggested that rising inequality played a role in causing the financial crisis and economic downturn, to date few studies have attempted to explain how the two would be causally related. Chapter 4 by Jon Wisman and Barton Baker takes on this task, aiming to identify mechanisms by which rising inequality raised risks of systemic financial dysfunction by comparing the financial crises of 1929 and 2008. Drawing on insights from Veblen, Keynes, Kalecki, and Marx, they point to three sets of dynamics that heighten risks of systemic financial distress. The first is that greater inequality drove individuals to struggle harder to find ways to consume more to maintain their relative social status. In the absence of rising incomes, people increasingly made recourse to borrowing to try to "keep up with the Joneses," taking on payment burdens that would become increasingly difficult to service. Second, holding ever greater income and wealth yet already having high levels of consumption, people at the upper end of the income distribution tended to channel their resources into financial investments, rather than spending on goods and services. This helped to keep interest rates low and encouraged the creation of

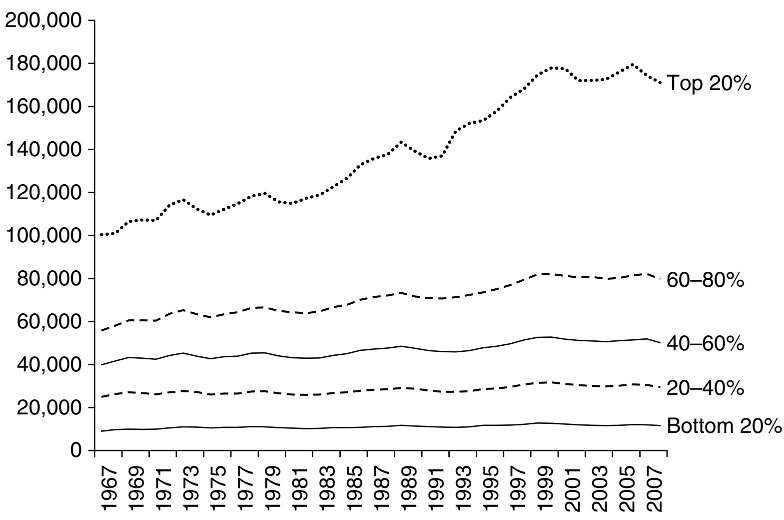

Figure 1.2 Average household income, by income quintile, constant 2008 U.S. dollars

Source: U.S. Census Bureau, Annual Social and Economic Supplements to the Current Population Survey. Income is pre-tax and does not include the value of noncash transfers.

new credit instruments with poorly understood risk properties. The third dynamic found in the years before the 1929 and 2008 crises was that, as the rich took larger shares of income and wealth, they gained more command over ideology and hence politics. Reducing the size of government, deregulating the economy, and failing to regulate newly evolving credit instruments flowed out of this ideology. Wisman and Baker argue that, because these dynamics reflect structural economic problems—spending levels above purchasing power, loanable funds above good investment opportunities—it is unlikely that measures to repair flaws in the financial system alone would be sufficient for putting the economy back on secure footing.

Chapter 5 by Steven Pressman takes up the issue of inequality, arguing that failing to reverse its rise poses a problem not just for financial stability but also for output growth due to effects of inequality on health and productivity. As careful research by Richard Wilkinson and others has found, countries in which income is unequally distributed tend to have lower levels of physical and mental health than countries in which income is more equally distributed.[6] Compared to relatively equal societies at similar income levels, relatively unequal societies tend to have higher rates of depression and anxiety; higher shares of the population with high blood pressure or cholesterol; higher rates of obesity; more detrimental health behaviors (smoking, drugs, alcohol abuse), which in turn cause higher rates of heart, lung and kidney disease; lower life expectancies; and more. In turn, relatively unhealthy people tend to lose more days of work due to illness or absenteeism, and even when they are on the job, they may contribute less than their full potential by virtue of feeling poorly; in addition, family members' productivity is often pulled down when they are worried about the health of a loved one. Pressman argues that, if the problem of income inequality is left unaddressed, growth in labor productivity is likely to be limited by these negative health effects. This would perpetuate the problems of stagnant incomes in the middle of the income distribution and attendant tendencies for people to take on too much debt.

The final paper in this section, by Mark White, takes up a key question about whether households should be seen as primarily responsible for their own borrowing decisions, and/or whether governments and lenders share the responsibility to keep them from taking on debts they may find costly and difficult to service. Traditional economic theory views consumers as making consumption, saving, and borrowing decisions shrewdly, handling their choices so as to get maximum utility out of their lifetime income streams and to keep their consumption levels relatively steady even when income fluctuates.[7] Thus, they will tend to borrow in periods of low income (e.g., when they are young and starting out, or going through temporary hard times), expecting to be able to repay the debt when their incomes rise. Yet new insights from behavioral economics suggest consumers are not so deliberative in financial decision-making and on the contrary have lots of "cognitive flaws." Thus, for example, participation in companies' 401(k) retirement plans turns out to be quite sensitive to how default options are set up, with participation being much higher when the default option is to enroll people in the plan, although they can freely opt out if they want, than if the default option is for people not to enroll, although they can freely opt in if they want; this is true even when the costs of opting out or in are made very small. That people's choices are so easily influenced by how options are presented is thought to have enabled lenders to push certain types of high-cost mortgages, especially those for which very high monthly payments kick in after some initial interval when very small amounts need to be paid.

These kinds of observations have led University of Chicago economist Richard Thaler and legal scholar Cass Sunstein to argue that government policies should try to "nudge" consumers to make decisions that will be in their best interest, primarily by making "good" choices the default option and "bad" choices available by special order only; only truly bad choices should come off the menu completely. This seems like a reasonable balance between protecting consumers from businesses eager to exploit their cognitive flaws, while also preserving their freedom of choice. Yet White argues that "nudging" has some extremely worrisome properties from the point of view of fostering economies in which people are fully participating and responsible agents, able to shape their own destinies based on the opportunities and constraints present in their social environment. For one, the whole idea of nudging assumes that the state is capable of identifying options that can be expected to yield the best outcomes for consumers, even though there is a tremendous amount of heterogeneity among consumers and the state's guesses as to what the future holds have no special claim to accuracy over those of consumers. For another, the understanding of the state as benevolent paternalist ignores realities of government policymaking, in which powerful institutions are able to lobby Congress to produce rules and regulations in which their interests are well-protected. Finally, shifting responsibility for decision-making away from people actually cements any tendencies toward "cognitive flaws" that experts think they detect in static observations of their choices, assuming that people are not willing or able to take responsibility for their own actions and disregarding fundamental concerns about building social environments that promote people's agency, dignity and autonomy. This is an issue to which the book returns in Chapter 12 by Deborah Figart.

Distributional Effects of Downturn

Standard macroeconomic analysis focuses on aggregate economic variables: gross domestic product, inflation, unemployment, business investment, and so forth. Measures of the economic well-being of specific groups—disaggregating, for example, by race, ethnicity, gender, education, region, and other dimensions of socioeconomic diversity—are not separately examined under the assumption that when the economy as a whole is doing well, so too will be the average person. Yet it has long been recognized that business cycles affect different socioeconomic groups differently.[8] Figure 1.3 shows some of the basic business-cycle dynamics related to unemployment, which is of course also a key driver of income, consumption, financial distress, economic insecurity, access to health care, and poverty. Three findings are notable. First, normally when unemployment rises, it rises more for racially and ethnically disadvantaged groups than it does for white non-Hispanics—which is especially concerning because rates of the former are higher to begin with. Thus, for example, in the recent economic downturn, unemployment for non-Hispanic whites rose from a low of 3.8 percent in 2007 to a high of 9.4 percent in 2009, an increase of 5.6 percentage points—while that for blacks rose from a low of 7.7 percent in 2007 to a high of 16.5 percent in 2010, an increase of 8.8 percentage points. Second, in recent recessions unemployment has tended to increase more among men than among women, at least in part because they are more likely to be employed in sectors that differentially contract when the economy turns down (construction, transportation, durable-goods manufacturing). Third, increases in unemployment tend to be much greater among workers with relatively low levels of education. In the most recent recession, the rate for workers who did not complete high school rose by almost 10 percentage points, from a low of 5.8 percent in late 2006 to 15.5 percent in mid-2009, while the rate for college-educated workers rose by only 3.2 percentage points, from 1.8 percent in early 2007 to a high of 5 percent in late 2009. Differential time spent in unemployment has effects that last beyond the end of recession, as the earnings profiles of workers who go through spells of unemployment tend to

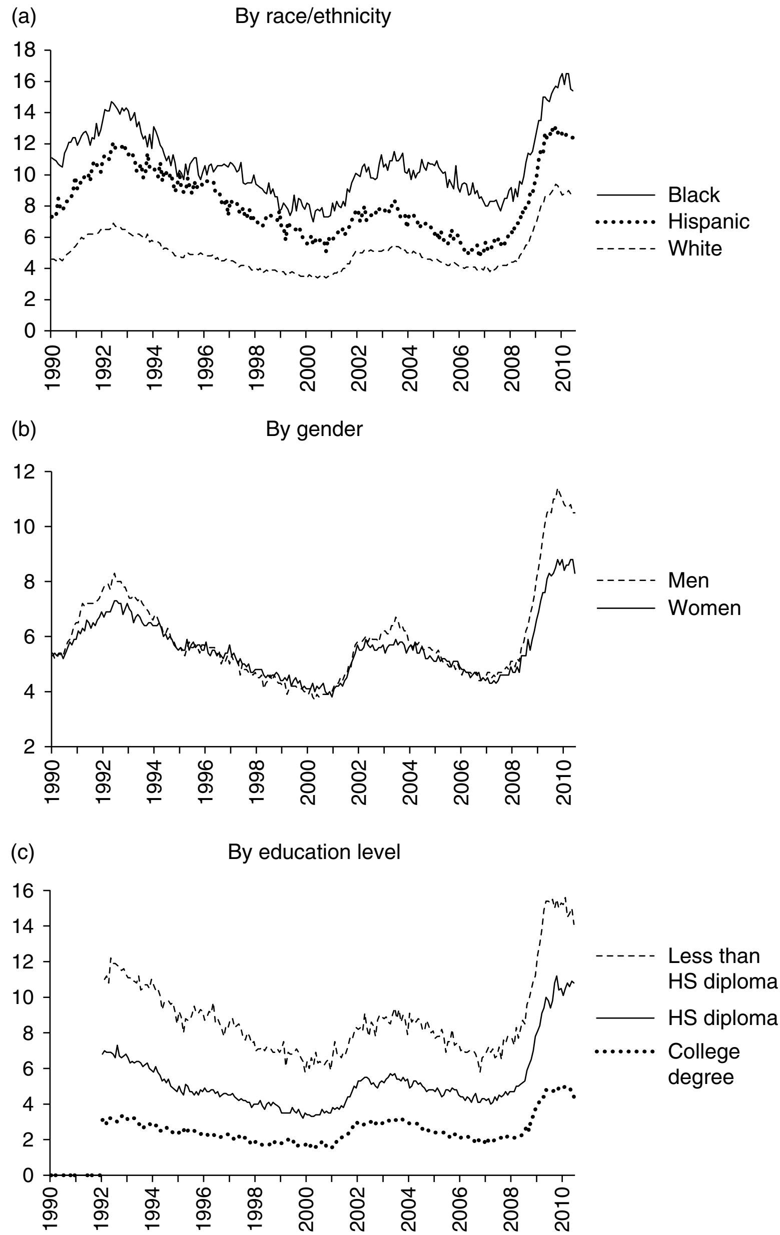

Figure 1.3 Unemployment rates by race/ethnicity, gender, and education (percent)

Source: U.S. Bureau of Labor Statistics. Note: 'White', 'black' and 'Hispanic' are not mutually exclusive categories, as Hispanics can be of any race.

remain persistently below those of equivalent workers who remained continuously employed—an effect known as "scarring" (Ruhm 1991).

And yet, there are also some unique features of the distributional consequences of the 2007–09 downturn, and these are the subject of the chapters in this section. In Chapter 7, Niki Dickerson vonLockette examines factors explaining the relative impact of recessions by race, by comparing labor-market outcomes for black and white men without college educations in the 1980s and 2007–09 recessions. As in the 2007–09 recession, the economic downturn of the early 1980s (actually two back-to-back recessions) was unusually long and severe. A notable difference between the two downturns is that, in the early 1980s, the unemployment rate for black men was more than double that of white men, whereas in 2007–09, the ratio of black to white unemployment was below 2 and falling. Dickerson vonLockette uses data from the 1980, 1990 and 2000 decennial censuses and the 2008 American Community Survey to investigate why the differential effect of recession on black men has been smaller in the 2007–09 recession than in the 1980s contraction. To control for differences in human capital, which are frequently overemphasized in discussions of differential labor-market outcomes by race, she focuses on men without college educations; confining the analysis in this way makes it easier to identify changes in people's labor-market opportunities due to shifts on the demand-side of the labor market, such as the extent of occupational and industrial segregation. It is frequently suggested that black men were especially hard-hit in the 1980s recessions because some of the sectors in which they were concentrated, notably manufacturing, experienced especially large declines in demand. Thus, one possible reason why the differential effect on blacks has been more muted in the present recession would be that their occupational and industrial segregation has fallen since the 1980s. But as Dickerson vonLockette shows, on the contrary, black and white men are no less segregated by industry and occupation than they were in the 1980s and may actually be somewhat more so. What is different in the present recession is that the sectors in which blacks tend to be more concentrated than whites (government, transportation, and entertainment) have contracted less than the sectors in which the opposite was the case (finance and construction). Her analysis underlines the importance of looking at differential outcomes as a matter of differential opportunities, not just differential skills, with opportunities being primarily situated in the metropolitan labor markets in which people live.

In Chapter 8, Cynthia Bansak and Martha Starr examine the distributional consequences of the housing-price bust, which contributed so centrally to the 2007–09 downturn. There has been much debate in recent years about whether the Federal Reserve should have taken action against the housing-price bubble as it was forming. This paper shows that, apart from other reasons for trying to check bubbles as they are forming (Rudebusch 2005), an additional and important one is that risks of letting one inflate and rupture are asymmetrically distributed: if the bubble subsequently bursts, adverse effects fall on a wide range of households, with the most costly and difficult ones (job loss, a spell in poverty, significant troubles with creditors, loss of a home, etc.) tending to fall on people whose economic lives and material living standards are anyway less secure. Using data from the Census Bureau's annual American Community Survey for 2005–08, Bansak and Starr find that (a) in metropolitan areas where housing price bubbles burst, prices slumped more on the lower end of the home-price distribution than at the upper end; (b) declining housing prices have not lowered housing costs for renters in a broad-based way; (c) while homeownership rates have slipped everywhere, some of the largest decreases occurred for black and Hispanic households in metros where bubbles had burst; (d) poverty rates increased in bubble metros between 2007 and 2008, while holding steady elsewhere; and (e) poverty rates may have risen differentially for households of Hispanic origin. Taken together, these findings suggest that declines in key elements of economic well-being have been concentrated among those without good resources for withstanding financial distress.

In Chapter 9, Caren Grown and Emcet Tas look at gender-related dimensions of the recession. In 2009, University of Chicago economist Casey Mulligan caused a splash by referring to the 2007–09 downturn as a "Man-cession," based on the fact that the unemployment rate for men had increased by almost 3 percentage points more than that for women (see Figure 1.3). Numerous papers and blogs since then have explored the question as to whether this means the traditional labor-market advantages of being a man (better jobs, higher pay, better promotion prospects) are now slipping away. Using data from the Bureau of Labor Statistics' Current Population Survey and Current Employment Statistics, Grown and Tas provide a more nuanced analysis, finding a more complex picture of how men and women have fared in the recent downturn. For one, though the unemployment rate for men overall was higher than that for women, the "gender gap" is not found uniformly across socioeconomic groups. For example, there is virtually no gender gap in unemployment for men and women with college educations; it is much smaller for Hispanics and Asians than it is for whites and blacks; and it is much smaller among men and women aged 25 years and older than it is for those 16 to 24. Moreover, unemployment rates among some groups of women are much higher than they are for men overall; notably, for single women maintaining families, unemployment reached a peak of 13 percent in late 2009, compared to the peak for men overall of 11.2 percent. In several other respects, women's labor-market outcomes tracked men's fairly closely during the recession; for example, their average durations of unemployment rose together, and within given sectors, women's rates of job loss were quite similar to those of men. Additionally, although men's inflows into unemployment exceeded those of women, women's inflows into underemployment categories, especially involuntary part-time work, exceeded those of men. Grown and Tas go on to review available evidence on how the federal stimulus package affected men and women; while the evidence is relatively sparse, it suggests that too little support was provided for low- and moderate-income women supporting children on their own, an especially vulnerable group. Altogether, their work suggests that the characterization of the 2007–09 recession as a "man-cession" obscures more than it illuminates about differential impacts across genders of economic downturn.

Social Economy and the Economic Downturn: Communities, Needs and Capabilities

As mentioned above, the traditional dichotomization of state versus market overlooks the multiplicity of different ways in which societies provision themselves and neglects the fact that pro-social actions can be launched by all kinds of institutions and individuals, not just governments. The papers in this section examine some dimensions of the "social economy" response to the downturn in the United States, meaning activities undertaken by collectivities that are neither public nor private for-profit, in the interest of promoting social well-being or some element thereof. Chapter 10 by Martha Starr examines the role of social-economy organizations in alleviating problems of unmet basic needs in the 2007–09 downturn. In recessions, there is typically an increase in unmet needs for food, shelter and health care. While government programs offset these to some extent, and friends and family may also help, an important role is also played by social-economy organizations, that is, private, largely nonprofit organizations relying on donations, grants and volunteer labor to support social welfare in their communities. People question whether social-economy organizations can really begin to offer the kind of support for incomes, consumption, and poverty-reduction that government programs can provide; as J.S. Mill [1909(1848): 969] put it, "Charity almost always does too much or too little: it lavishes its bounty in one place, and leaves people to starve in another." However, as Starr shows through an analysis of the emergency-food system (food pantries, soup kitchens, food banks, etc.), many of the logics via which social-economy organizations operate actually make them very effective in mobilizing resources to offset recessionary increases in unmet needs. These include: strong intrinsic motivation to help others; use of multiple strategies to mobilize goods, labor, and funding; ingenuity and efficiency brought on by chronic insufficiency of resources relative to needs; pursuit of gains from cooperation with other like-minded organizations; and a dominant ethic of care. In this sense, the social economy has done valuable if not necessarily sufficient work in alleviating problems of unmet needs during the downturn. While some view the fragilities of the social economy as underlining the need for more generous government programs to meet basic needs, Starr takes the contrary position that the social economy constitutes a critical reserve of nonmarket, nongovernment values that hold better promise for addressing issues of need and social justice than expanded entitlements. As such, the question is how to reduce fragilities and imbalances in the social economy, where furthering its institutional innovations is likely key.

In Chapter 11, Bruce Pietrykowski depicts the human costs of the economic crisis happening on the ground in Detroit. Detroit's economic crisis started well over a decade ago, as its long-term reliance on the production of consumer durables, primarily automobiles and auto parts, left it highly vulnerable to the intensification of global industrial competition and minor shifts in consumer demand. The recent economic downturn, characterized by massive declines in consumer spending, has wreaked havoc on an already devastated regional economy. The consequences of the decline can be seen in local markets for labor and land: Detroit's official unemployment rate is approaching 30 percent, while fully one-third of all residential property lies vacant or abandoned. In this context, standard economic approaches to job dislocation—such as government-sponsored job training programs or efforts to lure big businesses into the area via tax breaks—just cannot achieve the kind of scale and scope needed to tackle the city's economic decline. Thus, Pietrykowski explores a range of alternative economic models which are, by necessity, taking root in the City of Detroit. Many center on concepts of economic provisioning and are situated in the efforts of local groups to build and sustain movements of ethical consumption and networks of economic solidarity. Of particular interest are developments related to the local production, distribution, preparation, and consumption of food. For example, with land abundant, a multiplicity of urban farming activities have been launched to reinvigorate neighborhood economies, with orientations as diverse as: satisfying households' own consumption needs, supplying schools and other community-based institutions with fresh and healthy food, and/or provisioning restaurants interested in acquiring food from community producers. While Pietrykowski cautions against idealizing local and community-based development strategies, his work makes the clear case that moving "beyond the wasteland" via plural, community-based economic activities could be just as socially beneficial—and probably more economically and environmentally sustainable—than trying to lure for-profit businesses to Detroit to invest and produce for other markets.

Finally, Chapter 12 by Deborah Figart analyzes the argument that building financial literacy would help offset terrible problems of asymmetric knowledge that contributed to the subprime mortgage crisis. Research confirms widespread impressions that many people who took out subprime and other nontraditional mortgages in the boom years had poor understanding of some of the risks they were taking on.[9] Thus, all sorts of federal agencies, large banks and brokerages, credit card companies, and nonprofit foundations have rolled out new programs to help consumers understand how to scrutinize financial products, identify those with low costs and risks that best meet their needs, and structure their spending, saving and borrowing patterns so as to minimize chances of financial distress and to ensure that their consumption needs are sustainably met. While the premise behind these programs that "knowledge is power" has broad-based appeal, Figart points to two critical problems with existing efforts to promote financial literacy. The first concerns the haphazard ways of developing content for these programs and of getting schools and communities to adopt one program or another. Many programs are developed by companies with some interest in getting consumers to "responsibly use" the financial products they offer, with no assurance that the skills and advice they give is in the best interest of the consumer rather than their own. Other programs developed by nonprofit organizations and governments still share the basic assumption that the end-goal of all economic activity is consumption; as such, instead of encouraging people to think broadly about their value systems and helping them devise life plans and financial strategies consistent therewith, they focus narrowly on transmitting skills that would enable people to conform to the neoclassical ideal of the deliberative, forward-looking consumer. Second, existing efforts to promote financial literacy effectively place all burden *on individuals* for making good financial decisions, avoiding unscrupulous actors, attaining financial security, and so forth—either bracketing or assuming away the question of whether government and financial institutions also bear responsibility for maintaining an orderly financial system that enables people to spend, save, and borrow to attain their goals. Figart concludes by laying out key ideas for financial literacy programs that would truly help build people's economic and financial capabilities, including their abilities to analyze and participate in (re)shaping policies and institutions that affect their economic lives.

Notes

1. As of this writing, the National Bureau of Economic Research has not yet declared the official end-date of the recession that started in December 2007, although current thinking is that it ended in the third quarter of 2009 (Reddy 2010).
2. Unemployment statistics from the Bureau of Labor Statistics' Current Population Survey, foreclosure statistics from realtytrac (2009), and poverty and health insurance statistics from the Census Bureau's Annual Social and Economic Supplement to the Current Population Survey.
3. See, for example, the list of 22 causes of the crisis which the federal Financial Crisis Inquiry Commission is tasked with investigating, which pertain overwhelmingly to the legal and regulatory governance of the financial sector [Public Law 111-21 (2009), Section 5].
4. Important works include Colander et al. (2009), Galbraith (2009), Krugman (2009), and Stiglitz (2010). For further discussion, see Chapter 2.
5. On this latter subject, see Hacker (2007).
6. Key works include Wilkinson (1996) and Wilkinson and Pickett (2010).
7. See, for example, Deaton (1992).
8. See, for example, Blank (1989), Cutler and Katz (1991), Spriggs and Williams (2000), and Heintz and Seguino (2010).
9. See, for example, Lacko and Pappalardo (2007).

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Part I

Ethics, Social Responsibility, and Economic Policy

Chapter 2

The Economic Crisis and the Crisis in Economics

George DeMartino

Introduction

In many quarters, it has long been accepted that the discourses economists construct when theorizing do not simply mirror the external world but also define it and influence its course in fundamental ways (Gibson-Graham 1996; Ruccio and Amariglio 2003). But this insight tends to be of little interest to most economists, who hold fast to much more conventional epistemological presumptions. As every economist worth his salt knows, the world out there is what it is, for better or worse. That we might like it to be otherwise—that we might prefer a world in which people acted on altruistic rather than egoistic motivations, say—is of no theoretical relevance. In this account, good theory provides a faithful representation of the world as it is, not as the economist would like it to be. And when two theories seem to do the job equally well, economists are trained to choose that alternative that is most elegant, parsimonious and tractable. Moreover, the economist's epistemology induces the comforting belief that theoretical knowledge improves over time, yielding explanatory models that do a better and better job of capturing the world. This is an epistemology that generates faith in theoretical progress. Hence there is little need to expend time and energy examining the macro-theory of the 1930s when surely the macro-theory of the 1990s has overtaken its predecessor in its explanatory power and verisimilitude.

This way of thinking engenders the belief that the ethical imperatives associated with professional economic practice are rather obvious and even trivial. The ethical economist must do his or her best to advance the science—to extend existing economic models to cover new situations, to test theory against the facts, and to introduce theoretical innovations when existing theory is found to be an inadequate representation of the real world. The ethical entailments of this kind of economic practice comprise principles such as objectivity (rendering the world as it is free of bias or personal convictions), truth-telling (one must not alter the data or misreport one's findings), professional respect for one's colleagues (one must not damage another's research projects) and other very basic and commonsensical dictates. Provided economists live by these rules, they and their profession are to be recognized as meeting whatever professional ethical responsibilities they may face. Indeed, over time this became the official view of the American Economic Association (AEA)'s Executive Committee on the need for professional economic ethics. When asked periodically about the AEA's code of conduct, Coats (1985, 1710–11) reports, "The usual response to enquirers was that the AEA needed no special code of ethics because the canons of correct professional practice were too obvious to require specification."

This view prevailed up until the outbreak of the current global economic crisis. Today, the view of economic theory as a neutral representation of the world beyond and the commonsensical ethical imperatives associated with that perspective are being abandoned at least in part by some of the most prominent economists of our era. The crisis has sparked recognition that what economists do matters in shaping the world that they purport merely to know. Paul Krugman (2009b, 37) put it this way:

> As I see it, the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth . . . the central cause of the profession's failure was the desire for an all-encompassing, intellectually elegant approach that also gave economists a chance to show off their mathematical prowess.

Krugman builds upon this insight to lay substantial blame on the economics profession for contributing to the crisis—not just by failing to anticipate it, but by validating dangerous investor behaviors and obstructing reasonable attempts by government officials to regulate financial institutions and markets. Financial economist Robert Shiller (2009, 16) makes the point even more directly:

> This mania was the product not only of a story about people but also a story about how the economy worked. It was part of a story that all investments in securitised mortgages were safe because those smart people were buying them. . . . *To a remarkable extent we have got into*

> *the current economic and financial crisis because of a wrong economic theory*—an economic theory that itself denied the role of the animal spirits in getting us into manias and panics. (emphasis added)

These arguments suggest correctly that the influence of the economics profession in shaping the world isn't restricted to applied economists who explicitly advocate or oppose economic interventions. Rather, the work of academic economists who never venture forth from the campus, and who view their endeavor as pure theory, also changes that world. Indeed, given the peculiar status hierarchy of the economics profession which values theoretical over applied work, academic economists exert far greater influence on the world than do those economists who dedicate their lives to achieving impact.

That economists change the world about them through their theoretical and not just their applied work suggests that the profession faces challenges of a professional ethical nature that it has historically ignored and even suppressed.[1] Recognition of influence (intended and unintended) implies that the basic list of dos and don'ts that implicitly have guided economists' behavior is woefully inadequate; that the ethical challenges of economic practice are much more complex than we have heretofore believed. Influence over others necessarily entails ethically complex matters—whether it is a teacher's influence over a student, a doctor's influence over a patient, a public health official's influence over the physical well-being of a community, or an economist's influence over the life chances of all those who populate the economy. All of this has been brought into sharp relief during the current crisis. Economists are now beginning to confront the nature of their influence and the depths of their culpability in creating economic freedoms and opportunities, but also economic constraints, vulnerabilities and even trauma.

All of this raises a difficult and yet pressing question: to what degree has the economics profession acted ethically in the fulfillment of its professional responsibilities? In the case of the current global economic crisis, it is now widely understood that economists made important and consequential mistakes. They failed to appreciate the extraordinary risks associated with the new financial instruments and practices that had emerged over the past several decades and that spread rapidly during the 1990s and after, or the consequent need for stricter government supervision of financial markets. No one put it better than former Federal Reserve Chair Alan Greenspan, who in testimony before the U.S. House Committee on Oversight and Government Reform Congress on October 23, 2008 admitted that he made a fundamental error: "I made a mistake in presuming that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders." Speaking of a "once in a century credit tsunami" he continued "[t]hose of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself especially, are in a state of shocked disbelief" (Andrews 2008). But error is inevitable in all of the professions; it arises from the condition of epistemic insufficiency that governs professional practice. Error alone does not imply professional ethical failure. Ascertaining whether the profession failed to meet its ethical duties requires a different kind of evaluation. But how should we make it? What should we look at, and on what basis might we draw the conclusion that the profession met or failed to meet ethical obligations that necessarily attend economic practice?

In what follows I will advance the case that the economics profession did indeed act unethically in the period leading up to the current economic crisis. It needlessly put into jeopardy the economic security of the most vulnerable individuals and communities across the globe, without their consent. This argument presumes that the profession could and should have acted differently—that its behavior was wrong-headed and, ultimately, terribly consequential. Making this case adequately would require a depth of analysis into the meaning of professional ethics and the conduct of the economics profession over the long sweep of its history that I cannot undertake here (but see DeMartino, forthcoming). Instead, I will offer a series of observations, each of which taken individually and all of which taken together represent *prima facie* evidence that our profession comported itself in a manner that fails the test of well-established professional ethical principles.

Financial Liberalization and Maxi-Max

From the 1980s onward mainstream financial economists pressed for financial liberalization in the global South and in the developed economies (Grabel 1996). This prescription involved privatization and deregulation within the financial sector, removal of capital controls, an increase in permissible leveraging, increasing allowance for banks to assess their own riskiness, and so forth (Johnson 2009). In the context of the United States, financial liberalization involved removal of restrictions on financial institutions that were intended to prevent conflicts of interest and systemic risk. The institutional interlinkages and financial innovations that followed outstripped the regulatory apparatuses that were in place to police them.

Economists not only pressed for the removal of existing financial regulation but also resisted new government oversight of the financial assets and market contracts that proliferated from the 1990s onward. Alan Greenspan consistently reassured policymakers and the public about the sufficiency of market mediation to discipline financial markets. In 1998 Greenspan blocked the efforts of Brooksley E. Born, head of the Commodity Futures Trading Commission (CFTC), to regulate derivatives markets. To prevent a repeat regulatory effort, Greenspan then pushed Congress to "strip the CFTC of regulatory authority over derivatives" (Goodman 2008). Treasury Secretary Lawrence Summers also used his substantial influence in the Clinton White House to oppose financial regulation. These and other leading economists believed that the new financial assets shifted risk to those agents most willing and best able to bear it; that on balance financial innovation which allowed for extensive and sophisticated hedging strategies served to make financial markets more complete, robust and safe; and that most steps by the government to stiffen financial regulation would cause harm to the economy while failing to reduce risk. As financial activity became more complex Greenspan became ever more confident. In 2004 he argued that "Not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient" (Greenspan 2004).

Greenspan's faith in the market stemmed in large measure from his conception of the ways in which market mediation generates the trustworthy behavior upon which it depends. Referring nostalgically to an earlier period in U.S. history, when government intervened far less in economic affairs, Greenspan (2005) said:

> Trust as the necessary condition for commerce was particularly evident in freewheeling nineteenth-century America, where reputation became a valued asset. Throughout much of that century, laissez-faire reigned in the United States as elsewhere, and caveat emptor was the prevailing prescription for guarding against wide-open trading practices. In such an environment, a reputation for honest dealing, which many feared was in short supply, was particularly valued. Even those inclined to be less than scrupulous in their personal dealings had to adhere to a more ethical standard in their market transactions, or they risked being driven out of business.

In Greenspan's view government intervention is unwise because it stifles economic innovation and, equally importantly, undermines trust among market actors by diminishing the return to reputation (see Zak 2008). It is also unnecessary not only because the market induces ethical behavior even from rogues, but also because market actors face a disciplining mechanism far wiser, more compelling and efficient than that provided by any government regulators.

I want to suggest that in the case for financial deregulation economists were guided implicitly by a utopian "maxi-max" decision rule. I also claim that application of this principle is entirely inconsistent with any viable body of professional ethics. What, then, is maxi-max?

The maxi-max decision rule instructs a decision-maker to select that policy option that "has of its many possible consequences one which is better than any possible consequence of any other available action" (Nozick 1974, 298). Selection under this rule is driven entirely by a comparison of the best possible outcomes promised by each of the potential courses of action without regard to the probability of that outcome actually materializing. This principle is extraordinarily aggressive since it considers just the one desideratum of maximum possible payoff in policy choice. As a consequence, it is a thoroughly utopian decision rule. Maxi-max recognizes risk explicitly, since it characterizes each policy option as a probability distribution of payoffs. But it then dismisses the matter of risk entirely in policy selection.

On what grounds can we conclude that the economics profession was in the grasp of maxi-max in the position it took on financial deregulation? From the 1990s forward Alan Greenspan and other leading economists resisted government regulation of the new financial instruments and practices on the exclusive grounds that liberalized financial markets promised greater rewards than any alternative regime. The profession's unequivocal advocacy of financial liberalization gave the impression that it would be foolish to forego the efficiency that legislative reticence promised. In this view no other policy regime (even at its best) could yield the benefits that would flow from financial liberalization.[2] Moreover, there was no debate over whether these benefits would indeed materialize, or whether the policy entailed appreciable risk to the economy in the event that it failed (in one respect or another). There was simply no need to consider other regulatory regimes, their respective risk profiles, and the damage that each would induce in the event of its failure. In possession of an available first-best policy option that was fully expected to succeed, all of that seemed beside the point.

Economists do not typically think of themselves as utopian—let alone revolutionary. The language of economic discourse is steeped in explicit recognition of trade-offs that necessarily entail costs and benefits. The economics profession understands itself as advocating marginal improvements in existing affairs that are based on hard-headed calculations of gains and losses, risks and returns. That there are no free lunches is deeply inscribed in neoclassical economic thought. And yet, in one of the most important policy issues of the past quarter century, leading members of the profession abandoned its historic prudence and advocated unequivocally for a policy regime that entailed enormous risk simply on grounds that its promised payoff would exceed that of any other alternative regime, full stop. Absent here was any serious consideration of the risk profiles of aggressive financial liberalization or any of the alternative regulatory regimes that were available. Leading economists simply assumed, absent any investigation into the likelihood of policy failure, that the regime they had reason to advocate would indeed succeed. Hence, consideration of the consequences of policy failure was deemed to be beside the point.

Revolutionaries typically embrace the maxi-max decision rule, to be sure, so convinced are they that they have in hand the uniquely correct blueprint for society that will bring about the utopia that they seek. Were we discussing revolutionary ethics (if there is such a thing) we might conclude that maxi-max is an entirely appropriate decision rule. Moreover, it is entirely appropriate for individuals to embrace maxi-max in deciding their own, private affairs (provided their resulting behaviors do not put others at appreciable risk). But in the world of *professional ethics*, where professionals are given extraordinary authority to make decisions that bear on the rights and welfare of others, maxi-max has no place. As Nozick (1974, 298) argues,

> Everyone who has considered the matter agrees that the maxi-max principle . . . is an insufficiently prudent principle which one would be silly to use in designing institutions. Any society whose institutions are infused by such wild optimism is headed for a fall or, at any rate, the high risk of one makes the society too dangerous to choose to live in.

No established body of professional ethics makes space for maxi-max. Indeed, it is difficult to imagine how it possibly could. To the contrary, professional ethics across the professions emphasize the antithetical principle of harm avoidance—such as medicine's principle of *Primum non nocere*. Moreover, professional ethics today generally emphasize the need for prior informed consent when a professional's actions involve risk to or substantial impact on those whom the professional hopes to serve. In contrast, maxi-max is a principle that entails total indifference to the matter of risk and that does not require prior informed consent (on the paternalistic grounds that the professional knows best). I would suggest that by embracing maxi-max in policy deliberations of the highest significance and impact—in deliberations over the need for and content of financial regulation—the economics profession violated the tenets of any imaginable body of professional economic ethics.

The Allure of Theoretical Elegance

Up until the crisis Greenspan was regarded widely as among the most successful Chairs of the Federal Reserve in U.S. history. His success stemmed in part from his refusal to commit to any particular monetary (or other) rule in conducting bank affairs (Andrews 2005, Mankiw 2006). Instead, he was renowned for gathering relevant data from all promising sources and factoring diverse kinds of information into nuanced judgments about the state of the economy and monetary policy. But in the matter of financial regulation he broke with the pragmatism that marked his leadership of the Federal Reserve to stake out a position that was extraordinarily rigid and even doctrinaire. In this matter his thinking was very much in line with mainstream economic thought, which advocated the efficient market hypothesis (EMH) with striking unanimity despite the recurrence of economic events and growing body of empirical evidence that should have called that hypothesis into question (e.g., Shiller 2003).

Paul Krugman has been particularly caustic in his assessment of the profession's failures leading up to the crisis. As the quotation cited above (taken from a cover essay in the *New York Times Sunday Magazine*) indicates, he blames the profession's fascination with theoretical elegance as the chief cause of its attachment to theoretical constructs that distort rather than elucidate economic events. The EMH in particular seduced mainstream financial and macroeconomists over the past several decades. According to the EMH the market price of an asset at any moment reflects correctly all existing available information regarding its underlying fundamentals. From this perspective, asset price volatility is explained by reference to the arrival of new information that bears on these underlying fundamentals. Even if some market traders are irrational and fail to value assets properly, the market as a whole will correct for any temporary price distortions that result from irrational investing.

The EMH implies that since the liberalized market discovers the correct price of assets on its own there is no basis for government intervention that would restrict the creation of new assets or regulate their exchange. No matter how complex financial assets become, the market will divine their correct price and risk profile owing to the incentive that market actors have in getting it right. Hence Ben Bernanke could claim as late as 2006 that "The management of market risk and credit risk has become increasingly sophisticated.... Banking organizations of all sizes have made substantial strides over the past two decades in their ability to measure and manage risk" (Bernanke 2006b). A consequence of this reasoning is the expectation that asset markets (if not the prices of individual assets) will remain stable over time in part because new information that bears negatively on one asset might have a negligible or even an offsetting effect on other assets. Government regulation that interferes with market price formation can only induce the financial fragility and instability that the regulation is intended to prevent.

The EMH came to inform not just neoclassical financial and macroeconomic theory but also the New Keynesian thought that emerged in the 1980s. We find little attention in New Keynesian theory to asset market bubbles or risks of systemic financial crisis. In Krugman's view such disturbances were off the economists' radar owing to the professional fascination with theoretical elegance and parsimony that led the mainstream in the profession to disregard the recurring financial crises of the past two decades. In the view of Willem Buiter, former Chief Economist at the European Bank for Reconstruction and Development, these trends "have set back by decades serious investigations of aggregate economic behaviour and economic policy-relevant understanding"; as a consequence, most " 'state of the art' academic monetary economics" is, in his view, "useless" (Buiter 2009).

In their advocacy of financial liberalization, then, influential academic and applied economists reflected a general consensus that had long prevailed among mainstream financial and macroeconomists. With the resurgence of neoclassical orthodoxy during the 1970s Keynesian insights about the potential volatility of unregulated financial markets had been put aside by the profession's most prominent members. As Krugman explains, "A general belief that bubbles just don't happen" had swept the profession, including its New Keynesian wing that had "come to dominate teaching and research."

> By 1970 or so...the study of financial markets seemed to have been taken over by Voltaire's Dr. Pangloss, who insisted that we live in the

> best of all possible worlds. Discussion of investor irrationality, of bubbles, of destructive speculation had virtually disappeared from academic discourse. (Krugman 2009b; see also Stiglitz 2009a, b)[3]

The consensus view on the virtues of financial market self-regulation informed the policy stance of Ben Bernanke once he took over as Chair of the Federal Reserve just as it had his predecessor. In the years immediately preceding the crisis Bernanke worried much more about the instabilities that might arise from the behavior of Freddie Mac and Fannie Mae, owing to their status as Government Sponsored-Enterprises (GSEs), than he did about disruptions emanating from unregulated financial institutions. In May of 2006 he spoke of the virtues of "financial innovation and improved risk management" including "securitization, improved hedging instruments and strategies, more liquid markets, greater risk-based pricing, and the data collection and management systems needed to implement such innovations." While recognizing risks associated with financial innovation, he argued that

> these developments, on net, have provided significant benefits. Borrowers have more choices and greater access to credit; lenders and investors are better able to measure and manage risk; and, because of the dispersion of financial risks to those more willing and able to bear them, *the economy and financial system are more resilient.* (Bernanke 2006a, emphasis added)

In June of 2006, Bernanke wrote: "Today, retail lending has become more routinized as banks have become increasingly adept at predicting default risk by applying statistical models to data, such as credit scores" (Bernanke 2006b).[4] In response to a question about whether there was need for increased regulation of hedge funds Bernanke told Congress on July 20, 2006 that

> the best way to achieve good oversight of hedge funds is through market discipline, through the counterparties, through the investors . . . at this point I think that the market discipline has shown its capability of keeping hedge funds well disciplined. . . .[5]

Under these conditions those who continued to harp on the risks of serious economic turmoil were easy to ignore. Among others, the list of dissenters includes Chicago's Raghuram G. Rajan (2005) who presented a prescient paper at a 2005 Kansas City Federal Reserve Bank gathering at Jackson Hole to celebrate the work of Federal

Reserve Chair Alan Greenspan. Rajan argued that financial developments during Greenspan's tenure had made the world far riskier and that financial crisis could be in the offing. In response Lawrence Summers said that he found "the basic, slightly lead-eyed premise of [Mr. Rajan's] paper to be misguided" (Lahart 2009a), while Federal Reserve Governor Donald Kohn "said that for central bankers to enact policies aimed at stemming risk-taking would 'be at odds with the tradition of policy excellence of the person whose era we are examining at this conference' " (Lahart 2009b). The list also includes Yale's Robert Shiller whose warnings about the pending housing crisis were ignored by Federal Reserve and other economists despite the rich empirical work he had done to cement the case, and despite the fact that he had been among the small minority of economists who had correctly identified the bubble in high-tech stocks in the late 1990s; Andrew M. Lo, the director of the MIT Laboratory for Financial Engineering, who presented a paper in 2004 at a National Bureau of Economic Research conference that "warned of the rising systemic risk to financial markets and particularly focused on the potential liquidity, leverage and counterparty risk from hedge funds" (cited in Lohr 2008, 5); Dean Baker, co-director of the Washington-based Center for Economic and Policy Research, who argued consistently from 2004 onward that the housing market was in a bubble; Morgan Stanley's Stephen Roach, who identified a housing bubble as early as 2002 and who in 2004 criticized the Federal Reserve for having become a "cheerleader when financial markets are going to excess" and having pursued "the ultimate moral hazard play that has turned the world into one gigantic hedge fund" (Roach 2004); and New York University's Nouriel Roubini, who argued from 2004 onward that a deep recession and financial crisis were imminent. All of these warnings were summarily dismissed by the vast majority of economists in academia, government and beyond.

Dismissing warnings about potential disaster within its domain is not a luxury that an ethical profession can indulge. Instead, ethical professional conduct requires relentless attention to what might go wrong, what anticipatory steps the profession can take to avert crisis, what might be the consequences for society if things do go wrong, and what remedial actions might be called for in the event that crisis cannot be averted. This is what we would expect of public health officials, who face the responsibility of preventing pandemics, or engineers, who face the responsibility of averting ecological disaster. If they fail to meet this burden, we expect them to suffer consequences.[6] It stands to reason that we should expect the same of our own profession and its members. And in the instant case, we find gross negligence rather than the diligence that professional economic practice requires.

Group Think, Intellectual Bubbles and the Crisis

The professional ethical failure in evidence here attaches to the profession as much as or even more than to individual economists. Leading economists during the period prior to the crisis were by no means pariahs who ignored the best judgments of their profession. Instead, their conduct was fully consistent with established economic orthodoxies. The problem lay with a profession that had by then come to accept such orthodoxies too readily, and to ignore contrary views.

The consensus around the desirability of financial deregulation (and the consequent dismissal of the warnings of the dissenters) in the years preceding the crisis is particularly troubling since economics has had at its disposal for over a century the resources necessary to think carefully about the risks posed by liberalized financial markets (Galbraith 2009). The Marxian tradition features systemic capitalist crisis as one of its central insights and has produced compelling accounts of the major crises of the 20th century. At the same time post-Keynesian thought (including the work of Hyman Minsky and those whose work appears in the *Journal of Post-Keynesian Economics*) has examined at length the crisis tendencies of liberalized financial markets and the need for close government oversight. Moreover, there is by now a well-established historical record of recurring financial bubbles and crises extending back many centuries that has been explored carefully by economic historians and other scholars (Kindleberger 2000; Shiller 2005). Add to this the compelling recent insights from behavioral finance, information economics and agency theory for which several Nobel Prizes have been awarded in recent years (Eichengreen 2009) and which give good reason to worry about liberalized financial markets, and the dire warnings offered by respected economists in the years preceding the crisis, and one must conclude that the mainstream in financial and macroeconomics exhibited extraordinary closed-mindedness in matters where nothing less than open and critical inquiry would pass professional and ethical muster.

In Eichengreen's view, shared by Simon Johnson (2009), the profession was led astray by financial and other inducements to provide powerful market actors with the analyses that they wanted to hear rather than what they should have been told. Other explanations focus on the substantial "psychic costs of nonconformity" which induced a tendency among economists to join rather than buck the intellectual herd that was pronouncing the efficiency and stability of financial markets (Eichengreen 2009). Shiller writes of his own insecurity in raising the idea that housing prices had become unstable during his tenure on the economic advisory panel of the Federal Reserve Bank of New York from 1990 until 2004. He warned about the bubble "very gently and felt vulnerable expressing such quirky views. Deviating too far from consensus leaves one feeling potentially ostracized from the group, with the risk that one may be terminated" (Shiller 2008, 5).

In contrast, Krugman lays much of the blame for conformance across the profession on the advocates of the EMH who resembled "fervent political activists—or members of a cult."

> In this sense efficient-market acolytes were like any other academic movement. But unlike, say, deconstructionist literary theorists, finance professors had an enormous impact on the business world—and not incidentally, some of them made a lot of money. (Krugman 2009a, 11)

Eichengreen concludes that the complicity of the economics profession in the crisis lay not in its failure of imagination, but in its failure of fortitude and independent-mindedness. For Dean Baker, the problem lay in the incentive structure operating within the profession that rewarded conformance and punished dissent:

> Taking issue with the prevailing views in the profession carries enormous risks. Economists who warned of the bubble and the threat it posed to the economy risked ridicule and jeopardized their careers. . . . On the other hand, when the consensus within the profession is wrong, there are no obvious consequences. None of [the economists who denied the existence of the bubble] are losing their jobs. In fact, it is unlikely that many are even missing out on a scheduled promotion as a result of having failed to see the largest financial bubble in the history of the world. (Baker 2009, 72)

Other economists point to particular features of the economics profession as cause for its recent failures. Colander et al. (2009) cite a "misallocation of research efforts" in economics that directed economists away from addressing "the most prevalent needs of society." This view of the culpability of the economics profession is shared by Wall Street insiders. Jeremy Grantham of the institutional asset management company GMO lays much of the blame for the crisis on the doorstep of the economics profession:

> In their desire for mathematical order and elegant models the economic establishment played down the role of bad behavior.... The incredibly inaccurate efficient market theory was believed in totality by many of our financial leaders, and believed in part by almost all. It left our government establishment sitting by confidently, even as a lethally dangerous combination of asset bubbles, lax controls, pernicious incentives and wickedly complicated instruments led to our current plight. (Cited in Nocera 2009, B1, 5)

These arguments and insights compel the conclusion that the economic crisis is a joint product of the behavior of economic actors and of economists which spawned twin, reinforcing bubbles. The profession generated an intellectual bubble that overvalued the virtues of liberalized financial markets and that discounted credible theory and evidence that challenged the euphoria. This intellectual frenzy contributed to and helped to sustain an even more dangerous financial and housing market bubble. In turn, rising asset prices in the context of steady economic growth and rising prosperity substantially increased the professional and psychic costs of intellectual nonconformance among economists. Over the course of the past decade, then, the two herds came to feed off each other's success, sustain each other's optimism, and trample each other's critics. In so doing, they sowed the seeds of their mutual crisis—one borne of short-sightedness and, ultimately, hubris.

Professional Error and Professional Ethics

I must reiterate that the fact that many economists got it wrong in the years leading up to the crisis is not in itself ethically indictable. Professional judgment is always prone to error; if it were not, the field of professional ethics would be much simpler than it is. What is ethically troublesome is why and how it got it so wrong. The profession ignored readily available evidence and theory that should have given it reason to suspect that the EMH could be leading not just the profession but market actors and policymakers into dangerous waters. The group-think that Krugman, Shiller (Cohen 2009) and others explore reflected the disturbing lack of value that the profession places on pluralism. More than other social sciences economics coalesced during the latter half of the 20th century around a predominant approach that posits a particular notion of human behavior and methodological reductionism. Economists who reject this approach are relegated to the professional periphery in terms of where they are likely to be hired and where they can publish, and what influence they can have on public affairs. Even as behavioral economists had begun to achieve standing in the profession, their insights were largely ignored when academic economists turned their attention to the most pressing policy issues.

Closed-mindedness contributed to the profession's hubris—to its failure to recognize its own limitations. It lost sight of the fact that it could commit error that induces substantial harm. The profession suppressed concerns about the risk of failure of its preferred policy regime. It therefore failed to present for the consideration of policy-makers alternative regimes that might have had more congenial risk profiles.

If economics is prone to consequential error, and if at the same time there are inadequate mechanisms ensuring learning and correction before the harm occurs, then the profession is failing to shoulder its ethical burdens. The profession has an obligation to scrutinize its institutional practices, to see how they might induce group-think and hubris and thereby discourage and even penalize independent thinking. Above all else it must consider ways to encourage among its practitioners the virtues of humility and open-mindedness regarding views that contradict their own, and to modulate advocacy of the interventions that they propose. The profession faces the related obligation to sustain pluralism.

Conclusion

The economic crisis has driven home the perhaps uncomfortable point that economists unwittingly shape the world they seek to know. The influence of academic economists on the world implies an ethical burden that they might prefer to ignore. The greater the influence, the more difficult it is to argue that those who restrict themselves to pure theory are spared ethical difficulties. Academic economists might need to attend to the unanticipated effects that their work may induce. The profession faces an obligation to take account of the diverse pathways of its influence—those that are direct and intended and those that are indirect and unintended—when thinking through its professional responsibilities. The profession may face an obligation to emphasize the limits of what it has to offer even and especially in the face of high demand for its services. It may face an obligation to take steps to make it more difficult for the consumers of economic theory—be they market actors or policymakers—to pick and choose just those theoretical insights from economic theory that best square with their objectives while ignoring the rest, to bet everything on this selective reading, and to invoke the authority of the economics profession when they do so.

The last point raises important and difficult questions about the extent and legitimacy of consumer sovereignty in the vital transaction between the provider and consumer of economic theory and advice. Rather than produce research without regard to how it might be used, the academic economist may have an obligation to follow her work out into the world, to do what she can to ensure that the limitations of her work are understood and that it is not employed in ways that cause serious harm to its users and to others. In the view of Colander et al. (2009, 6):

> Researchers have an ethical responsibility to point out to the public when the tool that they developed is misused. It is the responsibility of the researcher to make clear from the outset the limitations and underlying assumptions of his model and warn of the dangers of their mechanic (sic) application.[7]

In the case before us, concerning the culpability of the economics profession in the current global economic crisis, we find little attention by the profession to the dangers of the wares that it peddles. We find instead a herd mentality about the right way to think about financial markets and financial regulation, a dismissal of theory, evidence and argument about the dangers associated with unregulated asset markets, and perhaps most important, a severe overconfidence among the most influential economists about the extent of economic expertise. The economics profession failed to meet its obligations to society by failing to promote and sustain a diversity of views among its members over matters that are terribly complex and important, and by failing to provide market actors, policymakers and citizens with a careful assessment of the potential risks of financial deregulation and the reward-risk profiles of alternative policy regimes. These mistakes were avoidable. The failure of the profession to do so is therefore ethically indictable, especially in light of the extraordinary suffering that has been imposed on vulnerable communities the world over in the wake of a crisis that a blind faith in efficient markets helped to induce.

Notes

1. I explore this and the other matters presented here in greater depth in DeMartino (forthcoming).

2. This discussion suggests a clear linkage between maxi-max and Pareto optimality. When economists undertake Pareto evaluations of policy options that consider only the best possible outcomes of the various policy proposals under review, and then advocate for the Pareto superior policy under the assumption of maximum payoff, they are applying the maxi-max decision rule. That said, the Pareto criteria can be applied independent of maxi-max—not least, by factoring in the range of possible policy outcomes, the payoffs under each of these outcomes, etc. Doing so certainly undermines the elegance and perhaps even the usefulness of the Pareto criteria. Perhaps for that reason, the textbook treatment of policy evaluation tends to ignore these complications, and to embrace implicitly the maxi-max decision rule.
3. It is more accurate to say that the discussion of instability continued within minority traditions in economics, ranging from post-Keynesian to Marxian theory, which the mainstream simply ignored.
4. These themes recur in Bernanke's public statements and Congressional testimony well into 2007. See Bernanke (2007a, 2007b). Even in early summer of 2007, as the subprime mortgage crisis was deepening, Bernanke continued to cite the advantages of market discipline over that of government regulators (Bernanke 2007c).
5. See U.S. House of Representatives (2006, 20–1).
6. As I write, the BP Gulf oil disaster is unfolding. If it comes to light that engineers were culpable in bringing about this crisis, is there any doubt that they will face consequences—legal and professional? In contrast, those economists who contributed significantly to the current economic crisis will face no sanctions of any sort.
7. The essay by Colander et al. (2009) represents one of the best discussions by economists to date of the ways in which the practices of academic economists contributed to the current crisis. In their view economists had the means available to do better: they could and should have warned the public about the dangers associated with the use of economic models for pricing complex financial assets and hedging against market risk. For Colander et al., economists' failure to do so amounts to a violation of their ethical responsibility: the economics profession "failed in its duty to society to provide as much insight as possible into the workings of the economy and in providing warnings about the tools it created" (14). These considerations lead the authors to argue that there is a need for "an ethical code for professional economic scientists" (4).

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Chapter 3

The Financial Crash of 2008: An Illustrative Instance of the Separation of Risk from Reward in American Capitalism

Robert E. Prasch

Risk Shifting in American Capitalism

Finance textbooks and Wall Street publicists never tire of describing senior bankers, executives, and traders as "risk-takers," and in an earlier time, one dominated by the stand-alone speculator and investment bank partnership, this moniker had some validity. But such memories are in stark contrast to today, where those who make speculative trades take substantially fewer risks with their own wealth. More often, they take risks with the wealth of other people, often people they do not know and who are rarely consulted on the matter. As things now stand, it would be more accurate to describe the U.S. financial system as a place where the separation of reward from risk has become a well-instantiated practice (Prasch 2004). With the crash, this systemic separation of risk from reward is no longer a well-concealed aspect (or should we say principle?) of American public policy. The collective and uniform response of the Federal Reserve and the Bush and Obama administrations has been to ensure the rescue and resuscitation of the largest and most problematic financial institutions, while letting "Main Street" and homeowners struggle through on their own. This very public performance simply affirms that the largest banks are now in a position to set the parameters of the official discussions of what can be done (Johnson 2009; Johnson and Kwak 2010; Prasch 2010b; Prins 2009).[1]

None of this is to deny that risky, and as we now know highly leveraged, positions are taken and traded regularly by firms and individuals in complex commodities, bond, asset, and derivative markets. But if we were to step back and take a look at the larger picture, it would be immediately evident that the trading of financial assets among prominent financial institutions accounts for only a portion of the instances in which risk is transferred in a free and fair market. Even setting aside the issues of routine subsidies and periodic bailouts, it is evident that risk is being separated from reward as a normal and routine consequence of the exploitation of unequal bargaining power, asymmetric information and normative standards, unequal access to the political process, and formally legalized protections. As a direct consequence of being negotiated within such unequal frameworks, "free exchange" can and does routinely promote the systemic shifting of risks toward those who cannot afford them, cannot control them, and do not want them. Sadly, those shouldering substantial risks are often unaware of their existence.[2] Finally, it is plausible that the ongoing divorce of risk from reward is contributing to the increased sense of insecurity being experienced by many middle- and working-class voters (Elliott and Atkinson 1998). It does not take much imagination to perceive the political implications of these trends.[3]

Deregulation in general, and financial deregulation in particular, is valued by its beneficiaries in part for its ability to separate risk from reward. Modern financial markets enable management, major shareholders, and other important and well-connected "players" and "insiders" to shift risk away from themselves—that is to say the decision-makers—and onto the shoulders of less informed, misinformed, or outright defrauded stockholders and bondholders, employees, pensioners, and other stakeholders such as suppliers and the general public. These latter groups are almost always less willing, less prepared, and less able to bear such risks. More often than not, they remain unaware that they are being subjected to these risks until it is too late to formulate an organized response.[4]

The Economics of Shifting Risk

Consider the following, a fairly conventional statement that can be found in almost any finance textbook written over the last thirty years:

> These considerations of risk and expected return lead to a general principle of great importance. Investors will make a risky investment only

> if they believe that the expected return justifies the risk. That is the key idea of the risk/return (or more exactly, the risk/expected return) trade-off. *It is simply a fact of life that high expected return and high risk normally go together.* (Kolb and Rodríquez 1992, 10, italics added)

This "canonical" understanding of the relation between risk and reward depends upon four crucial, and almost always unstated, premises: First, the risks in question are well-known and understood by all interested parties. Second, there are "complete markets" for each and every risk. Third, these hypothetical "complete markets" are perfectly competitive. Fourth, these risks will be entirely and voluntarily borne by either (a) those parties whose decisions and activities are creating the risks in question, or (b) another party who has contracted freely and without duress with the first party, either directly or through one or more intermediaries, to accept this risk in exchange for an explicit fee or other consideration.

But what happens to the validity of this canonical perspective in the event that one or more of its crucial, and unstated, assumptions is false? After all, it is not that hard to suggest that these risks are often unknown, and when they are known, may be difficult if not impossible to calculate (a condition that Post-Keynesian economists refer to as "Knightian Uncertainty"). Worse, these risks are often disguised by deliberate misrepresentation supported by an extensive public relations program. The effectiveness of this misrepresentation is often enhanced by drawing upon the assistance and good name of third parties such as law firms, accounting firms, real estate appraisers, and credit-ratings agencies. Misrepresentation achieves its greatest effectiveness when it can depend upon the assistance of a "captured" government agency (Black 2005; Partnoy 1999, 2006).

As an example of this last point, consider the cozy relationship between the Office of Thrift Supervision (OTS) and Washington Mutual (WaMu). As is normal in these instances, the rot starts at the top. Years after the event, former OTS Director John M. Reich was either so ignorant or so bold as to continue to insist to a Congressional investigation that it was a "panic" rather than poor loan quality that caused the demise of WaMu and the largest bank failure in American history. In his words, "This was a liquidity failure, not a capital failure." A *Washington Post* reporter covering the hearings observed that "Lawmakers marveled that Reich was unaware that 90 percent of the home equity loans originated by Washington Mutual were no- or low-documentation mortgages." The same reporter revealed that the committee's doubt as to the underlying quality of WaMu loans was enhanced by the knowledge that "In 2007, only 14 Washington Mutual employees oversaw more than 34,000 third-party brokers" (ElBoghdady 2010).

A well-trained finance professor would claim that if the four assumptions listed proved to be false, and for that reason inhibited profitable exchanges to the detriment of one or more powerful economic interests, it would present a "business opportunity" for any enterprising firm that could devise a means to address it. At first the new firm's profits would be substantial, but this would inspire imitators until profits returned to normal and the formerly false assumption would now become workably true. The paradigmatic instance of private sector innovation enhancing the efficiency of financial markets used to be the rise of the credit-ratings agencies. But, as everyone knows, they are now a marvelous case study in how the prospect of superior profitability can readily suborn a third party in a situation of asymmetric information (for details, see Partnoy 1999, 2006; Prasch 2010a).

It is somewhat irritating to finance professors, well-remunerated bankers, their public relations staff and lobbyists that history, recent experience, and common sense have each and severally failed to support their pet theories (Prasch 2010a). But this awkwardness aside, there remain substantial reasons to suppose that risks will continue to be shifted away from the economically powerful and politically connected, and toward those whose lack of economic clout and political standing leave them with little voice in formulating the rules at the foundation of the nation's markets.[5] While each industry and market might be said to have its own idiosyncrasies and particularities, there exist several broad qualities of American financial markets that, on their own, tend to support and encourage the shifting of risks.

Limited Liability

In American capitalism, decision-makers routinely, if not typically, enjoy legal protection from full responsibility for the risks they generate. This is most apparent when we consider the legally limited liability accorded to shareholders and managers of incorporated firms (Prasch 2004, Ricketts 2010, Eeghan 1997).

In the event that a firm whose liability is limited by law faces a financial debacle, its creditors can demand, at most, the sale or liquidation value of the firm's assets unless they can prove negligence or fraud on the part of the firm's management (a non-trivial task given the generosity with which American courts of appeal are inclined to treat day-to-day incompetence and even malfeasance). From this it follows that the private assets of shareholders and managers, beyond what they have invested in the firm, are legally protected. This arrangement works exactly as it was designed. It "socializes" risk while "privatizing" reward by legally sanctioning the separation of decision-makers from the full consequences of their decisions and actions.

This quality of American law is especially pernicious in unregulated financial markets. The reason is that many financial transactions take the form of money now for a contingent claim to a payment at a later time. For a simple example that illustrates how readily risk can be separated from reward, consider a "shady" insurance company. The customer makes periodic payments to insure against an event, say a fire in their home, that they hope will never occur. The insurance company books the payment. Now, this payment is supposed to cover three pools of money—operating costs, an investable reserve to cover future losses, and profit. If the company can demonstrate to the satisfaction of itself and its regulator that the returns on its portfolio will be sufficiently high, and/or the event(s) that would trigger payments are sufficiently remote, then the firm can set aside a smaller amount as a reserve against future claims. This allows it to treat a larger portion of its revenues as profit with which to pay dividends and—it goes without saying—lavish bonuses for the "genius" of senior management. (I should add that just as profits can be overstated, operating costs can also be padded to include perks such as board meetings in luxurious and exotic locations, etc.). In the event that, at some future period, the estimates made for the return on the portfolio or the amount of payouts turn out to be unrealistic, management can say "Whoops, we're sorry!" and put the firm into bankruptcy.

The simple point is that to the extent that a firm can overstate the value of its portfolio, or understate the expected value of its risks, it will appear to be more successful over the short term, and can pay out higher dividends and bonuses. This risk-enhancing attribute, rather than the absolute size of the bonus pool, is the pernicious element of today's compensation schemes that so greatly increases risk and almost inevitably causes the demise of the financial institution and perhaps even the broader economy (Crotty 2010).[6] Lest anyone think that this is all new, and for that reason was understandably and excusably overlooked these past few years, let us recall that it played an important part in the savings and loans ("S&L") debacle of the 1980s. Then, as now, the firms that grew the fastest and were most celebrated for their "innovation" were the largest failures and therefore the largest charges on the public purse (Black 2005, Akerlof and Romer 1993).[7]

The embedded irresponsibility of the corporate form of business organization has been significantly exacerbated by a relatively recent legal "innovation" called the limited liability partnership (L.L.P.). As intended, it spread quickly to cover partnerships in professions such as law and accounting—fields that formerly, and with good reason, have not traditionally been incorporated. The idea is that fully liable owners provide the public with some protection from the unscrupulous or dishonest performance of persons working in professions that are difficult for clients, regulators, and other interested parties to monitor.

Before we were subjected to this remarkably poor legal innovation, it was understood that one of the few, perhaps only, *effective* checks on the professionalism of brokers, lawyers, accountants, and others was peer review by one's fully liable partners. It is reasonable to suppose, for example, that the decisions and actions of the Chicago head office of Arthur Andersen would have been different if the firm's partners had been each and severally liable for the Houston branch's handling of the Enron account. Thanks to limited liability, former Andersen partners, that is to say those who were the persons best placed to understand and head off the developing fraud and crisis within that firm and its major client, were fully protected. Enron shareholders and pensioners, who we cannot expect to have been highly informed on the corrupt accounting practices of their firm and its auditor, were left in penury.[8]

It should now be evident to everyone that the consequences of allowing investment banks to incorporate, be it as publicly- or privately-held corporations, were as substantial as they were predictable (Prasch 2004, Prins 2009):

> The moment Salomon Brothers demonstrated the potential gains to be had from turning an investment bank into a public corporation and leveraging its balance sheet with exotic risks, the psychological foundations of Wall Street shifted, from trust to blind faith. No investment bank owned by its employees would have leveraged itself 35:1, or bought and held $50 billion in mezzanine CDOs [collateralized debt obligations]. I doubt any partnership would have sought to game the ratings agencies, or leapt into bed with loan sharks, or even allowed mezzanine CDOs to be sold to its customers. The short-term expected gain would not have justified the long-term expected loss. (Lewis 2010, 258–9)

Asymmetric Information

A deeply embedded error of the canonical theory of finance is the belief that all markets are, in essence, the same and therefore governed by the venerable theory of "supply and demand." This is simply false. Markets differ in ways that matter for both their structure and performance. To be specific, a market featuring "spot" contracts for an "inspection" good will have properties different from one in which an "experience good" is traded in a "relational" contract. If I give you a dollar for the pencil you are holding in your hand, that would be a spot contract for an inspection good. By contrast, employment and mortgages are relational contracts. As such it is desirable to know a lot about one's counterparties. The former type of market features a genuinely "arm's length" contract where information plays a minimal role at the time of the contract and later. This, in a word, is the variety of contract so prominently featured in our introductory textbooks. Assets, unlike pencils or coffee cups, are necessarily experience goods because financial contracts typically take the form of a payment today in exchange for a promised payment later under pre-specified conditions. Only in the future will we come to learn its true value.[9]

Relational contracts in general, and financial markets in particular, feature what economists term "asymmetric information." Here one party has privileged access to the specific details or underlying qualities of a given situation while their counterparties do not. For example, a firm's "insiders" may know that its practices have created substantial risks, but "outsiders," either those with whom the firm is dealing, or third parties such as the public at large, may be allowed or even encouraged to substantially underestimate the risks they are undertaking in their relationship(s) with this firm.

Where asymmetric information exists, insiders can benefit if their counterparties or the larger public remain ill-informed about the risks in question. Producers and purveyors of products such as radium, asbestos, and tobacco all evoke this issue here in the United States. The motivation to increase sales, exacerbated by the institutionalized myopia of American firms, ensures that dangerous drugs, treatments, products, and practices are routinely promoted and distributed while known risks are as routinely denied and covered up (Clark 1997, Markowitz and Rosner 2002).

It is now clear that the same behavior typifies American financial markets. Day-trading, "aggressive" and fraudulent accounting, front-running, market-timing, dotcom IPOs, CDOs, CDSs, the "analysis" forthcoming from major investment banking firms, telecom stocks, and myriad other dubious and noxious adventures of the past several decades each and severally affirm that the "sales side" of the market routinely uses its superior knowledge of financial products and markets to misrepresent the qualities of overly risky assets so as to facilitate its goal of selling them to ill-informed, misinformed, and periodically outright-defrauded, customers (Black 2005, Cassidy 2002, Das 2006, Johnson and Kwak 2010, Partnoy 2009).[10]

Asymmetric Behavioral Norms

Another aspect of the financial markets that has greatly facilitated the shifting of risk is an asymmetry between the norms of human beings and the corporations with which they interact. With so many homes now "underwater" across the United States, and with many of the most impacted locales being in states such as California and Arizona that are "no recourse" jurisdictions, we have created a "natural experiment" in the "rationality" of homeowners.[11] What researchers are finding is that most people fail to act in their own self-interest by walking away from onerous mortgages, even though it is perfectly legal and to do so would be overwhelmingly advantageous financially. A variety of indirect and survey evidence suggests that the reason is *not* a failure to understand the incentives. Rather, it is a sense that doing so would be immoral, combined with a sense of "fear, shame, and guilt" in an environment where "these emotional constraints are actively cultivated by the government, financial industry, and other social control agents in order to induce individual homeowners to act in ways that are *against* their own self-interest. . . . " (White 2010, 2).

Given the size of the housing bubble and consequent crash, this "norm asymmetry" between homeowners and financial institutions implies that there are important redistributional consequences at play. Law professor Brent White draws the following conclusions:

> Unlike lenders who seek to maximize profits irrespective of concerns of morality or social responsibility, individual homeowners are encouraged to behave in accordance with social and moral norms requiring that individuals keep promises and honor financial obligations. Thus, individual homeowners tend to ignore market and legal norms under which strategic default might not only be a viable option, but also the wisest financial decision. Lenders, on the other hand, have generally resisted calls to modify underwater mortgages despite the fact that it would be both socially beneficial and morally responsible for them to do so. This norm asymmetry has led to distributional inequalities

> in which individual homeowners shoulder a disproportionate burden from the housing collapse. (White 2010, 4)

Interestingly, early evidence suggests that the owners of high-end homes—that is to say the relatively wealthy—are significantly less constrained by these normative concerns. For that reason they are substantially more inclined to pursue "strategic defaults" than middle-class or working-class mortgagees (Streitfeld 2010).

Externalities

In some instances, the shifting of risk to third parties not present at the negotiation of the original contract is an inherent quality of the activity in question. One might take an "economistic" view and ascribe this problem to a lack of complete markets, and this certainly is the case. To take today's most prominent example, oil giant BP did not pay, and was not expected to pay, Gulf shore fishermen, motel owners, and private homeowners for the "risks" they unknowingly shouldered when it decided to drill the Macombo well. While the issue of "externalities" has long been understood by our colleagues working in environmental economics, there is no reason why a parallel analysis should not be applied to financial markets.

Although it was repeatedly denied by economists under the sway of the canonical theory, most thinking adults understand that financial markets are notoriously subject to externalities. Everyone knows that the failure of a highly interconnected firm or market will have repercussions for people well beyond those who are in the markets—and who never benefited from any upside associated with the speculative risks being created. Jobs, savings, retirement plans, house prices, and the entire payments system can be put at risk in the event that the failure of a prominent financial firm precipitates a sudden and widespread reassessment of the riskiness of a particular class of assets, thereby inducing a flight from other assets with similar qualities. Loans collateralized with these assets are called in, leading to forced sales, and a general collapse of asset prices. Given how little the public, regulators, and—it now appears—prominent Wall Street traders and their own CEOs know about the actual economic circumstances and balance sheets of these firms, much less the large number of firms they deal with on a daily basis, and given the short period of time in which people have to decide to "sell" or "hold" once the flight from an asset begins, it is not at all surprising that such contagions can occur. Moreover, and this is important, such catastrophes are not a consequence of "irrational" or "ill-informed" herd behavior. Rather, these booms and busts are deeply embedded in the incentives and institutions that govern these markets (Bhaduri 2010; Keynes 1936, Ch. 12; Kindleberger 1996; Shiller 2005; Prasch 2010a; Freeland 2010).[12]

In light of the above analysis we might ask whether decision-makers account for the full impact of their actions on the level of systemic risk when they decide to purchase or sell assets, take on more leverage, put together complex derivative deals, and so forth. This is an instance where asking the question serves to answer it:

> . . . financial firms do not price into their activities the costs their losses might impose on society as a whole. Yet those costs are a familiar consequence of financial failures. Not only do many financial dealings resemble the cliché house of cards, but one house going up in flames can spark a financial firestorm as loss of confidence sweeps away the entire street. (Eatwell and Taylor 2000, 17–18)

At one time, these considerations were widely understood. Americans of the New Deal era demanded protection from these risks in the form of regulations and even some prohibitions. For close to 30 years we have been told, by bank executives and their kept politicians and economists, that these protections had to be rolled back because they were "outdated." What we never got was a coherent or compelling argument.[13]

Risk-Bearing and Economic Behavior

In considering behavior toward risk, a fairly conventional analysis employing premises that few would question can derive results contrary to the canonical theory and more in keeping with the world as it is actually experienced. Let us begin with the idea that economic security is what the textbooks refer to as a "normal" good (for non-economist readers, a normal good is one that people are disproportionately inclined to purchase as their incomes rise). It follows that people with higher incomes will purchase greater quantities of items such as insurance, preventative health care, safety and preventative maintenance repairs on their homes and cars, and so forth, than more impecunious persons. Everything we know of the world overwhelmingly supports this proposition.

Second, let us suppose, again drawing upon the facts of experience, that when people are shielded from some or all of the costs of taking an action that is otherwise beneficial to themselves, they will engage in more of it, *ceteris paribus*. Those who make decisions in our largely deregulated financial markets are generally the wealthy, who can be presumed to make arrangements, either through legislation, incorporation, or insurance, to ensure themselves a disproportionate degree of economic security. If shielded from the full consequences of their actions, the wealthy can be expected to draw upon their enhanced sense of security to generate more than the socially desirable quantity of risk, while shifting much of it to others, or to society as a whole. This is simply a restatement of the well-known proposition that people, who are presumed to desire more for less, will tend to "privatize rewards" and "socialize risks" when the opportunity presents itself, unless a sufficiently strong moral sanction or legal penalty is present. While this might sound "radical," it should be a rather mundane observation for anyone with an elementary understanding of economics.[14]

The dynamics sketched above will be enhanced if the poor and downwardly mobile feel obliged to contract into greater than socially desirable levels of risk out of simple desperation. While this may not be a problem in principle, it does exacerbate the tendency of markets to concentrate risks on the shoulders of those who cannot readily afford or manage them. Since we, as a civilized society, are as yet unwilling to see the children of the unfortunate die in the streets, at least some of the costs associated with these risks will be passed along to the broader public.

Conclusion

Today we can survey the consequences of 30 years of widespread deregulation, self-regulation and privatization. What we got in exchange was a vicious series of ever-intensifying bubbles, with this last one followed by a tremendous recession. Our political classes seem to be committed to a bloated, inefficient, and astonishingly bankrupt financial sector. For an encore, we have created a most visible and lasting monument to the idiocy of "self-regulation" in the form of a remarkably polluted Gulf of Mexico. In a range of areas, from finance, to deregulated electricity, to complex telecommunications contracts, Americans are being forced to accept ever-increasing quantities of risk in their multiple roles as consumers, employees and savers.

Exacerbating these risks is the fact that the average family spends substantially more time in waged work than 30 years ago. Hence, even as the complexity and uncertainty of our lives as consumers and savers has risen, the time and energy that we can draw upon to assess and monitor our newfound and ostensibly "free choices" has declined (Prasch 1997). Unsurprisingly, our incapacity to monitor this complexity has worked to the advantage of the unscrupulous, including, but not limited to, mortgage brokers.

Those whose thoughts are not fogged by the canonical teachings of finance economists already know that this increased level of risk is being disproportionately borne by segments of our society that are generally unprepared for, and often unaware of, the risks to which they are being subjected. Under such conditions it is difficult, if not impossible, to imagine how they can "price" these risks, or bargain for adequate compensation in exchange for accepting them. In the "real world," the one in which most of us live, "risk-taking" consumers, employees and investors generally: (1) cannot afford these risks, and (2) cannot control these risks. As a consequence, (3) they do not want these risks.

In light of recent events, the simultaneous increase and shifting of risk has been revealed to be one of the most important, if not dominant, trends of our time. Workers and investors in Enron, Lehman Brothers, Bear Stearns, Washington Mutual, WorldCom, Globalcrossing, and literally hundreds of dotcom firms now understand this (Cassidy 2002, Partnoy 2009). Today we are living in a substantially more "financialized" world (Orhangazi 2008). For most of us, this means that we are living with an increased quantity of risk, the bulk of which is undesired and beyond our control.

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Notes

1. Simon Johnson of MIT points out that while the Bush and Obama Administrations are *correct* to argue that American capitalism needs a functioning financial system if payments are to clear and loans to be made, neither of them has made the case why we need *this particular* financial system.
2. It is true that the size and scope of the risks being shifted are difficult if not impossible to quantify. One reason is that long and variable lags

can occur between the shifting of risk and the downside event occurring, if it does in fact occur. Moreover, these shifts are infrequently the result of an explicit negotiation or market transaction and for that reason are not "priced" effectively, if they are priced at all. Now, it is a long-standing tradition in economics that if something is difficult to quantify the "shadow price" assigned to it must be zero. But in this instance, as with so many others, a lack of easy quantification is insufficient proof that the phenomenon is either not occurring or is unimportant.

3. I have often had occasion to quip that the largest error of Marxian sociology is to presume that the downwardly mobile will be oriented to the left of the political spectrum—causal observation suggests that they are more inclined to the right. For example, Arizona has been in the news recently for passing draconian legislation targeting immigrants and ethnic minorities. So let us look at the situation of homeowners in that state. Just as the financial crisis peaked, in October 2008, 29 percent of Arizona mortgagees owed more on their mortgage than the market value of their house. They were, in the language of banking, "underwater." As of February 2010, fully 51 percent of Arizona mortgagees were underwater. As is well known, in the United States the home has long been the primary vehicle for middle-class saving. It follows that these disappointed expectations will have enormous implications for the decisions that Arizona families will make regarding vacations, college for their kids, and retirement. I should add, since we are on the subject, that the state in the worst condition is Nevada, with 70 percent of mortgages underwater. There we have seen a member of the rightist "tea party" win that state's Republican primary for the U.S. Senate. Nationally, the number for February 2010 is 24 percent (up from 18.3 percent in October 2008). This is a debacle of a monumental scale, especially when it comes paired with headlines describing the bonuses now routinely awarded to the same bankers who created this mess. Perhaps even more remarkably, this debacle is gaining very limited attention from those in our nation's capital who promised us "hope and change." A harsh judgment? Let's examine the facts. Collectively, the estimated gap between the nation's underwater mortgages and zero equity is $806 billion. On February 19, 2010, the Obama Administration announced a "new initiative" in which it would establish a $1.5 billion "innovation fund" to be granted to housing finance agencies in those states where home prices have fallen by 20 percent or more to assist in the development of solutions. Translation—none of this paltry sum is for homeowner relief. The administration promised that these moneys would be governed by "strict transparency and accountability rules," a position that stands in sharp contrast to the approximately $2 trillion that the Fed and the Treasury handed out to the banks with no debate, no strings attached, and no accounting to the public. These facts support the theme of

this chapter. Those who created the risks are being lavishly rewarded, while those who were unaware of them and did not want them are being thrown to the wolves. (All the mortgage data in this paragraph are drawn from reports compiled by First American CoreLogic).

4. Several studies of the characteristics of people who are "risk-averse" have been conducted. There are few surprises in this literature. They generally find that women, those with less income, less wealth, and less schooling "prefer" less risk, *ceteris paribus* (Hartog, Ferrer-i-Carbonell, and Jonker 2002).
5. Dean Baker (2010) has suggested that progressives should retire the term "market fundamentalism." His reasoning is that this phrase incorrectly positions the debate over economic policy as one between the virtues of "free" as opposed to "managed" markets. Baker's point is that free markets are an academic myth, and that a more fruitful line of debate should be over how, and in whose interest, markets are structured and managed (see also Galbraith 2008, Prasch 2011).
6. "If the bonds were dog meat, no one would have said it. Bonus time was soon upon us, and honesty about the quality of our merchandise was trading at a discount" (Lewis 1989, 230).
7. As Michael Lewis nicely dismisses the idiocy of the ideological and regulatory "thinking" that equated growth with success and was ultimately responsible for the bubble and ensuing crash, "The problem wasn't that Lehman Brothers had been allowed to fail. The problem was that Lehman Brothers had been allowed to succeed" (Lewis 2010, 262).
8. Actually, it would be inaccurate to state that the corporate form is ignored in the canonical theory of finance. Rather what is ignored is the attribute of limited liability. It is acknowledged that corporate shares are traded in open markets. An important theorem that follows from this latter observation is that "responsible" corporations can and should maximize shareholder interests by consciously taking on more risky projects than privately-held firms since shareholders can achieve the risk/reward structure they "prefer" by adjusting their portfolios of stocks. Of course, it is assumed, without any explicit discussion, that these additional risks will be exclusively borne by those owning the shares of the firm (Bodie and Merton 2000, 10–13).
9. For a more detailed treatment of these distinctions and their importance for a coherent understanding of markets and market processes, see Prasch (2008, 2010c).
10. That capable and articulate authorities understood and warned the public of these issues is evident if one considers the important book by Henry Kaufman (2000). Despite Kaufman's immense stature as a leading Wall Street economist, this book was criticized for its "pessimism" and for an alleged failure to understand what promoters labeled "the New Economy."

11. In a non-recourse state, lenders are unable to go to court to seek what is called a "deficiency judgment" in the event that a borrower defaults on the loan for their primary residence.
12. While detailed arguments supporting the assertion in the text can be found in the several citations provided, Michael Lewis captures an important psychological element of it with his usual wit: "Everyone wants to be one [a contrarian investor], but no one is, for the sad reason that most investors are scared of looking foolish. Investors do not fear losing money as much as they fear solitude, by which I mean taking risks that others avoid. When they are caught losing money alone, they have no excuse for their mistake, and most investors, like most people, need excuses" (Lewis 1989, 175).
13. Of course, in reality these laws were changed because Wall Street wanted them changed and were willing to make the investments necessary to accomplish that end. For example, as Lewis reports on the case of Lewie Ranieri, who developed the Mortgage Securities Market while working at Salomon Brothers in the early 1980s: "He hired a phalanx of lawyers and lobbyists in Washington to work on legislation to increase the number of potential buyers of mortgage securities. . . . 'I had a team of lawyers trying to change the law on a state-by-state basis. It would have taken two thousand years. That's why I went to Washington. To go over the heads of the states.' 'If Lewie didn't like a law, he'd just have it changed,' explains one of his traders" (Lewis 1989, 100–101).
14. Toward the end of F. Scott Fitzgerald's *The Great Gatsby,* the narrator reflects on the death and destruction wrought by his wealthy protagonists: "I couldn't forgive him [Tom] or like him, but I saw that what he had done was, to him, entirely justified. It was all very careless and confused. They were careless people, Tom and Daisy—they smashed up things and creatures and then retreated back into their money or their vast carelessness, or whatever it was that kept them together, and let other people clean up the mess they had made. . . . " (Fitzgerald 1925, 180–81). To put it bluntly, there are few statements that better capture the ethical standards of societies with an enormously unequal distribution of wealth. One might suggest that a reduction in this "carelessness" is in itself an important argument for a more progressive income and capital gains tax. But that argument is properly the subject of another paper.

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Chapter 4

Rising Inequality and the Financial Crises of 1929 and 2008

Jon D. Wisman and Barton Baker

> *...in any community in which class distinctions are somewhat vague, all canons of reputability and decency, and all standards of consumption, are traced back by insensible gradations to the usages and habits of thoughts of the highest social and pecuniary class.*
>
> (Veblen 1899, 104)

> *Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation.*
>
> (Keynes 1936, 159)

> *The class which has the means of material production at its disposal, has control at the same time over the means of mental production, so that thereby, generally speaking, the ideas of those who lack the means of mental production are subject to it.*
>
> (Marx 1846)

The financial crisis of 2008 has prompted research into its commonalities with that of 1929 and a search for common causes. Most scholars agree that in both instances low interest rates, financial innovation, and laissez-faire ideology supporting lax regulation played important causal roles. While this analysis is not incorrect, it addresses proximate as opposed to more profound underlying causality. At this deeper level, both crises were in part caused by the consequences of dramatically rising inequality.

There were many differences in the economies that led up to the crises of 1929 and 2008. For instance, in 1929, the federal government constituted only about three percent of GDP versus about 22 percent in 2008. Whereas extreme speculation on the eve of the current crisis was most visible in the real estate market, it was in the stock market in the late 1920s. Yet beneath such differences were striking similarities.

In both periods, union membership substantially declined, undermining the bargaining power of workers; taxes on the rich were cut significantly; income and wealth distribution became radically more unequal, forcing households to struggle ever harder to maintain their relative social status, their social respectability; an elite had ever-rising funds to invest, but because everyone else had smaller shares to spend, investment potential was greater in the financial than the production sector, stimulating innovations in credit instruments; and real estate bubbles were critical to both crises.

In both periods, a wealthy elite's possession of an ever-rising share of society's resources enabled their increasing command over political ideology, often diverting attention from economic to cultural issues. As cultural wars divided the electorate in the post-Reagan era, so too the 1920s saw political combat over such issues as evolution, prohibition, immigration, and the increasingly militant Klu Klux Klan.

But of all the similarities, what was causally most important in setting the stage for both crises was a dramatic rise in inequality. Inequality during the preludes to both crises reached unparalleled extremes for the 80-year period in which they occurred. Yet students of both crises have largely ignored any role that rising inequality might have played in rendering the financial sector more vulnerable to systemic dysfunction.[1]

Although the analysis developed in this chapter fits into the Keynesian/Kaleckian underconsumptionist school, it enriches that perspective by drawing upon Thorstein Veblen's theory of consumer behavior and Karl Marx's theory of ideology formation to clarify the manner in which growing inequality prior to both crises made U.S. financial markets prone to dysfunction. Greater inequality generated three dynamics that heightened conditions in which these financial crises might occur. The first is that greater inequality meant that individuals were forced to struggle harder to find ways to consume more to maintain their relative social status, thereby decreasing their saving and augmenting their indebtedness. The second is that holding ever greater income and wealth, an elite flooded financial markets with credit, helping keep interest rates low and encouraging the creation of new credit instruments. The third dynamic is that, as the rich took larger shares of income and wealth, they gained more command over ideology and hence politics. Reducing the size of government, deregulating the economy, and failing to regulate newly evolving credit instruments flowed out of this ideology.

Financial crises have plagued capitalism since its beginning. Recovery was usually quick, mostly because the major consequence was the destruction of a great deal of paper wealth held by an elite. What distinguishes the crises of 1929 and 2008 is that the speculative mania preceding them occurred not only in stock markets, but in real estate markets as well. Real estate markets are more democratic than stock markets in that a larger share of the population participates in ownership, and thus a collapse of a speculative bubble in real estate has consequences that are far greater and potentially far longer lasting. Real estate ownership also possesses a social characteristic that is special: for most households it constitutes not only the most important store of wealth, but also the most important symbol of social status.

Rising Inequality

Since the Civil War, there have been three major explosions in inequality: the first between the end of the Civil War until about 1900; the second between World War I and the late 1920s; and the last between the 1970s and at least 2008. Both of the latter two ended in severe crises.

The periods leading up to both crises appeared to be highly prosperous. Between 1922 and 1929, real GNP grew at an average annual rate of 4.7 percent and unemployment averaged 3.7 percent (White 1990, 69). Between 1993 and 2007, real GDP grew at an average of 3.3 percent, and unemployment averaged 5.2 percent.[2] However, in both periods productivity gains outpaced wages, with important distributional consequences. As Long noted, “So large is labor’s share of national income that any substantial disparity between productivity and real wages would exert great impact on the other shares—either largely expropriating them or presenting them with huge windfalls” (1960, 112). Accordingly, the share of total income received by the richest five percent of the population increased from 24.3 percent in 1919 to 33.5 percent in 1929. The disposable income of the top one percent of taxpayers rose 63 percent (Livingston 2009, 38). The number of millionaires increased from 7,000 in 1922 to 30,000 in 1929 (Phillips 2002, 11). The real prosperity of the 1920s was reserved for those residing in the top of the income scale (Bernstein 1966, Stricker 1985). Contributing to

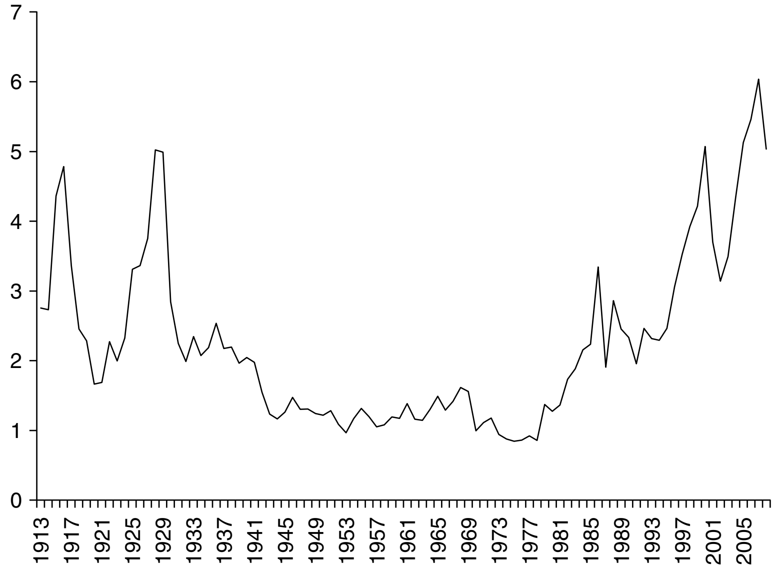

Figure 4.1 Income share of the top 0.01% of households, 1913–2008

Source: Saez (2010). Income is the sum of all items reported on tax returns (wages and salaries, pensions received, profits from businesses, capital income such as dividends, interest, or rents, and realized capital gains) before individual income taxes. It excludes government transfers such as Social Security or unemployment benefits.

this heightened inequality were tax "reforms" that reduced corporate taxes and lowered the maximum personal income tax rate from 65 to 32 percent (Sobel 1968, 52–53).

Similarly, real disposable income declined for wage earners in the three decades leading up to 2008. Average weekly earnings (in 1982 dollars) declined from \$331 in 1973 to \$275 in 2005, greatly lagging behind productivity gains (Miringoff and Opdyke 2008, 226). What is especially striking about the two periods is the dramatically larger shares of income and wealth accruing to the ultrawealthy, especially the top one-hundredth of one percent (see Figure 4.1). Their income shares soared from about 1.7 to 5 percent in the first period, and from about 0.9 to 6 percent in the second.

Rising Inequality and the Struggle for Status Security

In the United States, since colonial times, there has been a widespread belief that vertical mobility is readily possible. Consequently, Americans have generally felt responsible for their own social status.

Through adequate dedication and effort, anyone can move up, even to the very highest rungs of social status. One's social status is not given, but earned.

However, how hard one works in modern societies is generally not directly observable. What more readily catches attention is how much one can consume, which can stand, more or less, as a proxy for how hard one has worked. Thus, because Americans believe they are individually responsible for their own social standing, they feel strongly compelled to demonstrate status through consumption. Greater inequality means that consumers must stretch further to move up, or even maintain their relative social standing.

An attempt to maintain or increase social standing through consumption is what Veblen meant by conspicuous consumption. His theory of consumer behavior is founded upon the fact that social status is critically important to people and thus strongly affects their behavior. Ultimately underpinning social status or respectability is the need for self-esteem or self-respect, what John Rawls suggested to be "perhaps the most important primary good," such that without it nothing else has much value (1971, 440).

Where there is a strong belief that vertical mobility is possible, a substantial increase in inequality could be expected to prompt households to respond in one or more of three ways to maintain social standing: consume more and thus save less; become more indebted; or increase work hours. As the evidence presented below demonstrates, as a whole, U.S. households did two of the three during the 1920s and all three during the three decades leading up to 2008 as inequality increased.

Automobiles, Houses, and Social Status

The automobile industry expanded dramatically from the very beginning of the century up until 1929, when over four million vehicles were produced, a level not attained again until 1949. Two of every three families owned cars by 1929 (Livingston 1994, 108).

Arguably, no single new consumer good had heretofore more transformed society than the automobile. Not only was the automobile a symbol of status, it also helped fuel a housing boom by making suburban living more viable. Because suburban land was less expensive, housing could be in individual units as opposed to the multi-unit apartment buildings on more expensive in-town land. A detached house has far greater potential for revealing status than units encased within an apartment complex.

The importance of the automobile and free-standing houses as status symbols is such that both played critical roles in the struggle for status stability as inequality rose prior to both crises. The fundamental reason, as Wilkinson and Pickett point out, is that "research confirms that the tendency to look for goods which confer status and prestige is indeed stronger for things which are more visible to others" (2009, 225).

During the 1920s, as the wealthy took ever larger shares of total income, they bought ever more expensive houses, vacation properties, automobiles, country club memberships and other luxury items.[3] Automobiles made possible the dramatic expansion of private playgrounds for the rich—so-called country clubs. The real estate boom was especially robust in vacation facilities such as hotels, tourist cottages, and motor courts (Grebler, et. al. 1956). This put intense pressure on all with lower incomes to consume more to maintain their relative social standing.[4]

The same basic scenario played out again over the three decades of rising inequality prior to the crisis of 2008. The struggle to keep up was especially intense in housing. As those at the pinnacle of wealth and income competed among themselves for status, they bought and had constructed ever-larger mansions, thereby degrading the status quality of homes owned or occupied by everyone beneath them. Because houses and cars are principal symbols of status, there was an explosion in the consumption of so-called McMansions and extremely expensive cars. In face of the intense competition to keep up, not surprisingly, a February 2008 Pew survey found that "the proportion of wealthy Americans who say they are very satisfied with their housing and cars . . . has declined considerably since 2001" (Pew Research Center 2008). As the wealthiest Americans received ever-larger income shares and increased their consumption more or less proportionately, they reduced the subjective value of consumption levels below them.[5]

As inequality dramatically increased, the struggle by households to maintain their relative status resulted in reduced saving,[6] greater indebtedness, and prior to 2008, more work hours for households. Personal saving as a percent of disposable income declined from 6.4 percent in the 1898–1916 period to 3.8 percent in the 1922–1929 period (Olney 1991, 48). In the decades before 2008, it fell from 10.4 percent in 1980–84, to 7.2 percent in 1985–89, to 6.4 percent in 1990–94, to 4.6 percent in 1995–99, to 3.2 percent in 2000–04, and to 1.9 percent in 2005 and 2006.

In their struggle to maintain their relative status in face of rising inequality, Americans became more indebted. Debt as a percent of income increased from 4.64 percent in 1919 to 9.34 percent in 1929 (Olney 1991, 88–89). Total consumer debt, which was $3 billion in 1920, rose to $7.2 billion by 1929 (Bernstein 1998, 194).[7] In the decades prior to 2008, average consumer household debt as a percent of income increased from 88 in 1989 to 150 in 2007 (Survey of Consumer Finances). Although this increased indebtedness held for households in all income quintiles, not unexpectedly, debt increased more for lower income groups.

This rise in indebtedness in both periods fits the Veblenian hypothesis that in a society in which vertical mobility is believed to be highly fluid, increasing gaps in income all along the spectrum stimulate everyone to struggle harder to meet their consumption status targets,[8] as those at the very top compete among themselves for the very pinnacle of status.[9]

A third possible response of households in their struggle to maintain their relative social standing in the face of rising inequality is to work longer hours. Although the work week continued its contraction during the 1920s, Bernstein notes that "New expectations regarding appropriate family income levels . . . encouraged more women to enter the labor market" (1998, 195). In the later period, the increase in work hours is more striking. As inequality rose dramatically between 1970 and 2002, work hours per capita rose 20 percent in the U.S. By contrast, in the European Union where income inequality increased far less, work hours fell 12 percent (OECD 2004, Chapter 1).

Inequality and Speculative Excess

Productivity gains significantly outpaced wage gains in the periods preceding both crises, resulting in labor's share of total income declining as that of capital increased. Despite a drop in the share of income of those with the highest marginal propensity to consume, growth continued in a positive direction. In both periods, economic growth was, in Kalecki's terms, profit-led as opposed to wage-led.

Lagging wages during the 1920s were due in part to technological innovations that were predominantly labor-saving and concentrated in manufacturing, causing a shift in demand for labor away from unskilled toward more skilled labor.[10] Low-skilled assembly-line workers were being replaced by labor-saving capital while the demand for more skilled workers such as machine repairmen increased, resulting in lower wages for the former relative to the latter (Hall and Ferguson 1998, 21).[11] Although total manufacturing output increased by 64 percent during the decade, the total number of workers in the sector remained almost constant (Stricker 1983–84). Consequently, the share of wages in manufacturing revenues declined from 52 percent in 1922 to 43 percent in 1929.[12] With prices and wages fairly stable, increasing productivity flowed predominantly to corporate profits, increasing them 62 percent, enabling dividends to double.[13] The result was that the disposable income of the richest one percent of the population rose by 63 percent (Livingston 1994, 114–15).

Similarly, in the three decades preceding 2008, wages lagged due to labor-displacing innovations, as well as increasing international trade that exported significant numbers of manufacturing jobs.[14]

During the 1920s, and the three decades preceding the financial crisis of 2008, the increased share of income and wealth accruing to the elite was far greater than could readily be spent, even on the most lavish consumption.[15] Thus in both periods an elite had additional saving, and they and their money managers sought to place these increased assets to maximum effect. But given the fact that those who spend most or all of their income had a smaller share of total income, profitable investment potential in the real economy was limited.[16] As a result, funds flowed into the financial sector, where they increased employment by 400,000 between 1925 and 1929 (Stricker 1983–84, 53).

Although new consumer durable goods such as automobiles, refrigerators, electric irons, and radios were driving forces for much of the economic dynamism of the early decades of the twentieth century, rapidly rising inequality during the 1920s constrained the demand for these products. Whereas installment credit permitted consumers to continue increasing their purchases, rising indebtedness meant that this would ultimately be limited by creditworthiness. As Stricker has put it, "Consumption-demand lagged behind potential output of consumption goods, and only installment credit and upper-class consumption smoothed over that problem for a while" (1983–84, 55). In addition, robust increases in productivity further reduced the need to invest in these industries. Investment in plant and equipment declined from $15.5 billion in 1926 to about $14.5 billion annually over the next three years (Stricker 1983–84, 51). Investment in construction also declined in the late 1920s (Stricker 1983–84, 52).

In 1970, the labor share comprised 60 percent of gross domestic income while capital received 24 percent. In 2006, labor's share was 50 percent and capital's 29 percent according to the U.S. Bureau of Economic Analysis. The resulting inequality meant that an elite had additional saving, and they and their money managers aimed to invest these increased assets at high returns. However, because households that consume most or all of their income received smaller shares of total income, fewer profitable outlets for investment existed in the real economy. In his memoirs, Alan Greenspan took note of this lack of profitable investment outlets: "intended investment in the United States has been lagging in recent years . . . presumably for lack of new investment opportunities" (2007, 387).

In the six years preceding the 2008 crisis, firms were investing less than their retained earnings—the longest period of such business behavior since the Second World War—even as corporate profits as a share of national income nearly doubled. But these profits soared especially in the financial sector. Whereas financial sector profits have generally constituted about 10–15 percent of total corporate profit, they jumped to 40 percent in 2007 (Stiglitz 2008, 36). In response to this profit shift, the finance, insurance, and real estate sector rose from 14.9 percent to 20.6 percent of GDP between 1974 and 2004 (President of the United States 2006, Table B12, 296–97). Major manufacturing firms such as General Motors, Ford, and General Electric developed increasingly powerful financial departments. By 2000, General Electric received more income from financial transactions than from manufacturing. This shift from the productive to the financial sector also shows up in compensation. Average compensation in the financial sector, which was close to parity with that of domestic private industries between 1948 and 1982, was 181 percent higher by 2007 (Johnson 2009).

The financial crisis of 2008 was able to sneak up on the economy because the dominant focus was on surface reality; on the fact, for instance, that between 1991 and 2006 output growth averaged 3.22 percent and inflation never went above four percent. However, beneath the surface, dramatically rising inequality was shifting investment from production to finance and speculation.

Prior to both crises, speculative excesses sequentially occurred in two different sectors, albeit in reverse order. In the 1920s, a speculative boom in real estate crashed three years before the stock market crash. In the most recent crisis, a stock market boom, fueled by a high tech craze, crashed before real estate collapsed six years later.

Speculative Fever Leading Up to 1929

Before World War I, homes were often financed by borrowing from family and friends. But after World War I, households turned increasingly toward borrowing from financial institutions that were flush with assets and thus offering attractive credit conditions. Mortgage lending by financial institutions increased by 55 percent between 1922 and 1925, helping fuel a real estate bubble.

The bubble was pricked by the severe September 1926 hurricane, causing widespread devastation in Florida where the boom had been most robust (Galbraith 1954). Housing prices that had soared about 20 percent in the early 1920s, declined by about 10 percent before the stock market crash.

Following the collapse of the real estate market, investment funds flowed more aggressively into the stock market, fueled in part by the explosion of investment trusts from about 40 in 1921 to more than 750 in 1929 (Carosso 1970). Toward the end of the 1920s, trusts came to hold the stocks of other leveraged trusts, creating a Ponzi-like structure. Galbraith noted that "In 1927 the trusts sold to the public about $400,000,000 worth of securities; in 1929 they marketed an estimated three billions' worth" (1954, 49–50).[17]

In the last few years before the crash, rising interest rates prompted an explosion in loans by corporations to brokers who were able to command higher returns on margin loans to speculators. Hall and Ferguson note that "Loans to brokers totaled $7.63 billion in 1924 and then rose to $26.53 billion by 1929 . . . while weekly rates on margin loans averaged 8.56 percent . . . individuals were [receiving] dividends yields averaging 2.92 percent" (1998, 24–25).[18]

Speculative Fever Leading Up to 2008

The relative lack of new investment opportunities in the real economy prior to 2008 created a premium for financial entrepreneurs devising new financial investment instruments. Traditionally, banks that originated loans held them until maturity, providing good cause to scrutinize well the creditworthiness of the borrowers. What changed is that financial entities began to buy up mortgages and credit card debt and then package them into bonds backed by the monthly payments of the mortgage borrowers and credit card holders. Between 1980 and 2000, this securitized debt expanded 50-fold, whereas bank loans expanded 3.7-fold. By the end of 2007, two-thirds of all private U.S. debt passed through Wall Street (Wilmers 2009, A19). Although banks no longer needed to be as cautious as to borrowers' credit risk, "securitization" was widely believed to strengthen the financial system by spreading risk more broadly.

These new tools encouraged more and more wealth to be held in the form of financial assets. Along with the booming high tech stocks of the late 1990s, financial assets seemed the most promising way to make one's wealth grow. Indeed, such instruments as hedge funds seemed a low risk alternative or complement to the sizzling tech stock market.

Nevertheless, with more wealth in the hands of those with less to lose from risky investments, the total amount of wealth held in stocks as a share of total assets more than doubled from 1983 to the crash in 2001 (Wolff 2004, 11). By holding more wealth in the form of stocks, investors scrambled for ever-higher returns from these investments, generating the tech bubble of the late 1990s. While the bursting of this bubble did have some repercussions on the real sector, because the bubble was mostly limited to the stock market, its impact was primarily felt by those in higher income brackets. In addition, an expanding housing market continued to grow through the bursting of the tech bubble, tempering the severity of the 2001 recession. More and more wealth was redirected into real estate. Between 2001 and 2007, the market value of residential property went up as a percentage of total assets (Bucks et al. 2009, A28).

With a plethora of credit fueled by expansionary monetary policy, inflow of foreign monies,[19] and greater use of financial instruments, financial institutions sought out less credit-worthy customers, with these loans securitized and sold. Lower-income households were sold sub-prime mortgages to purchase housing at increasingly inflated prices. Mortgage lenders saw great short-term gain potential in these skyrocketing housing prices. But when low-income borrowers could not make their mortgage payments, the collapse was assured.[20]

What made the crisis of 2008 severe was the breadth of participation. Whereas the percentage of households holding equity in their homes had remained at about 64 percent between 1975 and 1995, this figure stood at over 69 percent by 2008. In a highly deregulated environment, as an elite poured much of its increasing share of income and wealth into the real estate market, an extreme speculator's market evolved (Bucks et al. 2009, A29).

A Richer Elite's Heightened Command of Ideology

Given the complexity of shifts in ideology, it is understandable that there would be no clear consensus as to why the political pendulum swung dramatically toward laissez-faire ideology between

World War I and 1929 and in the three decades leading up to 2008. Nevertheless, some things stand out. In the first period, the ease with which labor's failure to fulfill its informal wartime 'no strike' pledge was depicted as unpatriotic at a time when the Russian Bolsheviks were introducing an alternative to capitalism. In a "Red Scare" environment, labor's struggles were increasingly portrayed as part of a communist conspiracy, while business interests embarked on a campaign to demonstrate the patriotism of business and the dangers inherent in labor's intransigence (Watts 1991).

In the more recent shift toward laissez-faire ideology, the fact that stagflation delegitimated Keynesian economics enabled the right to nurture and draw upon a virulent strain of neoclassical economics in the form of supply-side economics. Also noteworthy was the loss of gold backing of the dollar and its devaluation, loss of the Vietnam War, and presumed lax discipline and rising moral degeneracy, as evidenced by sexual promiscuity, sloppy attire, and drugs.

Reinforcing these ideological shifts in both periods was the fact that rising inequality meant that the very rich had more resources with which to influence public opinion and policy. Different income and wealth groups have different interests and these interests are captured in ideologies that compete in the public sphere. The generation and dissemination of ideology require resources, and thus the larger share of income and wealth accruing to the wealthy was destined to have ideological and political consequences.

With superior education and increasing resources, it is understandable that the rich would progressively learn to craft their self-serving ideologies so that they become ever-more convincing to a majority of the electorate.[21] Their disproportionate control over the media, educational institutions and think tanks makes this outcome inevitable. As they received ever-larger shares of national wealth and income, this process was sped up. Research reveals that their expenditures on creating and disseminating ideology yield high returns (Glaeser 2006).

The Surge of Laissez-Faire Ideology during the 1920s

The election of 1920 returned control of the federal government to the Republican party, such that "Business-oriented Republicans dominated national politics and lobbying efforts in Congress" (Edsforth 1998, 246), claiming that the American free-enterprise system promoted the values of "social harmony, freedom, democracy, the family, the church, and patriotism." Advocates of "government regulation of the affairs of business" were characterized as subversive (Carey 1995, 27). In an anti-union climate, the courts issued as many anti-labor injunctions during the 1920s as during the entire period from 1880 to 1920 (Bernstein 1966, 2000). The Supreme Court ruled minimum wage legislation in the District of Columbia unconstitutional in 1923. Undergirding these decisions was the doctrine of "freedom of contract." The right of labor to organize was virtually nonexistent and radical organizations were repressed (Edsforth 1998, 247).

A new media technology, the radio, greatly assisted the dissemination of ideology. The first regular radio broadcast took place in November 1920. By 1923 more than 500 radio stations operated in the U.S. and 550,000 radio sets were sold that year. In 1928, 12 million sets catered to 40 million listeners (Blanning 2008, 204–05).

So completely did business dominate the climate of opinion during the 1920s that Roger Babson, a powerful investment advisor and founder of Babson College, claimed that it had "the press, the pulpit and the schools" (cited in Cochran and Miller 1942, 343–44).

The Resurgence of Laissez-Faire Ideology Prior to 2008

During the three decades leading up to 2008, the media—newsprint, television, and radio—became increasingly concentrated in the hands of a few megacorporations, due in significant part to deregulation. For instance, the number of newspapers controlled by chains went up significantly as a result of relaxed ownership regulations (McPherson 2008, 165). Blethen notes that "The majority of our media are controlled by just five companies [such that] [a]bout one-third of the population now listens to radio stations owned by a single company. . . . The 1996 deregulation of radio virtually ended local ownership in that medium" (2004, B7). Increased corporate media concentration served to restrict criticisms of laissez-faire ideology and the corporate power structure.

An important component of the increasing influence of conservative, free-market ideology was the proliferation and empowerment of conservative think tanks such that they came to outnumber their liberal counterparts by a ratio of two to one (Rich 2004, 206). By 2006 the Heritage Foundation alone had larger expenses than the largest four liberal think tanks combined. Corporate influence over higher education also dramatically increased (Perelman 2002, Washburn 2005).

In addition to greater support from think tanks and lobbyists, from the 1970s onward, academic economists provided increasing support to free-market ideology, thereby lending support to right-wing policies, even when such was not their intent. The mainstream economic canon became generally supportive of unfettered and thus unregulated markets, even when the consequence was greater inequality.[22]

Because of an elite's increased command over ideology, the losers—the overwhelming majority of Americans—could not use the political process to stop the super-rich rip-off. Through the democratic process, in principle, they could have forced the creation of compensatory measures to relieve workers harmed by technological change or international trade. Taxes could have been restructured in their favor, and public services that benefit them could have been vastly expanded and improved. However, an elite's increased control over the ideology infrastructure resulted in the majority buying into the ideology of the rich that such measures would not be to their own benefit.[23] As former chief economist of the International Monetary Fund, Simon Johnson, put it, "...the American financial industry gained political power by amassing a kind of cultural capital—a belief system...[such that] the attitude took hold that what was good for Wall Street was good for the country....Faith in free financial markets grew into conventional wisdom—trumpeted on the editorial pages of the *Wall Street Journal* and on the floor of Congress" (2009).

Final Reflections

During the 1920s and the three decades prior to 2008, concern about rising inequality was widely dismissed as either irrelevant or missing the economic dynamism that inequality generates.[24] Its irrelevance, much of mainstream economics insisted, was that if everyone is becoming materially better off, the size of shares is unimportant.

A broader understanding of the scope of what constitutes economic phenomena, however, reveals the myriad ways in which inequality is central to economic processes and even, as this study demonstrates, how its dynamics can set the stage for severe systemic dysfunction. Veblen's theory of consumer behavior reveals how rising inequality generates a struggle to maintain social respectability through augmented consumption. A Keynesian/Kaleckian perspective reveals how rising inequality impairs aggregate demand and redirects investment away from the real economy into financial speculation. Marx's theory of ideology shows how rising inequality enables an elite to gain increasing control over economic and political ideology.

The crisis of 1929 marked a turning point, reversing rising inequality, and ushering in roughly four decades of democratically-driven policies that significantly lessened inequality and made possible what many consider a "golden age" of U.S. capitalism following World War Two. Might the crisis of 2008 promise to have similar long-run distributional and growth-dynamic consequences? Perhaps. As Milton Friedman put it, "Only a crisis—actual or perceived—produces real change" (1982, ix).

Notes

1. A glance at highly influential treatises on the Great Depression, e.g., Bernanke 2000, and Temin 1976, 1991, finds no mention of a role for inequality in the generation of that crisis. A few exceptions can be found among more heterodox economists, e.g., Hughes 1987, Faulkner 1960, Potter 1974, Livingston 1994, and Stricker 1983–84.
2. Data from the U.S. Bureau of Economic Analysis and Bureau of Labor Statistics.
3. Business spending on advertising increased from $2.28 billion in 1919 to $3.43 billion in 1929 (Olney 1991, 137), keeping the consumption practices of the superwealthy ever on display.
4. "Shoestring mortgages" enabled property to be bought on margin. The expansion of such credit instruments unhinged the traditional relationship between income and spending (Olney 1991, 130–1).
5. A "free-to-choose" interpretation does not adequately capture the dynamics of this intensified struggle. People do, of course, choose. However, as Robert Frank has noted, their choices are socially constrained:

    > Increased spending at the top of the income distribution has not only imposed psychological costs on families in the middle, it has also raised the cost of achieving many basic goals. Few middle-income parents, for example, would be comfortable knowing that their children were attending below-average schools. Yet the amount that any given family must spend to avoid that outcome depends strongly on the amounts that others spend. . . . [Moreover], people cannot send their children to a public school of even average quality if they buy a home in a school district in which house prices are well below average (2000, 258).
6. The argument set forth here is directly opposite that of Keynes (1936, 372–5). For Keynes, an increase in inequality is expected to increase saving since wealthier households have higher marginal propensities to save than do the less well off. What Keynes failed to take into account is the manner in which rising inequality pressures all households beneath the top to increase consumption to maintain their relative social status. For an extended discussion of Veblen's theory of consumer behavior applied to U.S. saving behavior, see Brown 2008; Wisman 2009.

7. Calder notes that "By 1930, installment credit financed the sales of 60–75 percent of automobiles, 80–90 percent of furniture, 75 percent of washing machines, 65 percent of vacuum cleaners, 18–25 percent of jewelry, 75 percent of radio sets, and 80 percent of phonographs" (1999, 201).
8. Wenning (2008) notes that much of the debt taken on between 2000 and 2007 was spent on SUVs, huge TVs, granite countertops, and other luxury goods. Increased availability of credit instruments such as credit cards and home equity loans greatly facilitated this emulative consumption (Scott 2007).
9. Supporting this relationship between inequality and indebtedness, Frank (2007) has found that in those parts of the U.S. where inequality had most risen over a ten-year period, bankruptcy rates also rose most.
10. There was a high-tech revolution led by companies such as RCA during the 1920s that gave the period a character not unlike the late 1990s (Western 2004, 166).
11. Williamson and Lindert have estimated that technological innovation during the 1920s increased the premium for skilled labor by 0.98 percent per year (1980, 247).
12. Between 1923 and 1929 weekly earnings declined about 20 percent in manufacturing, and about eight percent in steel production (Bernstein 1966, 66–7). Wages as a percentage of value-added in manufacturing fell from 45.0 in 1923 to 36.9 in 1929 (Bernstein 1998, 198).
13. Suggesting a dearth of good investment options for retained earnings, dividends as a share of national income rose from 4.3 percent in 1920 to 7.2 percent in 1929. About 82 percent of these dividends were paid to the wealthiest 5 percent of Americans (Hall and Ferguson 1998, 21).
14. Manufacturing represented 21.2 percent of GDP in 1974, but only 12.1 percent in 2004 (*Economic Report of the President* 2006: Table B12, 296–7).
15. According to Hall and Ferguson, between 1922 and 1929, "the share of wealth held by the top 1 percent of adults rose from 32 percent to 38 percent. In 1922 the top 1 percent of income recipients accounted for 49 percent of total U.S. saving; by 1929 they accounted for 80 percent of saving" (1998, 21).
16. Hall and Ferguson argue that the mild deflation during the 1920s (an average of about 0.5 percent per year between 1921 and 1929) was traceable to the fact that the expansion in aggregate supply outpaced increases in aggregate demand (1998, 18).
17. Galbraith reported that, in a population of 120 million, only one and a half million "had an active association of any sort with the stock market" (1954, 78).

18. Bernstein claims that "Margin-buying was the rule not the exception [and] brokers often allowed as much as 80 percent of the value of a stock purchase to be borrowed... frequently extended in the absence of any formal check on the credit-worthiness of the customer involved" (1998, 197).
19. Prior to both crises, foreign funds flowed into the United States, helping fuel credit expansion. Leading up to 1929, the United States and France required that Germany pay its war reparations in gold, creating a net gold inflow into the United States and increasing the availability of credit (Bernstein 1998: 204). Leading up to 2008, the underinvestment in the goods-producing sector led to a weak export sector and increasing imports, generating an increasingly large trade deficit. These dollars abroad flowed back into the U.S. financial system, helping keep interest rates low and fueling profitability, while impeding the value of the dollar from substantially falling, thereby allowing the trade deficit to grow further as exports remained expensive and imports cheap.
20. Financial innovation fueling the housing boom before the 2008 financial crisis included adjustable-rate mortgages, interest-only loans, and 100 percent-plus mortgages. Other financial innovations included mortgage-backed securities, derivatives, credit default swaps, and exotics. A bubble in the derivatives market was fueled by the housing bubble.
21. Veblen believed that because the elite are emulated, their ideology would carry special weight: "The fact that the usages, actions, and views of the well-to-do leisure class acquire the character of a prescriptive canon of conduct for the rest of society gives added weight and reach to the conservative influence of that class. It makes it incumbent upon all reputable people to follow their lead" (Veblen 1899, 200).
22. For a discussion of the manner in which economic science has served to legitimate inequality, see Wisman and Smith (forthcoming).
23. As former U.S. Secretary of Labor Robert Reich asserts, "As inequality has widened, the means America once used to temper it—progressive income taxes, good public schools, trade unions that bargain for higher wages—have eroded" (2007, 4).
24. This claim, however, has not withstood critical scrutiny (e.g., Easterly 2002).

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Chapter 5

Inequality and Its Discontents: The Real Causes and Consequences of the Crisis

Steven Pressman

Introduction

Over the past several decades, one case for deregulating financial markets has been that this would release the forces of financial innovation for the good of all. Unhindered financial markets were supposed to increase efficiency in financial markets and reduce costs to borrowers, which would benefit the whole economy. Greater access to credit would increase consumption, spur business investment, raise the rate of homeownership, increase productivity, and enable Americans to enjoy a higher standard of living.

In the 1980s, Michael Milken convinced investors that junk bonds, when combined into a package of diverse bonds, would spread and reduce risks. This let firms obtain credit that otherwise would not have been available. Then the case expanded to encompass mortgages and other loans. Because loan originators could package and sell off their loans, it was argued that they could obtain cash and make more loans. Consumers, homeowners, college students, and small businesses would all gain as a result of greater credit availability.

Following this advice, the U.S. Congress relaxed lending standards starting in 1980 and passed major legislation deregulating the U.S. financial sector. In 1994 President Clinton signed the Riegel-Neal Interstate Bank Efficiency Act, which repealed restrictions on interstate banking. This fueled the rise of mega–financial institutions that became too big to let fail. The Glass-Steagall Act—a New Deal reform that separated investment and commercial banks and limited the risks that commercial banks could take with insured deposits—was repealed when President Clinton signed the Gramm-Leach-Bliley bill in November 1999.

These activities did lead to a boom in financial services, which created many jobs in finance and considerable economic growth. But instead of money flowing to investments that would improve efficiency, it went to inflate housing prices beyond what a typical family could afford. There was a massive bubble, which began to burst in 2006; as of this writing, the end is still not in sight. In early 2010 around a quarter of all mortgages were underwater—debt on the house is more than the home's current value. Many families with small, but positive, housing equity are struggling to make their monthly mortgage payments; however, they cannot sell their home and downsize due to the high transactions costs (taxes, realtor fees, legal fees, etc.) that must be paid at closing. These homeowners too are sinking.

Adding further injury, financial deregulation did not yield the benefits promised. Table 5.1 shows productivity growth in the United States by decade and U.S. productivity growth compared to other developed nations (which tended to follow the United States in deregulating finance). These figures make clear that the financial

Table 5.1 Gross domestic product per employed worker: Average annual growth in constant 2005 U.S. dollars (adjusted for purchasing power parity)

	1950s	1960s	1970s	1980s	1990s	2000–07
United States	2.47	2.33	1.01	1.46	1.90	1.43
Canada	2.94	2.27	0.96	1.04	1.71	0.66
Australia	2.41	2.26	1.40	0.95	2.13	1.01
Japan	7.13	8.57	3.68	3.01	1.09	1.75
Austria	2.62	5.27	2.89	2.07	1.91	1.31
Belgium	2.62	4.26	3.13	1.83	2.88	0.96
Denmark	3.15	3.29	1.93	1.72	2.21	1.16
France	6.59	5.17	3.17	2.10	1.35	1.02
Italy	4.34	6.23	3.10	1.84	1.45	−0.24
Netherlands	3.97	4.01	2.18	1.13	0.99	0.74
Norway	3.67	3.44	2.91	1.97	2.48	1.22
Sweden	3.13	3.82	1.17	1.47	2.69	2.08
United Kingdom	2.06	2.58	1.73	1.96	2.23	1.72
Decade averages: (unweighted)	3.62	4.12	2.25	1.73	1.92	1.14

Sources: Bureau of Labor Statistics, International Comparisons of Manufacturing Productivity and Unit Labor Cost Trends for all decades except the 1950s. For the 1950s, data are from the Groningen database.

liberalization beginning in the early 1980s did *not* improve U.S. productivity growth. For a few nations, productivity growth has improved slightly since the 1970s, but every country lags way behind the stellar productivity performance of the 1950s and 1960s.

One likely reason for this outcome is that deregulation led to a misallocation of capital. Money went to make bad loans that could be sold off quickly, and it went toward speculation in real estate and financial assets rather than to productive investments (such as more R&D and more education).

The financial services boom also contributed to greater income inequality in the United States. Typically this is not the case during economic expansions, when plentiful employment and rising wages reduce income inequality. Inequality in the United States has risen for several decades—mainly due to the rising incomes of those making the most money. In 1965, the average CEO pay was 24 times what the average worker made; by 2008 top executives were making 319 times more than the average worker (Anderson et al. 2009). But changes took place throughout the income distribution. The share of total earnings going to the bottom 20% of the population and to the bottom 40% of the population has declined since the 1980s. Standard measures of inequality such as the Gini coefficient also document a fairly continuous rise in inequality. By the end of the 2000s, income inequality in the United States reached levels not seen since the 1920s (Autor et al. 2008; Frank 2007).

But things are even worse than the standard data show. Lost jobs and income require families to borrow in order to make ends meet. This solves the immediate problem of inadequate income, but borrowed money must be paid back—increasingly, at very high interest rates on credit card debt and other loans. Pressman and Scott (2009a, 2009b) argue that ignoring interest on consumer debt yields flawed measures of poverty and inequality. Subtracting just the interest on consumer debt from disposable income, inequality and poverty are much worse since the 1980s than standard figures indicate. And this mismeasurement has been growing markedly over time.

There are several reasons why financial deregulation and greater inequality went hand in hand. First, deregulation increased the size and economic power of financial institutions. These institutions then increased prices to consumers. Interest rates rose on credit cards, as did late fees, over-the-limit fees, and other charges. Second, as the profits of these monopolistic institutions increased, the pay of their top executives increased on the (mistaken) belief that these CEOs were responsible for the gains and should be rewarded for it. Third, through large contributions to help politicians get re-elected, financial institutions and their CEOs pressured politicians to cut taxes on the wealthy. This worsened the after-tax distribution of income. And to help pay for these tax cuts, many government programs that benefit the poor and the middle class had to be cut (see footnote 4). Finally, large cuts in tax rates for the very wealthy, in conjunction with pay and bonuses predicated on short-term firm performance, created great incentives for CEOs to show enormous profits in the short run. This meant cutting jobs and reducing wages.

Our current crisis should contribute to even greater income inequality, as has been true of most post-war recessions. We have already seen the beginning of this process. Although Wall Street continues to pay large bonuses to its senior executives, real median weekly earnings for non-supervisory workers fell by 1.6% in 2009. Of course, this decline excludes the millions of workers who lost their jobs and their earnings in 2009.

It was Mendershausen (1946) who first noted some probabilistic reasons inequality rises during recessions. To keep things simple, consider a five-person economy, with incomes of \$200K, \$70K, \$50K, \$20K and \$10K.[1] If any of the four lowest earners loses his job, and receives less than \$10K through various government benefits (such as unemployment insurance), inequality increases on most measures. Taking the top/bottom quintile measure, we go from an inequality measure of 20 to an inequality measure of more than 20. If the top earner loses her job and her income falls below \$3.5K, again inequality increases, since the top/bottom measure again exceeds 20. In brief, as long as unemployment insurance pays less than what the lowest income earners make, it is likely that inequality will rise. Since unemployment insurance programs generally try to maintain work incentives, they pay low benefits, and rising unemployment will lead to greater inequality. Adding to all this, unemployment puts downward pressure on wages, especially those at the bottom of the distribution.

Many empirical studies have confirmed that income inequality rises during economic downturns and falls during expansions. The earliest work on this topic used national income account data (Mendershausen 1946, Kuznets 1953). Work in the 1970s confirmed these results using micro datasets (Thurow 1970, Mirer 1973). Blank and Blinder (1986) and Jäntti (1993) examined the fraction of income received by each income quintile and provided econometric evidence that unemployment acts like a regressive tax: it worsens inequality, mainly due to the lost incomes of those who become unemployed.

Longitudinal studies following the same individuals over time also support the view that recessions create inequality. This literature concludes that jobs are the main way out of poverty and that unemployment leads to greater economic inequality. Using the Panel Study of Income Dynamics (PSID), Duncan et al. (1997, 270) found that when it comes to escaping poverty: "Employment was by far the most frequent cause of exits, accounting for between one-third and two-thirds of them." Using data for 2000–2003 from the Survey of Income and Program Participation (SIPP), which included one recession, Fujita and Rao (2009) found that, on average, earnings were 7 percent lower for those who experienced unemployment and then got rehired. But those with earnings in the bottom quartile before being unemployed lost nearly 40 percent of their pre-unemployment income, while those with earnings in the top quartile before being unemployed gained around 30 percent relative to their earlier income levels.

The remainder of this paper discusses how greater income inequality leads to several further problems and argues that these problems follow from increased inequality and from lower incomes—both of which are consequences of the current crisis. Our main focus will be on health and on productivity, although this does not exhaust the long list of negative consequences that flow from greater inequality (see Wilkinson and Pickett 2010) or from lost income. The paper argues that the current economic crisis will adversely impact both health and productivity through two main channels. First, lower incomes will generate greater health and productivity problems. Second, and independently, greater inequality itself generates health problems and also reduces productivity growth. Section 2 discusses the health consequences of both lower income and greater inequality. Section 3 explains why slower income growth hurts productivity growth. Finally, Section 4 questions whether greater incentives actually improve productivity and argues that greater inequality may actually reduce work effort and productivity. Section 5 draws out the policy implications of this analysis.

Inequality and Health

Health is important for many reasons. The growing cottage industry studying happiness (Layard 2005) has found health to be one of the main determinants of human happiness. Health also affects the ability of children to learn in school and the ability of adults to hold down jobs and be productive at work. A great deal of empirical evidence, stretching back to the 1980s and early 1990s, demonstrates that those at the bottom of the national income distribution have higher rates of disease and live shorter lives than those higher up in the income distribution (Dutton and Levine 1989; Pappas et al. 1993; Wilkinson 1992a, 1992b). There are many obvious explanations for this. Wealthier households are better educated about health issues and have access to better health care. They eat better, exercise more, live in safer neighborhoods and work at safer jobs.

Health outcomes depend not only on absolute income levels but also on the distribution of that income. In one of the earliest papers on this topic, Rodgers (1979) gathered data from 56 countries and examined the relationship between absolute income levels, the distribution of income as measured by the Gini coefficient, and several measures of health outcomes (life expectancy at birth, life expectancy at age 50, and infant mortality rates). He found that the independent variables explained around three-quarters of the variation in the dependent variables and that having a more egalitarian income distribution added between 5 and 10 years to the life of a citizen. Expanding on this work, Le Grand (1987) found that, across 17 developed countries, the average death rate was correlated with the nation's income distribution but not with average income levels; Kennedy et al. (1996) found this relationship to hold for individual states within the United States.

There is now a vast literature, spanning several decades, showing that income inequality is bad for our health (see Wilkinson 1994, 1996, 2000). People living in countries with greater inequality tend to have worse health on average than people living in countries with greater income equality (Wilkinson 1996, 75), after controlling for per capita income. The middle class in nations with a relatively unequal distribution of income have worse health and die earlier than poorer groups in countries with a more equal distribution of income.

Moreover, the causal arrow seems to flow *from* income inequality *to* worse health. One reason greater income equality might lead to more health problems is that more egalitarian societies tend to spend more on public goods, such as education, and that a more educated population tends to be a healthier population. Another related possibility is that inequality tends to reduce political participation, especially by those at the bottom of the income distribution. The median voter hypothesis conjectures that politicians will seek out the vote of the median voter. Low political participation by the poor will reduce redistributive efforts by the government, and so greater inequality leads to policies favoring those high income groups with a greater propensity to vote.

Michael Marmot (2004) provides yet another explanation for the impact of inequality on health, one that relies on the principles of evolution. Inequality reduces the control that people have over their lives, and low-status individuals are subject to the arbitrary demands of others and are frequently discriminated against. This all leads to sustained and chronic stress. Stress in turn leads to problems with one's immune system, cardiovascular system and glucose metabolism, and it can destroy brain cells involved in memory. Stress triggers "fight or flight" responses—chemical reactions in the body that were designed for emergency situations where an individual had to fight or flee.[2] These responses helped save the lives of our ancestors during times of immediate threat. But with repeated stress, these chemicals remain in the bloodstream, disrupt normal body functions, and increase the probability of health problems (Sapolsky 1998). There is also some evidence that when the body experiences repeated stress, the brain develops certain neurological pathways; once developed they tend to get replicated through time as we look for stressful situations, find them, and react inappropriately (Kishiyama et al. 2008).

Finally, there is epidemiological research indicating that the comfort foods (full of fat and sugar) we crave when under great stress have a protective function. When our ancient ancestors needed to flee from predators, they needed the quick energy boost available from sugary foods. When stressed about the future availability of food (due to great uncertainty concerning where the next meal would come from) cravings for fatty foods helped our ancestors survive (because fat is stored in the body and used when food is not available). Our human ancestors without such cravings tended to die off. That is why we crave these foods today when we are stressed out. But when the stress is continual due to great income inequality, and eating such foods occurs with great frequency, the result is an epidemic of obesity and the many health problems that stem from being overweight (Wilkinson 1996, 188).

Of course a healthier society will also be a more productive society. If I have to worry about where my next meal will come from, how to pay next month's rent and utilities, and how to survive over the coming weeks, I will not sleep well and will be less productive at work. In addition, a sicker society will need to devote more resources to health care, leaving less money for productivity-enhancing investments such as education, R&D and infrastructure investment. We turn now to the issue of productivity.

Macroeconomic Productivity Problems

There are many reasons why productivity growth is important to economic well-being. More than anything else, productivity growth is responsible for annual increases in our material standard of living. It also enhances our nonmaterial well-being. Productivity growth allows for greater time off from having to work. It lets people retire, take vacations, work fewer hours each week, and be at home around the birth of their children. Moreover, productivity provides the resources to develop a first-rate, educated labor force in the future, and to deal with problems such as pollution and global warming. Finally, productivity growth helps tame inflation, by offsetting higher input costs with a decline in the number of inputs necessary in production.

The standard economic view is that inequality enhances productivity because of incentives at the top and the bottom of the distribution. Economic incentives spur people to work hard so that they can become wealthy. Inequality also provides disincentives to be lazy since the lack of effort is likely to lead to poverty in absolute and relative terms.

But this standard view is rather myopic. It focuses on positive microeconomic incentives, while ignoring any effects on productivity from aggregate macroeconomic outcomes. It also ignores any negative incentives stemming from inequality. In particular, the incentives needed to spur people toward greater productive effort may generate outcomes perceived to be unfair. This in turn will reduce productivity. We deal with macroeconomic issues in this section and negative individual incentives in the next section.

Three mechanisms help explain why slower economic growth leads to slower productivity growth (see Pressman forthcoming).[3] First, Adam Smith (1936 [1776]) noted that productivity improves when firms can divide tasks, when individuals can specialize and become competent in narrow duties, and when machinery can be employed to assist workers. This is possible only when firms sell enough goods to justify capital investment and the restructuring of production. Thus, according to Smith, the greater the extent of the market, the greater the amount of sales and the greater productivity will be.

This idea remained dormant until the 1920s when Allyn Young (1928) argued that many industries operate under conditions of increasing returns to scale. When producing more, unit costs fall because goods can be produced more efficiently in large quantities and fewer resources are needed to produce each good. Increasing returns mean that productivity grows as output expands; in contrast, during times of slow growth, productivity grows slowly.

A second reason that productivity growth is demand-driven stems from the nature of productivity growth in a service economy. The productivity of a symphony orchestra does *not* depend on how fast the musicians play a piece of music. Rather, its productivity (the value of its output divided by the number of players) depends on ticket sales. When the economy does poorly, people are reluctant to spend money and go to the symphony. The productivity of the orchestra and its growth languish. Conversely, in a booming economy, the concert hall is full and productivity grows. The orchestra may also produce compact discs, a manufactured good. But people are really buying the music on the CD, another service. Once again, it is demand that determines productivity. The value of the output depends on how many CDs get sold. When demand is high and sales boom, productivity growth soars; when people purchase fewer CDs, productivity falls.

What is true of the symphony orchestra is likewise true of most service occupations and many goods-producing industries (as the CD example shows). The productivity of real estate agents and newspapers reporters depends on the value of sales. When home sales fall due to poor macroeconomic conditions, the productivity of realtors drops. When newspaper sales decline and advertising revenues fall, everyone working at the newspaper becomes less productive. Even the productivity of college professors depends on the state of the economy. In boom times, more students attend college and classes have more students in them. Thus, the value added of a college professor rises. In contrast, during hard economic times, fewer people attend college, classes are smaller, and productivity falls.

A third reason that demand determines productivity growth focuses on the fact that aggregate productivity growth is just a weighted average of productivity growth in different industries, and that productivity growth changes as the industrial composition of the nation's output changes. As demand shifts to goods produced by more productive economic sectors, average productivity will increase. In addition, in an expanding economy, growing sectors are likely to be more productive and labor will shift there. In a stagnant economy, labor tends to stay put, and productivity tends to stagnate.

This analysis was first developed by François Quesnay in the eighteenth century (Pressman 1994), and then ignored until the twentieth century, when Nicholas Kaldor (1967) stressed the composition of demand as a key determinant of productivity growth. Kaldor looked at a thriving manufacturing sector (rather than agriculture) as the engine for productivity growth, but his argument was essentially the same as that of Quesnay: some sectors are more productive than other economic sectors, and we need these more productive economic sectors to expand. Thus, we need a growing economy to aid the growth of new, more productive economic sectors. This view regarding the determinants of productivity growth receives some empirical support. Basu and Fernald (2000) and Sbordone (1997) found that productivity growth at the national level varies pro-cyclically, rather than counter-cyclically or remaining constant over the business cycle.

Inequality comes into play here, and contributes to reduced productivity growth, because of its impact on spending and hence on economic growth. In *The General Theory*, John Maynard Keynes (1964[1936]) pointed out the positive effects of greater equality on the propensity to consume and thus on economic growth. Testing this hypothesis with U.S. data, Christopher Brown (2004) finds that greater inequality does reduce consumption spending. This view also receives considerable empirical support across nations. Many studies have found that those countries with greater income inequality experience slower economic growth (Alesina and Rodrik 1992, 1994; Deininger and Squire 1998). Inequality may also reduce long-run growth because of the impact of growing up poor on educational attainment and future earnings (Holzer et al. 2007).

Microeconomic Incentives and Productivity

A final problem plaguing the standard economic view is that inequality may lead to asocial behavior by individuals, which adversely impacts productivity. But first, it should be noted that greater incentives by themselves may adversely affect individual performance and productivity. When people are internally motivated to perform well, large economic incentives may actually harm these internal incentives. There is even some empirical evidence of such a tradeoff (Gneezy and Rustichini 2000; Heyman and Ariely 2004). This issue has received little attention among economists, but has sparked the interest of psychologists. It is known as "choking under pressure" (Baumeister et al. 1986; Beilock and Carr 2005). Social psychologists hypothesize that greater incentives lead to greater ego threats, greater self-consciousness and excessive attention to the task at hand. These psychological responses can and many times do reduce performance when incentives are too high. Ariely et al. (2009) speculate that there is a threshold level, and increasing incentives above this can reduce performance.

But incentive problems go beyond the single individual. Humans are social animals and care about relative incomes (Easterlin 1974, 1995; Frank 1999, 2007; Layard 2005). Relative income is a major determinant of happiness, and as we saw above it also affects health. People have a natural inclination to want to do better than their neighbors; they worry and are unhappy when they do much worse than their neighbors. This is why people feel less secure, less happy, and less well-off, even if their income has increased in absolute terms.

These feelings and anxieties have real-world consequences. Earlier we looked at some of the health consequences of inequality; now we look at some behavioral consequences. When inequality leads to bad behavior, it generates productivity problems. The ultimatum game lets us conceptualize this issue. It is about issues concerning fairness, individual self-interest, and aggregate output. In the ultimatum game, two people are given a fixed sum of money to divide. The first subject can propose any division of the money that they like; the second subject can only accept or reject that division. If the division is accepted, each person receives the amount of money proposed by the first subject; if the division is rejected, each person receives nothing. From a standard economic perspective, dividers should propose that they get most of the money; the second subject, faced with a choice of little or nothing, should then choose the little rather than rejecting the offer.

However, in experiments where individuals played this game for real stakes, dividers tend to make substantial offers to the other subject, and most people reject unequal offers, despite the fact that it is personally costly, economically irrational, and leads to less for everyone. These results have been replicated many times, including cases in which people rejected offers as large as one month's pay when they felt that the split was unfair (Henrich et al. 2001; Kahneman et al. 1986; Klasen 2008, 260–1).

Now consider a modified version of the ultimatum game. Proposers still get to divide the pie, and the second subject still can accept it or reject it. However, the result of rejecting this division is *not* that both subjects get nothing. Rather, both subjects get less—although distribution of the pie remains pretty much the same. This modified ultimatum game approximates what goes on in the real world. Large firms (or their senior executives) propose a division of company revenues. Workers can ill-afford to reject this offer outright, since most workers need a job and an income to survive. But workers can *quasi-reject* a proposal they regard as unfair in other ways—by working less hard and sabotaging production and firm efficiency, requiring firms to use resources to set rules, monitor workers, and deal with actual and possible lawsuits. The result is a loss of efficiency, or a smaller economic pie.

Herbert Simon (1957) was one of the first to argue that the relative distribution of pay within a firm was a critical determinant of employee behavior. Harvey Leibenstein (1966) then developed this idea, arguing that worker productivity is a variable at the control of the individual worker. He coined the term "x-efficiency" to indicate that a large part of worker effort is discretionary.

Joanne Martin (1981, 1982, 1986) has shown that people lower in organizations actually do compare their rewards to those at the top and that large differences lead to feelings of injustice. When workers feel that their wages are unfairly low and too much income is going to the owners and the heads of the firm, they do not quit; instead, they tend to work more slowly or less efficiently, and they produce more defective goods that cannot be sold and that do not count as output in productivity data. Large pay differentials can also lead to increases in vandalism, absenteeism, strikes and other forms of sabotage against the firm (Crosby 1984).

Income inequality may also adversely affect the behavior of managers. When rewards are much greater from advancing up the corporate ladder, competition among managers is stiff. Jeffrey Pfeffer (1998) argues that this reduces managers' commitment to the firm and leads to worse social relationships among employees, thereby reducing firm productivity. Baron and Pfeffer (1994), Kohn (1993) and Pfeffer (1994) argue that large pay differentials promote employee dissatisfaction and create disincentives for cooperation. People focus only on their own performance, to the detriment of organizational performance. Going even further, when rewards are so great and the winners so few, there is also an incentive to sabotage the work of other managers in order to make them look bad (Lazear 1995).

This view of inequality and economic performance actually receives some empirical support. In a study of pay and performance for 29 baseball teams over the years 1985 through 1993, Mat Bloom (1999) found that greater pay dispersion led to worse player and team performance. He concludes: "Across almost all measures, player performance was negatively related to more hierarchical pay dispersion, as were all measures of organizational performance" (Bloom 1999, 33). Outside the world of athletics, Pfeffer and Langton (1993) found that greater pay dispersion led to less collaboration and lower productivity among academics. Cowherd and Levine (1992) examined manufacturing firms and found that greater pay dispersion led to lower product quality. Finally, Bloom and Michel (2002) found that organizations with greater pay dispersion had higher turnover rates among managers and managers with lower tenure, contributing to worse productivity performance for the firm. Thus, for firms with a large number of employees who must work together, it appears that large pay differentials hurt productivity and productivity growth.

The Needed Policy Response

Understandably, most analyses of our current economic and financial crisis have taken a macroeconomic approach. They have proposed limiting the risks that financial institutions can take by increasing bank capital requirements. They have called for greater regulations on banks and for breaking up large financial institutions so that they are not "too big to fail." They also advocate standard macro policy tools to deal with the Great Recession of 2008–9, namely, drastic cuts in interest rates plus a large Keynesian fiscal stimulus (both of which have been done).

While such solutions are necessary, if our problems stem from income inequality, these solutions may be necessary but not sufficient. They deal with symptoms but not underlying problems. To end the current crisis and prevent future ones, we must also address the issue of income inequality.

Here the role of government is essential. For most developed nations, income inequality looks pretty much the same before any government policies. In economic jargon, the distribution of market income is quite similar. It is therefore mainly government tax and spending programs that determine differences in the distribution of disposable income across nations (Gottschalk and Smeeding 1997; Pressman 2007a, 2007b, 2010a). Moreover, since market income distribution is similar in all developed nations, it is hard to argue that government redistribution hurts economic incentives. If incentives were damaged, this should show up in market income data. It should also show up in the data on productivity. But, as Table 5.1 shows, Sweden and Norway (the most egalitarian countries) consistently outperform the United States (the least egalitarian country).

Thus, to deal with our current crisis and to prevent future crises, we are going to need effective government policies that mitigate income inequality. Spending programs such as family allowances (see Pressman 2010b), Social Security and generous unemployment benefits will help a great deal. Just as important is the need to make the U.S. tax system more progressive.[4]

Of course, such policy changes are more difficult because of greater inequality. As inequality increases, the rich find it easier to opt out of government programs and either self-insure or purchase substitutes in private markets (Reich 1991; Schwabish, Smeeding and Osberg 2003). For example, the wealthy can easily save and do not need Social Security or a government retirement plan. Moreover, they can likely earn a better return on their retirement savings through private investments than they get from their Social Security contributions. So the wealthy push for ending Social Security and replacing it with private retirement accounts. Nonetheless, Social Security in the United States has greatly reduced poverty among the elderly and has resulted in greater income equality among the elderly.

Just because our task is difficult does not mean it is impossible. A long time ago, John Kenneth Galbraith (1960) referred to election time as "the liberal hour." It is when people decide the direction the nation shall take. Each citizen gets one vote and one vote only—no matter how much money they have. For people to prosper in the face of great forces pushing for greater inequality, all they need to do is cast their ballot for those willing to reverse such trends. To do so, as this paper has shown, is surely in their own self-interest.

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Notes

1. To make this more realistic, think of these as five income quintiles, with the figures representing the average income for the group. This picture is then not far from the current U.S. income distribution.
2. The adrenal gland produces cortisol, which is a steroid hormone. It speeds up the functioning of the heart (to allow for a more effective flight response), and it inhibits the functioning of the immune system (to keep the body from over-reacting to injury while fighting).
3. The next few pages draw on this paper.
4. Since 1980, the top marginal tax rate in the U.S. has been reduced dramatically, and the average tax rate paid by the very wealthy has declined. The tax burden now falls more heavily on the middle class. Some of this is overt, but some of it is covert. For example, when tax

cuts for the wealthy lead to less government spending on education, tuition and fees must rise sharply at colleges and universities that no longer receive government support (Scott 2010). While not an official tax hike, the greater cost of higher education is a *de facto* tax increase.

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Chapter 6

We've Been Nudged: The Effects of the Downturn on Dignity and Responsibility

Mark D. White

The economic downtown that began in 2008 has had tremendous consequences in the United States (and abroad), including declines in traditional economic variables such as gross domestic product, the stock indices, and employment, as well as the broader measures of well-being detailed in other chapters in this book. Scholars will argue for years to come over the true causes of the downturn—how much was due to imprudent practices on the part of business (chiefly, financial concerns), irresponsible behavior on the part of consumers and borrowers, and ill-designed regulation and intervention by the government—as well as the effects of various aspects of the government response.[1]

Regardless of the relative validity of these factors, the common perception seems to be that private institutions—the market in general and the financial sector in particular—failed, and government intervention is necessary to serve the functions that private institutions used to provide. As a result of this perception, the American people may be more open to increased regulation of economic and financial activity, including state intervention in personal decision-making, as typified by the "libertarian paternalism" made popular by the book *Nudge* and incorporated into proposed federal legislation to enact broad reform of the financial sector. I argue below that we should not be too hasty to surrender choice over personal decisions to the state, based on criticism of libertarian paternalism and its academic basis in behavioral law and economics from the viewpoint of dignity and autonomy as described by 18th century philosopher Immanuel

Kant. I discuss the specific work in the area that inspired the most recent attempt at financial regulatory overhaul, show how its features are consistent with the broader literature from which it derives, and also how it suffers from the same epistemic and ethical shortcomings. Ultimately, I argue that the perception of the failure of the market that has led us to question our own choices results from a misunderstanding of the role of the market in society, and an improved understanding of the market will serve to reassert the importance of individual choice and dignity over the supposed benefits of government decision-making on the behalf of consumers.

Libertarian Paternalism and Dignity

One problem with shifting more choice from the private sector to the public is the diminution of responsibility that results. Broadly considered, this has been occurring in American society for years, and many of the instances of it have little if anything to do with the economic crisis. For instance, there have been moves toward a centralized, national health care system (culminating in the massive health care reform bill of 2010), in which responsibility for the allocation of scarce health care resources risks being shifted from the hands of patients and their doctors to remote decision makers and advisory boards. Moves to tax or ban foods or activities regarded as unhealthy will limit the choices available to persons to live as they choose, in part motivated by increased health care costs which, under a centralized system, are no longer the responsibility of the patient.

Similarly, as a direct result of the economic crisis and its epicenter in the financial industry, there have been parallel moves toward more focused and precise regulation of lending practices, moves that have been justified and encouraged by research in the field of *behavioral law and economics.*[2] This field takes the psychologically-based insights into cognitive biases in human decision-making from behavioral economics and incorporates them into legal frameworks, both traditional and economic. The policy implications of behavioral law and economics were popularized by Richard Thaler and Cass Sunstein's (2008) best-selling book *Nudge*, which makes a case for "libertarian paternalism," the practice of making subtle changes in choice sets and strategic determination of default options to steer or "nudge" people into making better choices in the face of their cognitive defects, ostensibly to favor their own interests.[3]

There are several problems with this concept, which can be described as epistemic and ethical in nature.[4] The epistemic problem derives from the fact that regulators can never know what an agent's true interests are without observing her free choice or obtaining explicit consent. Instead, designers of choice situations or default choices substitute their own estimation of the interests of those they purport to regulate. Two of Thaler and Sunstein's favorite examples deal with a cafeteria in which healthy foods are easier to reach than unhealthy foods, and automatic enrollment for new employees in 401(k) retirement plans (with the possibility of opt-out). These choice manipulations are predicated on the agent's interests consisting of health and prudent saving, respectively. But they have no basis to make that assumption, aside from the supposition that they themselves support these interests. They have no reason to believe that the cafeteria patron's most important interest is in eating healthy food, or that the new employee's is in building retirement savings, but nonetheless they manipulate their choices in the name of these interests.

One of the valuable insights of behavioral economics is that persons often make inferior decisions as judged by their own interests. People often say that they eat more than they would like to and save less than they should. But these people are free to seek help, through diet centers or savings plans, of their own accord, because only they know if they are succumbing to these practical irrationalities. The outside observer has no basis on which to judge another person's choices except by the observer's standards, which are not necessarily the same as the person's herself. Claire Hill (2007, 448) writes that advocates of libertarian paternalism

> sometimes speak as though they have access to the knowledge of what people really want apart from what they choose. This position is ultimately untenable. . . . As convenient and tempting as it may be to extrapolate from our own introspection that others want what we do, or should, want, we simply have no access to others' beliefs and desires.

I presume that, if Thaler or Sunstein were to see me eating a luscious Danish, they may presume I had succumbed to some cognitive failure or bias, choosing immediate delight to the exclusion of my long-term health. But for all they know, I may be enjoying the Danish to celebrate the birthday of my late grandmother, in remembrance of the long talks we had over Danish in my youth; or perhaps I am using them as an internal incentive to reward myself for finishing this book chapter (hey, they worked!). And if a new employee does not sign up for a 401(k) plan, she may be negligently imprudent, but perhaps she may be waiting until she pays off her student loans, or saving for a down payment on a house, or sending money home to her family. Generally, people's true interests are often complex and multi-faceted, and regulation of the type espoused by Thaler and Sunstein impose uniform, simplistic interests on everyone.

The necessary ignorance of the paternalistic regulator in turn feeds the ethical problem with such manipulation. By substituting their own interests (or the interests they presume agents to have) for the true interests of the agent, and then manipulating those choices toward those artificially imposed interests, regulators deny agents the respect they deserve by virtue of their dignity as rational persons. According to the moral philosophy of Immanuel Kant, which is ultimately based on the autonomy and dignity of persons, one must use another person "never simply as a means" but "always at the same time as an end" (the basis of the Formula of Respect, one of the versions of his categorical imperative) (Kant [1785] 1993, 429). In operational terms, this requirement rules out coercion and deceit, both of which exclude the agent from fully participating in the situation, using her as a means only, without her consent (which, if secured, would satisfy the requirement of treating her also as an end).[5]

Thus understood, the type of manipulation recommended by libertarian paternalists fails to respect the dignity of persons through using their cognitive biases to pursue ends chosen by the regulator. As philosopher Gerald Dworkin (1988, 123) writes, in instances of paternalism "[t]here must be a usurpation of decision-making, either by preventing people from doing what they have decided or *interfering with the way in which they arrive at their decisions*" (italics mine). If people are more likely to select foods placed at eye level, then regulators place healthy food there, relying on the agent's faulty cognitive processing in order to further "her" interests in health; if people are often too lazy to deviate from default options, then regulators use this laziness to choose default options in the employees' "own" interests in prudent savings. More generally, behavioral economists (in general and in law specifically) treat persons with cognitive failures as broken machines that must be fixed or corrected, "nudged" in the right direction. But what they fail to respect is that, while human beings are not perfectly rational decision makers, they are autonomous persons capable of determining their own interests and making choices toward them. They may sometimes fail to make the right choices by their own standards, much less the standards of outside observers, but the respect they are owed as autonomous persons imbued with dignity demands that their choices and interests be respected, as long as they lie within the bounds of respect for others as required by justice.

Borrowing Gets a Nudge

For an example of a government policy intended to reduce the chances of a repeat of the downturn that began in late 2007, I now turn to the Consumer Financial Protection Agency Act, introduced into the U.S. House of Representatives in 2009 (as H.R. 3126). The original impetus for this legislation, which is intended to simplify consumer borrowing, can be traced to several papers: Oren Bar-Gill and Elizabeth Warren's (2008) "Making Credit Safer," and Michael Barr, Sendhil Mullainathan, and Eldar Shafir's (2008) "Behaviorally Informed Financial Services Regulation."[6] Both of these papers claim, consistent with the behavioral law and economics/libertarian paternalism approach, that because of cognitive failures that enable deceptive practices on the part of lenders, borrowers make decisions that are not in their own best interests, and therefore lending practices must be regulated more precisely in order to prevent bad choices and guide better ones.

For example, Barr et al. (2008, 1) write that "individuals consistently make choices that, *they themselves agree*, diminish their own well-being in significant ways" (emphasis mine). According to Bar-Gill and Warren (2008, 5), there are "a growing number of families that are *steered* into overpriced and misleading credit products . . . families that get tangled up with truly dangerous financial products" (emphasis mine). They argue that "sellers of credit products have learned to exploit the lack of information and cognitive limitations of consumers in ways that put consumers' economic security at risk" (p. 6).[7] Barr et al. assert that credit card markets are "dominated by 'low-road' firms offering opaque products that 'prey' on human weakness" (p. 4), and that "credit card companies provide complex disclosures regarding teaser rates, introductory terms, variable rate cards, penalties, and a host of other matters. Both the terms themselves and the disclosures are confusing to consumers" (p. 12). With respect to mortgage markets, Barr et al. write that "families commonly make mistakes in taking out home mortgages because they are misled by broker sales tactics, misunderstand the complicated terms and financial tradeoffs in mortgages, wrongly forecast their own behavior and misperceive their risks of borrowing" (p. 8).

Generally, Bar-Gill and Warren's "central idea is that consumers make systematic mistakes in their choice of credit products and in their use of these products. These observed mistakes indicate the existence of deficits in either information or rationality—or both" (pp. 26–7). As evidence of this irrationality, they cite a study by economists Haiyan Shui and Lawrence Ausubel (2004), who "identified mistakes in consumers' credit card choices. They found that a majority of consumers who accepted a credit card offer featuring a low introductory rate did not switch out to a new card with a new introductory rate after the expiration of the introductory period, even though their debt did not decline after the initial introductory period ended" (p. 33). As another example, they cite a study by David Gross and Nicholas Souleles (2002), showing that "many consumers pay high interest rates on large credit card balances while holding liquid assets that yield low returns.... With a median balance of more than $2,000 for consumers who have a balance, and a spread of over ten percentage points between credit card interest rates and the interest rates obtained on assets in checking and savings accounts, a typical consumer is losing more than $200 per year in interest payments that could have been easily avoided" (p. 35).[8]

But this behavior is easily explained, if the analyst is willing to consider that every individual or household is not solely focused on optimizing a financial portfolio. Consumers choose whether to take advantage of credit card teaser rates for many different reasons; if they recognize the dangers—perhaps aware of their own tendencies toward overspending—they might accept such offers only in periods of particular distress. Or, perhaps they accept one offer, realize the monkey's paw in the situation, and swear off them (by the process of learning-by-doing discussed below). Furthermore, the puzzle of holding low-interest but liquid savings balances and high-interest credit card debt simultaneously is just as easily solved: a preference for liquidity, the security of having an easily-accessible reserve of funds available for emergencies, even if one pays for that convenience. (Absent the credit card debt, the saver would pay for the liquidity through lower interest rates anyway.[9])

Am I some sort of clever genius to have divined these alternative explanations? As the editor of this volume will surely attest, no—all it takes is a willingness to consider the vast array of reasons that human beings make the choices they do. Consistent with the behavioral law and economics paradigm, Bar-Gill and Warren assume that consumers' and borrowers' only interest is in financial optimization: "The evidence summarized above suggests that many credit products are extremely costly to consumers. The data on credit card choice and use show that consumer mistakes cost hundreds of dollars a year per consumer" (p. 56). It is ironic that behavioral economics claims to incorporate the myriad psychological complexities of actual human choice, but Bar-Gill and Warren reduce human motivation to the most simplistic common denominator, such as wealth maximization. These authors cite similar studies regarding mortgage lending, particularly subprime loans that have been identified most closely with the economic downturn, and payday loans, the *bête noire* of the consumer lending industry. But since they do not consider alternative, nonfinancial reasons for making financial decisions, anything that does not solve a maximization problem taken in isolation appears as irrational; the machine is broken, and is in need of repair.

They even find evidence of consumer irrationality in the loan offerings themselves: as Bar-Gill and Warren write, "perhaps the best evidence of consumers' lack of information or their systematic irrationality is in the credit products themselves, which are carefully designed to exploit any such problems. Accordingly, the observed product designs may prove the prevalence of information and rationality deficits" (p. 27). For instance, they cite the combination of low annual fees and high interest rates on credit cards, presumably chosen because demand elasticity with respect to fees is higher than that with respect to interest rates (p. 46). According to them, this is crafty manipulation because borrowers are overly optimistic about their future debt level, while it could just as well have been prudent planning among clear-sighted borrowers—there is no way to tell. They also take aim at introductory "teaser" rates, "another example of product design that targets consumers' imperfect rationality" (p. 50), while they can be interpreted as promotional features meant to provide incentive to try a new card.[10] But as we saw above, researchers also wonder why people don't switch cards to take advantage of teaser rates *more* often; so if they use them often, borrowers are myopic, short-sighted fools, and if they use them seldom, they are not maximizing their wealth. With this logic, it is not hard to see why such scholars see consumers and borrowers as irrational.

As a solution to these "problems," Bar-Gill and Warren "propose the creation of a single federal regulator—a new Financial Product Safety Commission or a new consumer credit division within an existing agency . . . that will be put in charge of consumer credit products" (p. 98) and "that will be responsible for evaluating the safety of consumer credit products and policing any features that are designed to trick, trap, or otherwise fool the consumers who use them" (p. 6). After listing possible regulations of mortgage lending (including banning prepayment penalties, short-term adjustable-rate mortgages, and balloon payments), Barr et al. write: "However, product regulation may stifle beneficial innovation and there is always the possibility that government may simply get it wrong" (p. 8). Nonetheless, they recommend that lenders "be required to offer eligible borrowers a standard mortgage (or set of mortgages), such as a fixed rate, self-amortizing 30-year mortgage loan, according to reasonable underwriting standards. The precise contours of the standard set of mortgages would be set by regulation," (p. 9), from which borrowers could then opt out, but only with some effort (which they term a "sticky opt-out"). They also recommend "build[ing] in banking agency supervision as well as periodic required reviews of the defaults, with consumer experimental design or survey research to test both the products and the disclosures, so that the disclosures and the default products stay current with updated knowledge of outcomes in the home mortgage market" (p. 11).

In the end, such financial industry reformers make the same mistaken presumptions that other advocates of behavioral law and economics or libertarian paternalism make: first, that they *know* that consumers and borrowers are making bad decisions, and second, that they *should* use state power to "help" them avoid these inferior decisions. But their judgments of the decisions made by other people do not take into account those people's own multifaceted reasons and motivations for making those decisions, and instead reflect their own preferences, or their condescendingly simplistic view of other people's preferences. But it is the ethical leap, from which they presume to "nudge" poor decision makers onto the path to rationality, that is much more dangerous. Not only does it place the government in the same position as the "manipulative" businesses it criticizes, but it also denies people recognition of, and respect for, their autonomy and dignity, their ability to make choices according to their own preferences, principles, and goals, and to take responsibility for these choices.

The Impact on Responsibility

An essential aspect of respecting the dignity of individuals is holding them responsible for their choices; to do otherwise is to treat them as less than fully human, and invites the kind of paternalistic response we have been discussing. Such choice manipulations or interventions steer people into making "better" choices, relieving them of the responsibility for making these choices, and with the result that cognitive biases are accommodated rather than reduced or corrected.[11]

Rather than trying to "nudge" people into making certain choices, we should hold people responsible for the choices they do make—which does not guarantee they will always make the "right" choices, but they will be more likely to make choices that reflect their true interests without introducing moral hazard in the form of a system which enables mistakes. Also, holding people responsible for their choices, while educating them about possible defects in their decision making, will encourage them to invest effort in making better decisions.[12]

Although they refer to responsibility often, proponents of choice interventions do not seem to understand or appreciate the effects of their proposals on responsibility. For instance, Barr et al. write that "the 2005 bankruptcy legislation focused on the need for improved borrower responsibility but paid insufficient attention to creditor responsibility for borrowing patterns" (p. 12), implying that lenders must share in the responsibility for borrowers' freely chosen behavior, presumably even under ideal conditions of transparency. With respect to credit cards, they propose an alternative payment plan in which minimum payments would be increased (to ensure the possibility of total payoff within a certain and shorter timeframe) with a "sticky" opt-out (pp. 13–14), as well as regulation of behavior-based fees such as late fees, because "consumers typically do not believe ex ante that they will pay such fees" (p. 14). So not only do these scholars not trust consumers and borrowers to take responsibility for making their own financial choices, but they do not want them held responsible for the consequences of their choices, a distinction to which we will return shortly.[13]

Besides the obvious implications about dignity and autonomy from this refusal to hold people responsible for their own choices and the consequences thereof, there are also deleterious effects on the same cognitive processes that motivated the state intervention in the first place, consequences that would seem to reinforce the need for such interventions.[14] As Daniel Hausman and Brynn Welch (2010, 135) explain, "No matter how well intentioned government efforts to shape choices may be, one should be concerned about the risk that exploiting decision-making foibles will ultimately diminish people's autonomous decision-making capacities." Jonathan Klick (2010) agrees, writing in an online debate on libertarian paternalism that "the more we protect individuals from making decisions (good or bad), the less willing they will be to invest in decisionmaking capacities."

One of the most intensive considerations of the negative consequences of "soft" paternalism comes from Klick and Gregory Mitchell

(2006, 1623), who detail the resulting "inhibition of the development of the regulated parties' decision-making skills." In particular,

> paternalistic interventions may exacerbate irrational tendencies by creating moral and cognitive hazards. Moral hazards arise because paternalistic regulations reduce an individual's motivation to act deliberately and carefully, and motivation level mediates many psychological biases. What we term "cognitive hazards" arise when paternalistic regulations interfere with information searches, educational investments, and feedback that would occur in the absence of paternalistic interventions and that are important to the individual's development of effective decisionmaking skills and strategies. (p. 1626)

Klick and Whitman go on to cite "research from developmental psychology [that] indicates that individuals improve their decisionmaking skills over time through a 'learning by doing' process, and that paternalistic policies threaten interference in this self-regulatory process."[15] This brings to mind the parental maxim that children must be allowed to make mistakes in order to learn from them; if this is true for actual children (with regard to whom paternalism is justified), then it seems it would also be true for individuals whom regulators (implicitly) view as children. Klick and Whitman also cite "research on self-fulfilling prophecies [that] warns that regulated parties are likely to become the weak decision makers envisioned by paternalistic policy makers, as paternalistic regulations undercut personal incentives to invest in cognitive capital and the regulated parties conform to the expectancies of the paternalist" (pp. 1626–7). Instead, "holding people accountable for their judgments and decisions can likewise move behavior toward the rational norm. . . . [E]xpecting to have to account for a choice may have positive effects on decisionmaking quality" (p. 1635).

Klick and Whitman also distinguish between *ex ante* and *ex post* paternalism, or "paternalism imposed before and after a choice is made . . . Ex ante paternalism reduces the incentive to search for information, carefully evaluate decision options, or develop good decisionmaking strategies. Ex post paternalism reduces the risk of thoughtless action, because the government will insulate the decision maker from the consequences of the thoughtless choice. Thus, ex post paternalism operates as a form of social insurance for irrational behavior" (p. 1636). These two types of control correspond to the limits on credit card offers and the restrictions of behavior-based charges (such as late fees) discussed above; the former betrays a lack of trust in people's knowledge of their own interests, and the latter a refusal to hold them accountable for their decisions (even if those decisions have been "nudged" in the right direction). As a result, Klick and Whitman conclude, "ex ante paternalism provides a negative incentive to invest in cognitive capital and exert cognitive effort . . . [and] ex post paternalism provides a positive incentive to reduce cognitive effort and care in many domains" (p. 1637). In terms of responsibility, both ex ante and ex post paternalism relieve the agent of accountability for her choices; the implication is that she will not make the best decisions going in, and should not be held responsible for them as they play out. Neither is consistent with a viewpoint that grants dignity, autonomy, and responsibility to individuals.

Conclusion: What Does This Say about Us?

If the analysis above is correct, and "soft" paternalism (and its harder variants) represents a co-opting of individual choice and responsibility and a failure to respect the dignity of the person—and this has happened through the actions of our duly elected government officials—then what does this development say about us as a people? Of course, this question should not be taken to imply that all of us are so willing; certainly there is opposition to these policies from across the political spectrum. Have we lost confidence in our own decision-making to such an extent that we are now willing to let other people—well-intentioned though they may be, but ultimately ignorant of our true interests—make decisions for us?

To be sure, autonomy implies the right to cede some of our choices to others, as long as we do not sacrifice our autonomy completely (by agreeing to become slaves, for instance). But ideally that should be each individual's decision; otherwise, we may find ourselves in a "tyranny of the majority" if the state has the power to take critical decision-making power away from all in response to the will of some. However, without any constitutional bar against it, voters are free to elect leaders for the express purpose of limiting their choices (although more likely they elect leaders for other reasons, and these policies are incidental). Of course, choice must be limited to some degree, such as by Mill's harm principle, but normally we are not comfortable with limiting a person's choice in his or her own (purported) interests alone.

One consequence of the failure to respect the dignity of persons is that the value of the person is forgotten; this leads to utilitarianism, in which there are no limits to what can be done to the individual in the interests of the group (the value of which is also thrown into question, if the constituent members have no independent value). In fact, the financial reformers discussed above are very utilitarian (or welfarist) in their worldview. Bar-Gill and Warren write that "markets and contracts can be relied upon to maximize welfare only when consumers are rational and informed" (p. 8), which reflects a contingent qualification of markets based on a utilitarian basis. Also, Barr et al. write that "actual competitive outcomes may not always and in all contexts closely align with improved decisional choice and increased consumer welfare," (p. 2), which is problematic only to a utilitarian, not to one who values market process in terms of dignity (on which more below).

Barr et al. also show their disregard for individual discretion over choice when they suggest: "Let us take the example of a consumer who does not understand the profound effects of the compounding of interest. Such a bias would lead the individual both to undersave, and to over-borrow. *Society would prefer* that the individual did not have such a bias in both contexts" (p. 2, emphasis mine). Being concerned with what "society" may prefer (to whatever extent that makes sense) is to cede individual choice to "society"—or rather, to the state, according to whatever interests the state chooses to promote, including the interests regulators sincerely believe individuals to have, but which can never be known with certainty without evidence from choice or consent. Such evidence is present in the context of free choice provided by the market, and cannot be acquired any other way. Criticizing the presumption of libertarianism in "libertarian paternalism," Gregory Mitchell (2005, 1260) writes, "the proper evaluative view of choice behavior from the libertarian perspective is not an objective consequentialist view, but rather one that examines only the quality of *individual consent*" (italics mine).

I have argued that, by ceding some degree of control over our choices to the state, we are sacrificing our own dignity. But why are we doing this? Is it because of perceived failures in private institutions such as the market and the financial sector? If so, this reflects a misunderstanding of the market, which exists for one reason: to provide a venue for the expression of free choice through facilitating voluntary economic transactions between relatively anonymous persons. To the extent that it is permitted to operate, the market performs this function implicitly, and insofar as this result is regarded as good, the market is good. By this understanding, markets cannot "fail" unless they were prevented from serving their sole function of enabling voluntary, mutually beneficial transactions.[16]

Markets are not meant to ensure prosperity; the most we can say is that, generally, they will provide the most prosperity possible under the prevailing conditions, especially the legal and political institutions within which they operate. And it follows from the above that those institutions should be designed to allow the maximal freedom to engage in voluntary transactions, limited only by essential rules of justice. If legal and political institutions go farther than this, and begin constraining the operation of the market for policy ends, the market will be hampered—in which case it may appear that the market has failed, when in reality it is the government that failed by improperly constraining the free operation of the market.

In other words, the market cannot and should not be blamed for disturbances in the pattern of economic growth because it is not the market's role to ensure that growth. The market is not a consequentialist enterprise aimed at maximizing some measure of output, wealth, happiness, or well-being. Rather it is a framework in which persons may engage in transactions with each other in pursuit of their individual goals. To the extent that market agents are free to pursue these goals consistent with others doing the same (that is, pursuing their own goals), the market has been a success. (In Robert Nozick's terms, the market is an institution that guarantees procedural justice, not patterned justice: the process is just, therefore the outcome is just, as with the rules of a game.)

So any time the economy falters, the market itself (in the abstract sense of the principles that organize commercial exchange) cannot be blamed or faulted. Instead, there are two likely candidates for blame: first, the internal rules of justice—against deceit and fraud—may have broken down, in which case some participants in the market behaved unethically (and often illegally), and second, the external influences on the market—policy and regulation—may have influenced outcomes in a detrimental way, in which case market participants reacted to skewed incentives which then led to inferior outcomes. But both of these are problems with the broader legal/political system in which the market operates, not a problem with market organization itself. Unfortunately, many people see market participants behaving in ways that seem unethical or illegal, and rather than blame them specifically (as would be appropriate), cast a wider net to the market system as a whole. And much behavior that seems improper to the casual observer may actually have been rational and ethically unquestionable reactions to poorly designed laws, policies, or regulations, which are less apparent than the high-profile behavior to which they lead.

What we have seen from the public reaction to the downturn is a shift away from private institutions such as the market and toward a more pervasive and extensive role for state regulation, ostensibly justified by the "failures" of the market as well as the decision makers within it. This is tragically ironic to the extent that poorly designed regulations, policies, and laws were actually to blame for the economic downturn. Even more troubling is what this shift in reliance from private, market processes to the state implies about how our national character has changed because of the downturn, changes which may last long after the economy recovers.

Notes

1. For an excellent overview and analysis of the various aspects of the downturn, see the essays in *Critical Review* 21(2–3), 2009.
2. For overviews, see Jolls, Sunstein, and Thaler (1998), and Korobkin and Ulen (2000). The former essay is also included in Sunstein (2000), an early collection of literature related to the nascent field. For a more recent collection, see Parisi and Smith (2005).
3. For a more academic treatment, see Sunstein and Thaler (2001).
4. The following discussion draws heavily on White (2010a).
5. For more on Kantian dignity, deceit and coercion, see O'Neill (1989) and Korsgaard (1996).
6. For the influence of this work and more, see Evans and Wright (2009, 310–15).
7. For this general line of argument, see Hanson and Kysar (1999).
8. Barr et al. share these concerns: "Credit card companies have fine-tuned product offerings and disclosures in a manner that appears to be systematically designed to prey on common psychological biases—biases that limit consumer ability to make rational choices regarding credit card borrowing" (p. 12).
9. For more on this point, see Brito and Hartley (1995).
10. See Epstein (2006, 129–30) on teaser rates.
11. Richard Posner (1998, 1575) accuses behavioral law and economics scholars of "treat[ing] the irrationalities that form the subject matter of behavioral economics as unalterable constituents of human personality. All their suggestions for legal reform are of devices for getting around, rather than dispelling, our irrational tendencies."
12. Of course, the points made here about responsibility hold not just for individuals, but also for businesses and government decision-makers, especially in the context of the recent bailouts that increase the risk of moral hazard among such agents. (See the chapters in this volume by Figart and Prasch for more on this theme.)
13. To add insult to injury, Barr et al. also recommend that "the bulk of such fees would be placed in a public trust to be used for financial education and assistance to troubled borrowers" (p. 14).

14. This is one mechanism by which even slight movements toward libertarian paternalism threaten to become a slippery slope; see Whitman and Rizzo (2007) and Whitman (2010).
15. See also Rachlinski (2003, especially 1220–2).
16. For more on this theme, see White (2010b).

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Part II

Distributional Effects of the Downturn

Chapter 7

Race and Recession: A Comparison of the Economic Impact of the 1980s and 2007–09 Recessions on Non-College-Educated Black and White Men

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Introduction

The impact of recessions is often borne unevenly. Different groups may have very different employment experiences in the same economic cycle, and this is especially true of different racial groups (Schulman 1996). Since the 1970s the unemployment rate as well as nonparticipation for black men relative to white men has increased throughout various economic cycles of expansion and contraction (Juhn 2000). Cutler and Katz (1991) argue that forces arise even during economic expansions that often work against those in disadvantaged positions. During the 1990s expansion, unemployment was at a historical low, but nonparticipation and nonemployment actually grew for a specific core group, both in number of people and duration out of work (Juhn 2000).

The goal of this study is to provide greater insight into the most recent economic downturn through an analysis of a period that exhibited similar characteristics: the recessions of the early 1980s, where racial differences in the impact of the contraction were particularly stark. Like the most recent downturn, which began in December 2007 and as of this writing had not yet been declared over, the contraction of the early 1980s—technically considered to have been two back-to-back recessions—was unusually severe.[1] Using data from decennial censuses, the Current Employment Statistics, the Current Population Survey, and the American Community Survey, this paper provides an overview and comparison of racial disparities during the 1980s and most recent recessions by documenting racial differences in employment outcomes among non college-educated black and white men. By focusing on workers without college educations, we examine the largest category of workers, as a minority of U.S. adults holds more than a high school degree. The analysis focuses on men in order to abstract from trends in labor force participation that differ by race and gender. The study shifts the focus away from human capital as the primary determinant of employment outcomes to examine other factors that are known to affect outcomes, chiefly occupational segregation.

The aim of this study is to offer greater insight into the 2007–09 recession by providing a deeper analysis of the 1980s downturn and comparing the labor-market dynamics in that period with those of the recent downturn. We focus on groups' relative labor market locations and their occupational segregation from each other as determinants of how groups were affected by the recessions. The paper's core questions are: First, did the 1980s shift in manufacturing (referred to as the "restructuring") explain the differential impact of that period's recessions by race? Second, does occupational segregation or differentiation explain this gap? Since characteristics of local labor markets vary and workers' employment opportunities are typically bound by the local labor market in which they work or are seeking work, the appropriate geographic scope for examining these questions is at the metropolitan level.

Background

The key marker of the recessions of the early 1980s was the large-scale shift from a manufacturing-dominated economy to a post-industrial economy where service, information and technology sectors dominate; these changes were so profound it has been referred to as the "restructuring" of the U.S. economy. Most specifically with regard to racial differences, whites were far more successful in shifting from the manufacturing industry to the newly emerging industries, even in cities and regions where manufacturing dominated, and as a result suffered less of a blow to their labor market outcomes in those recessions relative to blacks. In contrast, blacks experienced massive job loss, displacement, and poverty as a result of restructuring.

Conventional theories for the substantial racial differences in employment outcomes as a result of the recession include racial disparities in education and the differential impact of restructuring. The education or skills-deficit hypothesis has received a lot of attention, but less so has restructuring or the importance of a worker's position in the market to his wages and other employment outcomes. Wage-setting mechanisms in local labor markets are affected not only by human capital or skills, but also by other factors such as crowding, segregation, and networks. Low-wage workers are aware of job opening information and have higher wage expectations when opportunities are widespread and lower when opportunities are more limited; this relationship has been documented (Juhn 2000).

Our focus on groups' relative labor market position is motivated by theories that emphasize group location as a key factor underlying group differences in labor market outcomes. These include dual labor market theory (Doeringer and Piore 1971) and split labor market theory (Bonacich 1972), which hold that the market is divided into a core and a periphery with industries in the core offering jobs with higher wages and more stability than those in the periphery. The key theme uniting these theories is the notion that one's position in the market is central to one's employment outcomes.

This emphasis on the relative market location of groups shifts the focus to the demand side from an overemphasis on worker characteristics. One of the key reasons to think white men have access to different jobs than black men is queuing. Persistent empirical evidence has found that employers tend to rank their preference for workers, among other things, by race (this is called a queue) and that young black and Hispanic workers are lower on employers' hiring queues (Moss and Tilly 2000, Waldinger 1993). Reasons why include hard and soft skill deficits (real or perceived), employer stereotyping, prejudice (employer, customers, coworkers), and hiring practices. Queuing becomes important to understanding groups' differences during different economic cycles, because changes in the supply of competing workers and cyclical shifts in demand can change their position in the queue. Employers move down the queue as the market tightens. Moss and Tilly (2000) find tightness to be associated with decreases in hiring whites and increases in hiring blacks, offering evidence that employers respond to the size and composition of the labor pool.

These mechanisms, however, can vary across metropolitan labor markets (Huffman and Cohen 2004). Industry concentration varies across metropolitan areas, as do black and overall unemployment rates. If the predominant theories explaining racial differences in the 1980s recessions point to the shift in manufacturing, but manufacturing concentration varied significantly across metropolitan areas, then a metro-focused analysis is essential to ascertaining the effects of these factors. Thus, the analyses in this chapter look both at national-level comparisons and then metro-level comparisons to add clarity to the picture of racial differences in employment outcomes at the national level.

Data and Analysis

This study utilizes a unique dataset of individual-level characteristics and the structural characteristics of the hundred largest U.S. cities. For the individual-level (non-metropolitan) analysis, we use the 1-percent Public Use Micro Data Sample (PUMS) from the 1980 and 1990 decennial censuses. For the metropolitan-level analyses, the 1980 and 1990 decennial census data are aggregated to the metropolitan level to construct the demographic, employment, educational, occupational, and industrial characteristics of this panel of cities. To extend the analysis to the present downturn, we use 2008 data from the Census Bureau's American Community Survey, accessed through the Integrated Public Use Microdata Series (IPUMS) maintained by the Minnesota Population Center (Ruggles et al. 2010). For the metro-level analysis, the unit of analysis is the "metropolitan statistical area" (MSA) or the "primary metropolitan statistical area" (PMSA), defined on a consistent basis across the data sets. As is common in many analyses of wage disparities, the analyses only include male workers who have a high school education or less, to control for educational disparities and confine the scope of the analysis. For background, we also present monthly data on employment and unemployment from the Bureau of Labor Statistics.

To analyze the 1980s and 2007–09 recessions, the paper uses several different approaches: an overview and comparison of racial disparities during the two recessions; a comparison of the density of employment of blacks and whites in manufacturing before and after the 1980s recessions; and a comparison of group differences in wages. As one means of gauging the differential impact of the 1980s recessions on black and white men, we conduct a synthetic cohort analysis in which actual changes in wages and other labor-market outcomes over the 1980–1990 period are computed for men aged 30–39 years in 1980, and then compared to analogous outcome measures for men 40–49 in 1980. Taking the latter to be the outcomes the 30–39 cohort would have expected to realize had there been no change in the structure of their labor-market opportunities over the period, the difference between the actual and expected values will indicate how their opportunities changed in the aftermath of the recession. Finally, changes in black/white occupational segregation are measured and assessed using the index of dissimilarity before and after the recession.

A commonly used measure of occupational segregation is the index of dissimilarity. The dissimilarity index implemented here measures segregation between white and black non-college-educated men in occupation-industry clusters. It is important to measure both industry and occupation because minorities tend to cluster in different industries than whites and the wage structure differs across industries. The index of dissimilarity is a linear function of segregation, meaning that the "cost" of reducing segregation is constant from more to less segregated environments. The function is also symmetric, so that it reflects the share of workers in either group who would have to change occupations to achieve an equal distribution across all jobs.

Specifically, the Duncan dissimilarity index is used to measure segregation with respect to occupation. The formula for the Duncan index is:

$$\frac{1}{2TP(1-P)}\sum_{i=1}^{n}[t_i|(p_i - P)|]$$

Where n = number of occupational categories
t_i = total number of workers in occupation i
T = total workforce (sum of all t_i)
p_i = minority group as a share of workers in occupation i
P = minority group as a share of the total workforce

A score of 0 indicates that the members of the minority group are represented in equal proportions in all occupations, and a score of 1 indicates that they are concentrated in one occupation. The score can be roughly interpreted as the percentage of a group's employees who would have to be shifted to different occupations to obtain equal representation in all occupations.

Results

Overview

First, to get a sense of how the 1980s and 2007–09 recessions compare, Figure 7.1 shows the evolution of total payroll employment in the two periods. The charts reveal that, for everyone, the most recent recession is markedly worse overall than the 1980s downturn; the drop in the number of people employed over 2007–09 was much more substantial than in 1980–1983. At the same time, the brunt of the recession may be a little better distributed in the most recent recession than in the 1980s. Figure 7.2 shows the ratio of the black

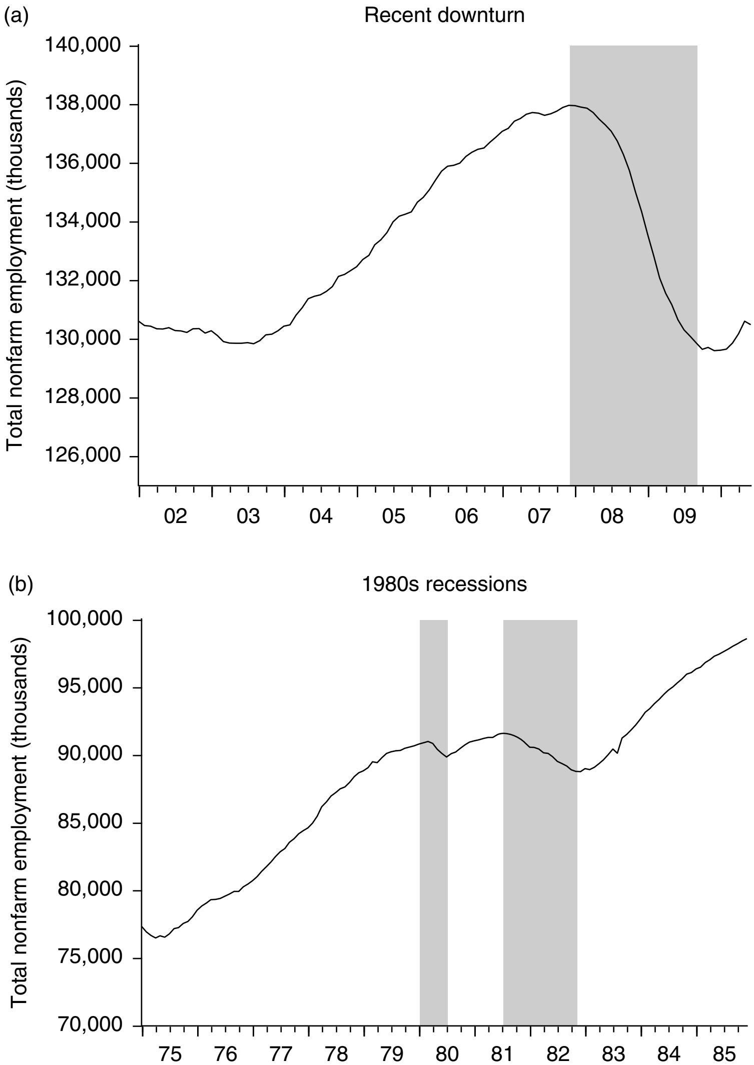

Figure 7.1 Recent downturn shows steep decline in nonfarm payroll employment compared to the 1980s recessions

Source: Bureau of Labor Statistics, Current Employment Statistics. Gray areas are recessions as defined by the National Bureau of Economic Research. As of this writing, the NBER had not officially declared an end to downturn that started in December 2007. Consistent with current expectations, the graph assumes the recession ended in the middle months of 2009, taken in the graph to be September (see e.g. Reddy 2010).

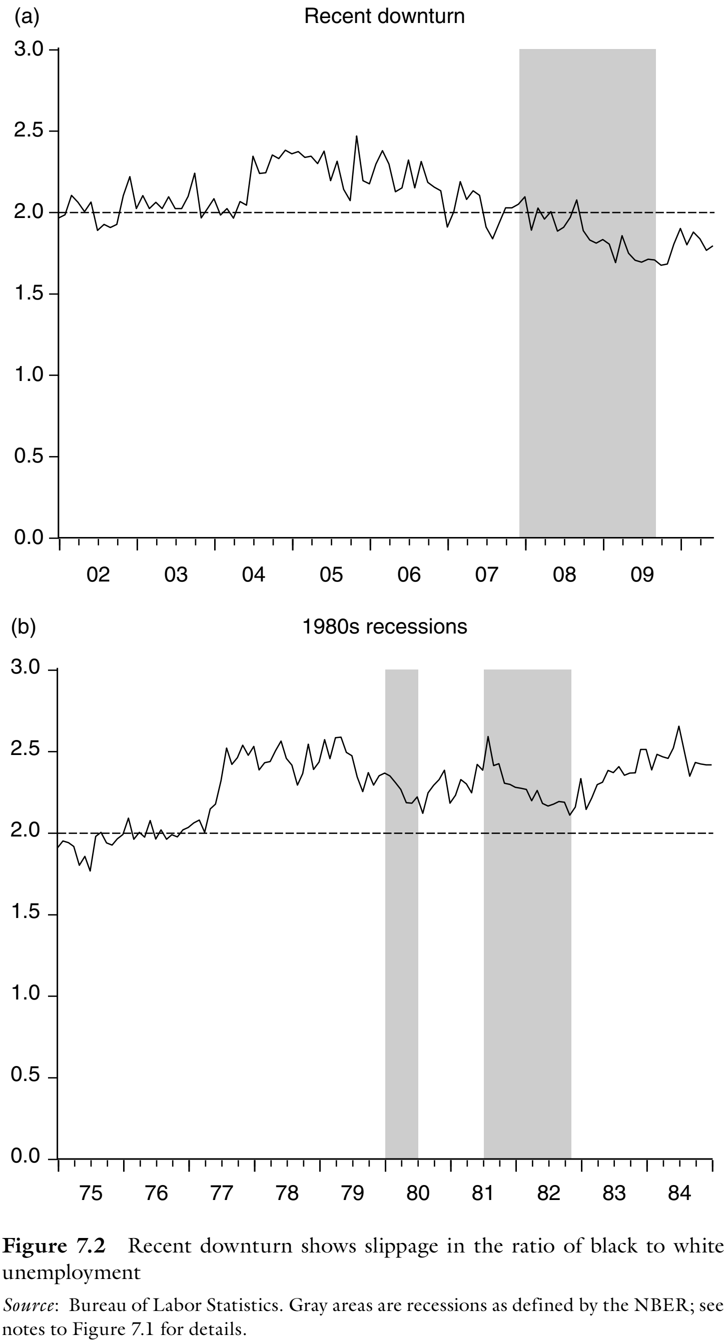

Figure 7.2 Recent downturn shows slippage in the ratio of black to white unemployment

Source: Bureau of Labor Statistics. Gray areas are recessions as defined by the NBER; see notes to Figure 7.1 for details.

unemployment rate to that for whites leading up to both recessions. For decades, this ratio has been at or above 2, that is, blacks were two or more times more likely than whites to be unemployed. The ratio is particularly high in the 1980s, but reaches a low by the 2007–09 recession. Blacks are still substantially more likely than whites to be unemployed to be sure, but the ratio between the two is smaller leading into the 2007–09 recession, reflecting this recession's more broadly distributed impact. Whereas white men in particular suffered the least in the 1980s recessions, in 2007–09 the story was different. Industrial concentration is one of the leading explanations for the somewhat more equitable distribution of the impact of this recession. White men were more concentrated in industries that suffered the largest losses in this recession; 50 percent of job loss has been in construction and finance where blacks are underrepresented, and blacks are overrepresented in the few industries that have been spared the most: government, health, and education.

The 1980s Recessions

To understand these differences better, we will now examine each recession in turn. The predominant explanation offered for the stark racial disparities in the 1980s downturn was the shift away from manufacturing. The notion was that manufacturing declined sharply in the United States in this time period, and that the loss of jobs was particularly devastating to blacks because these were well-paying, stable jobs. Table 7.1 examines racial differences in representation in manufacturing employment of non-college men in 1980 and 1990, which sheds insight into labor-market adjustments after the 1980s recessions.[2] In 1980, blacks were slightly more likely than whites to work in manufacturing (although not more likely to work in all goods-producing industries), but by 1990 they were less likely than whites to work in manufacturing. This does not offer convincing evidence for

Table 7.1 Percent of male workers without college degrees employed in manufacturing and goods-producing sectors, by race

	Manufacturing		Goods-producing	
	1980	1990	1980	1990
White	21.4	21.6	32.4	38.4
Black	22.2	20.4	30.7	32.9

Source: Decennial censuses, author's calculations.

Table 7.2 Average hourly wages of black and white men employed in manufacturing (constant 1980 dollars)

	1980	1990
White	$6.94	$6.90
Black	$7.86	$8.98

Source: Decennial censuses, author's calculations. Amounts are converted to constant 1980 dollars using the all-item consumer price index.

the restructuring hypothesis. Table 7.2 looks further at racial differences in manufacturing employment by showing the racial wage gap among workers employed in manufacturing. There is a significant gap in wages between black and white men who work in manufacturing, and these disparities actually grew after the 1980s downturn.

Another way to assess the differential impact of the recession on black and white men is to compare the expected change in their employment outcomes before and after the downturn to the actual change in their employment outcomes. For this, we construct synthetic cohorts of black and white non-college men aged 30 to 39 in 1980 and estimate how their wages and number of hours worked per week changed over the next 10 years by comparing their wages and hours worked to those of comparable men aged 40 to 49 years in 1990. To identify effects of the 1980s recessions, we compare these *actual* changes to changes these cohorts would have *expected* to realize had there been no change in the structure of their labor-market opportunities over the period; these expected values are taken from men in the 40 to 49 age range in 1980, assuming that those aged 30 to 39 at that time would have looked like them 10 years later had the labor market not changed. As shown in Table 7.3, over the 1980–90 period, real hourly wages grew more than expected for white men and less than expected for black men. White men's hours worked per week grew substantially more when they were actually expected to decline. Black men's hours grew more than they were expected to, but not nearly as much as white men's.

How different are the occupations and industries in which black and white men work, and did the recession change that? Occupational segregation is one way of measuring this different market position. As mentioned, the dissimilarity index is a common way of measuring occupational segregation among two groups; it ranges from 0–1, where higher numbers reflect greater segregation. In Table 7.4, the dissimilarity index for black and white men is shown for men of all

Table 7.3 Synthetic cohort analysis: Changes in average wages and hours for non-college men aged 30–39 in 1980

	White		Black	
	Average hourly wage	Number of hours per week	Average hourly wage	Number of hours per week
Actual Δ	\$2.69	9.33	\$0.81	3.90
Expected Δ	\$2.25	–0.62	\$1.35	2.64
% difference between actual and expected	18%	228%	-50%	39%

Source: Decennial censuses, author's calculations. Note: % difference between actual and expected is computed using the midpoint method.

Table 7.4 Dissimilarity index: Occupations of black and white men

	1980	1990
All education levels	0.24	0.27
Non-college	0.26	0.23

Source: Decennial censuses, author's calculations.

education levels and for those with only a high school degree or less. In the decade after the 1980s recession, the dissimilarity index between all black and white men went up, but among those with a high school degree or less it actually went down. Of course, since the dissimilarity index measures differences only among those working, and the 1980s recessions' worst impact was to increase unemployment, race differences in labor-market outcomes are not fully captured in the dissimilarity index. This is all the more true because non-participation went up during this time period, especially among black men.

In another paper examining these relationships in multivariate regressions, which control for various characteristics of MSAs including occupational segregation, Dickerson vonLockette and Spriggs (2010) find that, in 1990, metros that had higher levels of occupational segregation among black and white non-college-educated men also had a higher white/black wage gap.

The 2007–09 Recession

Turning to the 2007–09 recession, we first look at racial differences in general employment outcomes in Table 7.5. Mean wages for white

Table 7.5 Employment outcomes of non-college men, 2007–2009

	White			Black		
	2007	2008	2009	2007	2008	2009
Average hourly wage (2008$)	15.03	14.58	14.69	12.57	11.82	11.92
Standard dev.	7.92	7.08	7.93	5.13	4.62	5.02
Labor-market status (%)						
Employed	72.6	70.2	64.0	54.3	53.3	47.0
Unemployed	5.2	6.6	11.3	8.9	9.8	14.4
Not in labor force	22.2	23.1	24.7	36.7	36.9	38.6
Ratio of employment to population for men with less than high-school education	59.4	56.3	50.9	32.5	31.9	25.0

Source: Bureau of Labor Statistics, Current Population Survey, October supplement, accessed through IPUMS (Ruggles et al., 2010). Sample is confined to men ages 16–64 living in metropolitan areas.

non-college-educated men were higher than for black non-college-educated men. Additionally, the amount of variation in wages is higher for white men than black men. White men in this group are much more likely to be employed than black men and are less likely to be unemployed. Black men are more likely to not participate in the labor force (recall that these are all working age adults). Non-participation has been linked to discouragement, is typically higher for black men, goes up during recessions, and is often a response to a slackening labor market and fewer job opportunities.

As mentioned in the introduction, one of the key explanations proffered for the racial differences described above has been the skills deficit explanation; that is, blacks suffer greater unemployment than whites, particularly during shifts in the economy, because they have less education than whites. Thus, according to this hypothesis, we would expect blacks and whites who have little education to be in a fairly similar situation, particularly during a recession as they are the most vulnerable. Table 7.5 shows the employment odds for black and white men with less than a high school education revealing in fact the opposite of what the aforementioned hypothesis suggested. Even the least-educated whites have substantially better employment rates than blacks with similar education.

This disparity in employment outcomes may be due to market position or location; that is, are white and black men working in the same or dissimilar industries and occupations? As Table 7.6 reveals, the industries in which white men are more concentrated than black men are construction, manufacturing, mining, and agriculture. Black men have a higher representation in transportation, entertainment, and public administration. With regard to occupations, non-college-educated white men are more than twice as likely to be in executive/administrative occupations and 50 percent more likely to be in craft occupations, both of which are relatively higher-paying. Black men are more likely than white men to work in transportation, protection, and other service occupations, all relatively lower-paying occupations. Thus, it is clear that white and black men without college degrees,

Table 7.6 Industrial and occupational distribution of white and black non-college-educated men, 2008

	White (%)	Black (%)
Industry:		
Agriculture	4.0	1.4
Mining	1.3	0.4
Construction	21.4	16.2
Manufacturing—nondurable goods	4.7	5.2
Manufacturing—durable goods	11.5	8.4
Transportation, communications, utilities	9.8	11.9
Wholesale trade	3.9	3.1
Retail trade	12.4	11.4
Finance	2.6	2.6
Professional, scientific, and management services	7.2	10.0
Personal services	4.7	4.6
Entertainment services	9.2	12.4
Education, health, and social services	4.5	8.5
Public administration	2.9	3.8
Total	100	100
Occupation:		
Executive and managerial	9.7	4.1
Professional Specialists	3.7	3.2
Technical	1.4	2.2
Sales	23.0	23.7
Administrative	8.0	10.0
Craft	21.8	14.5
Operators	4.7	4.9
Transportation	18.5	23.1
Handlers	0.3	0.7
Protective services	2.8	4.0
Other services	6.2	9.6
Total	100	100

Source: American Community Survey, accessed through IPUMS (Ruggles et al., 2010). Sample is confined to employed men, ages 16 years and older.

despite their similar educational status, are positioned very differently in the labor market.

This location difference may explain their different employment outcomes, particularly with respect to wages, described above. Again, occupational segregation is one way of measuring this different market position. As shown in Table 7.7, in 2008 the index of dissimilarity between black and white non-college-educated men was 0.17 nationally. This index is not much different from the overall index for all black and white men (i.e., including those with college educations); the index computed for this group is 0.19. It should be kept in mind that these are broad occupational categories, and occupational segregation usually is higher when the categories become more detailed. The average dissimilarity index computed across the 100 largest metropolitan areas was 0.43, higher than in 2000, and much higher than the 0.17 national, individual-level index for 2008. This underscores the idea that nationally, we may be comparing black and white men who are not necessarily competing for jobs in the same local labor markets, but when we specifically examine white and black men within local or metropolitan labor markets, we see a much more varied picture. While these indices are not directly comparable—the national indices include all men (in both metro and non-metro areas), whereas the within-metro indices only include men in metro areas (i.e., a smaller set of individuals than in the national)—the contrast offers a more nuanced understanding of how and where racial disparities in employment operate.

Table 7.8 shows the dissimilarity index and the ratio of wages of black and white non-college-educated men in the 50 largest MSAs. Here we can see significant variation across metropolitan labor markets in occupational segregation or the dissimilarity index, ranging from 0.24 in New York to 0.60 in San Jose, as well as in the wage ratio (varying from 1.06 in Los Angeles and Riverside-San Bernardino to

Table 7.7 Dissimilarity index: Occupations of white and black non-college-educated men, 2008

Computed from individual-level data	
All education levels	0.19
Non-college	0.17
Average across indexes computed within MSAs	
Largest 100 MSAs—2000	0.37
Largest 100 MSAs—2008	0.43

Sources: Decennial census for 2000, American Community Survey for 2008.

Table 7.8 Dissimilarity index and wage ratio for non-college-educated men in the 50 largest metropolitan areas, 2008

Metropolitan area	State	Dissimilarity index	Ratio of white to black wage
Los Angeles-Long Beach	CA	0.32	1.06
New York-Northeastern	NJ	0.24	1.46
Chicago-Gary-Lake	IL	0.29	1.37
Washington, DC	DC/MD/VA	0.31	1.46
Atlanta	GA	0.26	1.41
Houston-Brazoria	TX	0.30	1.44
Philadelphia	PA/NJ	0.26	1.54
Dallas-Fort Worth	TX	0.31	1.28
Riverside-San Bernardino	CA	0.39	1.06
Phoenix	AZ	0.37	1.19
Detroit	MI	0.25	1.45
Boston	MA	0.29	1.61
Orange County	CA	0.50	1.16
San Diego	CA	0.35	1.24
Tampa-St. Petersburg-Clearwater	FL	0.35	1.42
Nassau County	NY	0.33	1.38
Baltimore	MD	0.25	1.54
St. Louis	MO-IL	0.36	1.56
Seattle-Everett	WA	0.47	1.36
Oakland	CA	0.40	1.34
Minneapolis-St. Paul	MN	0.40	1.25
Denver-Boulder-Longmont	CO	0.40	1.35
Cleveland	OH	0.31	1.60
Pittsburgh-Beaver Valley	PA	0.42	1.48
Orlando	FL	0.29	1.32
Miami-Hialeah	FL	0.30	1.40
Newark	NJ	0.34	1.48
Fort Worth-Arlington	TX	0.32	1.27
Las Vegas	NV	0.25	1.24
Sacramento	CA	0.39	1.26
Portland-Vancouver	OR	0.41	1.45
Charlotte-Gastonia-Rock Hill	SC	0.34	1.48
San Jose	CA	0.60	1.22
Indianapolis	IN	0.32	1.17
San Antonio	TX	0.43	1.09
San Francisco-Oakland-Vallejo	CA	0.52	1.58
Fort Lauderdale-Hollywood-Pompano Beach	FL	0.31	1.47
Kansas City	MO-KS	0.31	1.48
Norfolk-VA Beach-Newport News	VA	0.32	1.43
Columbus	OH	0.33	1.42
Raleigh-Durham	NC	0.31	1.55
Salt Lake City-Ogden	UT	0.50	1.39
Cincinnati	OH/KY/IN	0.31	1.48
Austin	TX	0.41	1.38
Nashville	TN	0.30	1.29
West Palm Beach-Boca Raton-Delray Beach	FL	0.31	1.65
Greensboro-Winston Point Salem-High Point	NC	0.34	1.34
Jacksonville	FL	0.30	1.38
Middlesex-Somerset-Hunterdon	NJ	0.50	1.18
Monmouth-Ocean	NJ	0.47	1.45

Source: American Community Survey, accessed through IPUMS (Ruggles et al., 2010).

1.65 in West Palm Beach). The wage ratio is mean hourly wages for non-college-educated white men, divided by the same for black men; thus the closer the ratio is to 1.0, the more equal their wages are, and the higher it is, the more white men's earnings outstrip black men's. This variation suggests that the mechanisms underlying these racial disparities in wages and occupational status seem to operate differently across metropolitan labor markets, and accordingly, assessing opportunities and barriers for workers must happen at that level.

Conclusion

The goal of this chapter was to compare the impact of the 1980s and 2007–09 recessions on black and white non-college-educated men. Racial disparities, while prominent during both time periods, were much starker in the 1980s recessions. We did not find racial differences in the shift of manufacturing employment to be associated with changes in employment status through that recession; occupational segregation went down slightly for this group by 1990. However, occupational segregation increased in the 2008 recession and may have actually contributed to the more equal distribution of the impact of the recession, given white men's overrepresentation in the hardest hit industries. The findings in this chapter underscore the importance of considering the structural location of workers in the labor market and shifting focus from an overreliance on education as an explanation for individuals' labor market outcomes.

These findings support a view of the labor market as an institution where workers' outcomes are partially a function of the institutional features and processes of the markets in which they seek work. At the outset, we suggested that wage-setting mechanisms such as occupational segregation and crowding are important determinants of pay, rather than only human capital. If these mechanisms are operating in the labor market particularly during downturns, what policy response makes most sense to protect workers in slack labor markets? The most logical policy responses ideally would focus on features of markets, practices of firms and employers, and not just on characteristics of workers as causal determinants of workers' employment outcomes. For example, if employers' need or ability to rank order applicants by race varies across cycles (queuing), then policies that encourage employers to use more objective means of selecting employees and posting job openings would create fair access to jobs even during downturns.

This study also employed and demonstrated the usefulness of a metro-level of analysis (Dickerson 2007). This approach added insight that characteristics of labor markets affect individual outcomes and explain group differences. As workers compete for jobs in the metropolitan labor markets in which they live and seek work, policies that consider local-level factors may be more effective at creating opportunities for workers during slack (or difficult) job markets.

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Notes

1. According to the National Bureau of Economic Research, the U.S. economy experienced one recession from January through July of 1980 and another from July 1981 through November 1982.
2. Manufacturing includes only manufacturing industries. The goods-producing sector includes all goods-producing industries, including agriculture, mining, and construction as well as manufacturing.

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Chapter 8

Who Pays the Price When Housing Bubbles Burst? Evidence from the American Community Survey

Cynthia Bansak and Martha A. Starr

Introduction

There has been much debate in recent years about whether the Federal Reserve should have taken action against the housing-price bubble as it was forming. As home prices rose, the Fed's position was that it was difficult to know whether a bubble was developing, and that monetary policy could always be eased if declining prices posed risks to continued expansion.[1] As much as it is now widely recognized that this was not a prudent position,[2] there remains little consensus as to whether monetary policy should incorporate any systematic concern with asset-price bubbles, above and beyond what is implied by its core concerns with inflation and unemployment. Thus, for example, procyclical adjustments in capital requirements could be used to keep asset values from drifting out of line with their underlying values (Yellen 2009, Evans 2009).

An important issue in this respect concerns who pays the price when an asset-price bubble bursts. Conceivably it may be of little social benefit to offset a potential bubble which, if it later burst, would impose costs on a relatively narrow and well-off segment of the population. Thus, for example, the high-tech stock bubble of the late 1990s affected shareholders and employees of high-tech companies, who were largely highly skilled and well-educated. In contrast, the housing-price bubble that burst in 2006 and precipitated an aggregate downturn imposed costs on a wide swath of households and businesses—although we know little as yet about how these were distributed. Characterizing the distributional effects of housing-price booms and busts is important in view of recent theoretical work on business cycles, which suggests that allowing for heterogeneities may significantly alter estimated welfare effects of aggregate fluctuations.[3]

To date, there has been little systematic research on the distribution of benefits and costs of housing-price bubbles. In an early paper, Case and Cook (1988) found that rising home prices increased the consumption opportunities of existing homeowners while decreasing those of renters and prospective homebuyers; much research since then confirms this finding (e.g., Gyourko and Tracy 1999). Mayer (1993) found that prices of lower-end housing tend to increase more rapidly during housing booms than those of higher-end housing, but that the volatility of higher-end housing is greater. Quigley and Raphael (2001) identify high housing costs as a significant determinant of variations in homelessness across areas, suggesting that housing-price bubbles contribute to problems of access to housing for very low income people. Work by Baker and Rosnick (2008) using the Survey of Consumer Finances suggests that the current drop in housing prices is particularly detrimental for households in the middle of the wealth distribution, given the importance of home equity in their portfolios. A shortcoming of existing research is that it tends to focus on housing-related issues without considering aggregate implications. Notably, rising house prices per se may be detrimental for low-to-moderate income households, but if they stimulate residential investment and/or boost consumer spending due to wealth effects, they may also improve prospects for income and employment. Thus, understanding how housing-price bubbles affect income and employment patterns, as well as housing-related outcomes, is beneficial for gauging how their costs and benefits are distributed across groups within the population.

This paper uses data from the Census Bureau's annual American Community Survey (ACS) to examine this question. Each year, the ACS collects social, demographic, housing and economic information from a nationally representative sample of 3 million U.S. households. As of this writing, data were available for 2005–08, enabling us to examine how the bursting of the housing price bubble after 2006 has affected households with varying characteristics. The next section of the paper lays out three mechanisms via which housing-market booms and busts affect the broader economy and different types of households within it: namely, wealth-effects on spending, swings in residential investment, and problems of financial distress. We then use data from the 2005–08 waves of the ACS to analyze how the housing-price bust has affected households with different characteristics, differentiating between communities in which home prices did and did not boom and bust. Our results suggest that costs of the bubble have tended to fall on households less able to endure periods of financial distress. This lends further support to the argument that monetary policy oriented to social welfare should tackle bubbles *ex ante* rather than *ex post*.

Conceptual Issues and Existing Research

Case and Quigley (2008) identify three mechanisms via which the unwinding of a housing boom would be expected to affect the broader economy. The first is the wealth effect on spending, whereby a decline in home prices reduces the net worth of homeowners, causing them to reduce their spending to reflect the lower value of their total wealth. Research by Case, Quigley and Shiller (2005), Carroll, Otsuka and Slacalek (2006), and Bostic, Gabriel and Painter (2009) suggests that, *ceteris paribus*, a $1 increase in housing wealth would boost spending by 4–8 cents, with the effect phasing in over the next 2 or 3 years. Estimates of the housing-wealth effect are stronger than those for stock-market wealth, which range between 2–5 cents per dollar, due to the greater prevalence of homeownership versus stockownership and a higher marginal propensity to consume among homeowners versus stockholders.[4] At the same time, higher home prices also boost the housing costs of renters, cutting into their ability to spend on other goods.[5] Nonetheless, because 66 percent of households are owner-occupied and home-owning households account for 77 percent of total consumer spending, the housing-wealth effect is estimated to be positive and strong on balance.[6]

Via this mechanism, the bursting of the housing-price bubble would be expected to slow growth of consumer spending and exert a drag on output, incomes and employment over the next few years. To provide a sense of the magnitude of the effect, we can use Carroll, Otsuka and Slacalek's (2006) estimates of a same-quarter wealth effect of 2 cents per dollar that increases to 8 cents per dollar after two years and data on the declining value of housing wealth from the Federal Reserve's Flow of Funds. Based on the extent of the decline in housing wealth and its time profile, we estimate that it had reduced real consumption growth by 1/2 of a percentage point by 2006:Q4, 1.5 percentage points by 2007:Q4, and 2 percentage points by 2008:Q4.[7] As such, it played an important role in bringing on the "Great Recession."

How this would affect employment and incomes among people of differing characteristics is not clear from existing research. To the extent that the reduction in spending follows the usual pattern in cyclical downturns, it would be expected to disproportionally affect spending on durable goods, as well as spending on discretionary goods and services (e.g., recreational travel, restaurant meals, fashion clothing).[8] It would also be expected to lead to higher unemployment, with people having less education and/or who are black or Hispanic experiencing the largest increases in unemployment rates (Blank 1989, Hoynes 2000, Spriggs and Williams 2000). Geographically, adverse wealth-effects on spending may tend to be somewhat larger in areas that experienced house-price bubbles due to declining demand for locally produced goods and services. On the other hand, the decline in housing prices would be expected to reduce upward pressures on rents in areas that had had bubbles, making housing more affordable for renters.

The second mechanism via which an unwinding housing boom would affect the broader economy is declining residential investment. Periods of unusual run-ups in prices tend to be associated with booms in residential investment, which in turn raise incomes and employment—both because of the construction activity itself and because of relatively high multiplier effects associated with residential investment (Fair 2004, Case and Quigley 2008). Thus, Case and Quigley (2008) expected a marked decline in the pace of new home construction to represent the largest effect of the housing-price bust on the broader economy, and indeed data from the National Income and Product Accounts show that it was a major factor pulling down growth of real GDP in 2007 and 2008.[9]

Whether we should expect declining construction investment and employment to be worst in areas that had the most sizable housing-price bubbles is not clear from existing research. Several previous studies suggest that housing-price bubbles are most likely to build in areas where land is scarce, so that increased demand pushes up price rather than eliciting increased supply of new homes (Glaeser, Gyourko, and Saiz 2008). In this case, it is possible that adverse effects on employment and incomes may not be concentrated in areas that had the worst housing-price bubbles, as these may not have experienced particularly strong booms in investment (Goodman and Thibodeau 2008). In terms of what types of people would be most affected by a construction slump, it is important to note that the construction industry employs people with varied levels of education, training, skill, and experience—ranging from construction laborers (12–13 percent of the construction work force in 2005), to skilled craftspersons such as carpenters, electricians and masons (40 percent), to office and administrative support staff (14 percent), to construction managers (who earned $91,000 per year on average and made up 7.5 percent of the work force in 2005).[10] But to the extent that the least skilled workers and/or minorities are the first to be laid off when construction business turns down, declining residential investment may also have regressive effects on incomes and employment. We can also expect declining construction to adversely affect production and distribution of building materials and supplies, so that its effects may not be confined to markets that had had construction booms.

The third channel via which a decline in housing prices affects the broader economy is financial. Because home sales tend to boom during housing-price bubbles, people shift out of jobs in other sectors and occupations and into jobs in real estate and finance (Hsieh and Moretti 2003). As prices fall and sales drop off, incomes and employment in real estate and finance decline; given that jobs in these fields require relatively high levels of education and/or training, job loss here may affect people in the middle-to-upper part of the income distribution. Additionally, because returns to homeownership seem so high during bubbles, and costs of waiting to buy rise, households that might otherwise rent may instead buy via leverage, taking on debt payments that are high relative to their incomes. Especially for households who bought late in the boom, a subsequent price drop can leave them holding an asset worth less than the debt associated with it, with little free cash-flow to spare. This problem was much exacerbated by growth of subprime lending in the past 10 to 15 years, where the availability of low- or no-down-payment loans increased the likelihood of going "underwater" when housing prices turned down, and mortgage payments on a non-negligible share of subprime loans were re-setting to higher levels just as housing prices peaked (Gramlich 2007). Thus, rather than being able to sell their homes to pay off their mortgages, homeowners instead suspended payments and/or defaulted on their loans. We know from financial data that defaults and foreclosures have increased significantly since 2007, especially in markets where subprime lending had grown most robustly; we also know that subprime lending tended to grow most rapidly in areas that had relatively large black and Hispanic populations (Mayer and Pence 2008). Still, the evidence is less than clear on what types of households have had to exit from financially unsustainable homeownership arrangements: because the financial data contain little information on household characteristics, we know only generally what sorts of borrowers have been caught in this sort of pinch.

Data

Data for this study come from the U.S. Census Bureau's American Community Survey, an annual cross-section survey which collects social, demographic, housing and economic information from a large sample of U.S. households. The survey is intended to measure changes between the decennial censuses and uses a questionnaire similar to its former "long form." As with the census, filling it out and returning it is required by law. About 250,000 households per month receive the questionnaire in the mail, yielding a sample size of about 3 million households per year (a 1 in 40 sample).[11] The ACS sample has been broadly representative geographically since 2005, with data presently available for the four waves between 2005 and 2008.[12] However, because relatively small areas have relatively small numbers of respondents, estimates of changes over time for such areas, especially for subsets of households within them, move a good deal due to sampling error. Thus, we confine our analysis to the 167 metropolitan statistical areas (MSAs) that had populations of 250,000 or more in the 2005–08 period. These contain about 220 million people, or about three-quarters of the U.S. population.[13]

To measure how the housing-market bust has affected households with different characteristics, we categorize metropolitan areas into those which experienced a boom and bust in housing prices, and those which did not. For this purpose, we use the quarterly all-transaction house-price indexes from the Federal Housing Finance Agency (FHFA), which are weighted, repeat-sales indexes computed for single-family properties having a mortgage purchased by Freddie Mac or Fannie Mae. While the FHFA data have certain disadvantages relative to the S&P/Case-Shiller home-price indexes, the former are available for all of the MSAs in our analysis while the latter are not. To identify MSAs that experienced housing-price bubbles that burst, we use two definitions based on the extent of the increase in the FHFA price index between 1995:Q1 and the peak value shown in the data, and the extent of the decline in the price index (if any) between the peak and 2008:Q4. In the first "broader" definition, an MSA is considered to have had a bubble if prices increased by at least 125 percent after 1995 and decreased from the peak by least 10 percent by 2008:Q4. In second "narrow" definition, the price had to have risen by 150 percent or more after 1995, and decreased from the peak by 25 percent or more by 2008:Q4.[14]

As shown in Table 8.1, 36 of the 167 MSAs experienced a burst bubble under the broader definition, while 23 had a burst bubble of the narrow type.[15] There is a clear negative correlation between the extent of the run-up in home prices after 1995 and the extent of decline thereafter. MSAs meeting the narrow definition are all found in California, Florida, and Nevada; MSAs added in under the broader definition are also found in these states, as well as Arizona, Massachusetts, and the Washington, D.C., metropolitan area (see Appendix for the list). There is of course no assurance that our definitions capture the concept of a bubble as a period when market prices diverged significantly from prices implied by the underlying value of housing services (see, e.g., Himmelberg, Mayer, and Sinai 2005, for discussion). But given the amplitudes of the upswings and downswings in the data, we expect that our definition does a reasonably good job of identifying metropolitan areas where a bubble in this sense occurred.

In what follows, we compare changes in various measures of housing, incomes, employment, inequality and poverty across bubble and non-bubble markets. To understand how declining home prices have affected households with varying characteristics, we use education as a proxy for permanent income, differentiating between households where the householder had not completed a high school diploma, had completed a high school diploma but not a college degree, or had completed a college degree.[16] We also analyze differences across households by race/ethnicity, given their well-known correlations with economic outcomes and opportunities. In particular, we differentiate between households where the householder is white and does not self-identify as Hispanic; those where the householder self-identifies as Hispanic; and those who classify their race as black.[17] Note

Table 8.1 Categorization of metropolitan statistical areas

	Broader bubble definition			Narrow bubble definition		
Categorization of MSA	Number of MSAs	Median peak (1995=100)	Median % change from peak to 2008:Q4	Number of MSAs	Median peak (1995=100)	Median % change from peak to 2008:Q4
Bubble	36	292.2	–27.7	23	309.5	–33.7
Non-bubble	131	182.7	–2.0	144	186.0	–2.4

Source: Federal Housing Finance Agency all-transaction home price indexes.

that these categories are not mutually exclusive as people of Hispanic origin may be of any race.

For a given measure x_{it} related to a housing, income, or employment outcome, where i is the metropolitan area and t is the survey wave, we calculate changes in the mean and median values of x_{it} among "bubble" and other metros, and test whether the difference between the two is significant. To avoid losing information by focusing on scalar measures of changes over time, we also use box plots to show how distributions of given variables have changed over the 2005–2008 period in bubble versus other metros—where the line in the middle of the box shows the median, the bottom and top of the box show the 25th and 75th percentiles of the distribution respectively, the ends of the whiskers show the 5th and 95th percentiles, and dots show extreme values beyond these points.

Housing Wealth and Housing Costs

Case and Quigley (2008: 164) argue that housing-market busts always begin with a decline in housing demand, and that is indeed what the ACS data show. As can be seen in Figure 8.1, growth in the number of housing units decelerated between 2006 and 2008 in both regular and bubble MSAs, with the decline especially pronounced in bubble MSAs. Whereas growth in the number of occupied units held roughly steady in regular MSAs, it fell significantly in bubble MSAs after 2006. This deceleration likely reflected a slower pace of household formation and postponed transitions into new or better homes, more than departures from unsustainable homeownership arrangements; thus, for example, the share of households living in the same house as they had one year earlier *rose* significantly after 2006 in bubble metros.[18] With demand for housing falling and supply continuing to rise, vacancy rates rose in both bubble metros and others, although by more in bubble metros than elsewhere.

While the ACS does not collect data on housing wealth specifically, it does collect data on its key components. As shown in Figure 8.2, in the typical (median) "bubble" metro, the median home price fell from a peak of $329,000 in 2006 to $275,800 in 2008—a drop of 16 percent. (All dollar values for the ACS survey data are expressed in constant 2008 prices). In contrast, in the typical regular metro, the median home price slipped from its peak of $156,900 in 2007 to $154,900 in 2008—a 1.3 percent decline.[19] The ACS does not ask homeowners about their mortgage balances, but they are asked whether they have a mortgage outstanding. As the results show, homeowners in bubble

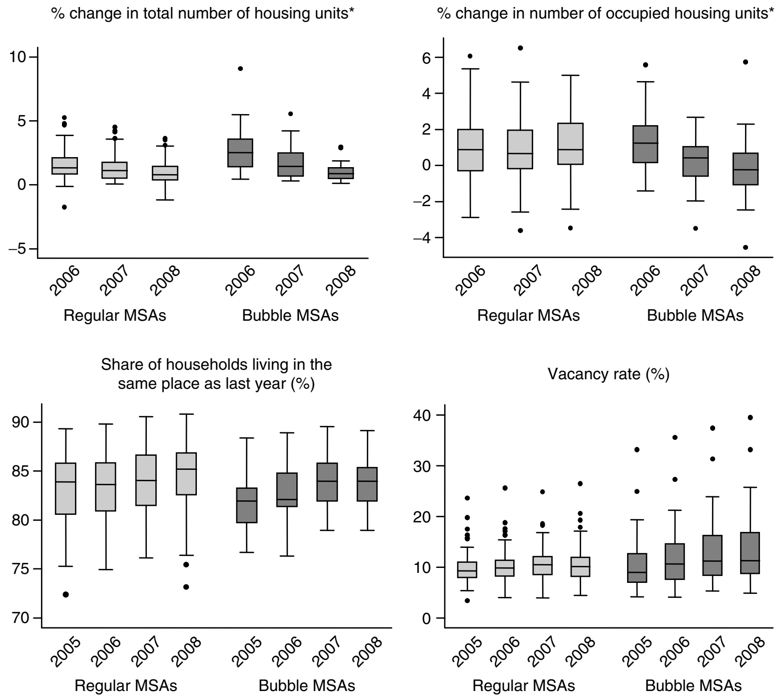

Figure 8.1 Housing market characteristics
* Excludes New Orleans.

MSAs are more leveraged than homeowners elsewhere, but in both cases these shares held fairly steady over this period. Thus, in bubble metros, the decline in home values is likely to have pulled down home equity significantly, without much change elsewhere.

The ACS data provide some evidence that house-price swings are somewhat wider at the lower end of the distribution of home prices. As can be seen in the bottom row of Figure 8.2, whereas the median home price in the typical bubble metro declined by 16 percent between 2006 and 2008, the home price at the 25th percentile fell by 19 percent while that at the 75th percentile came down by 14 percent. This is qualitatively similar to what is found in the "tiered" S&P/Case-Shiller indexes, although their data show larger spreads between low- and high-tier homes.[20] Especially given that home equity represents a large share of the net worth of homeowners of more moderate means (see, e.g., Bertaut and Starr-McCluer 2000, Starr 2009), the larger percentage decline in home prices at the lower end of the distribution

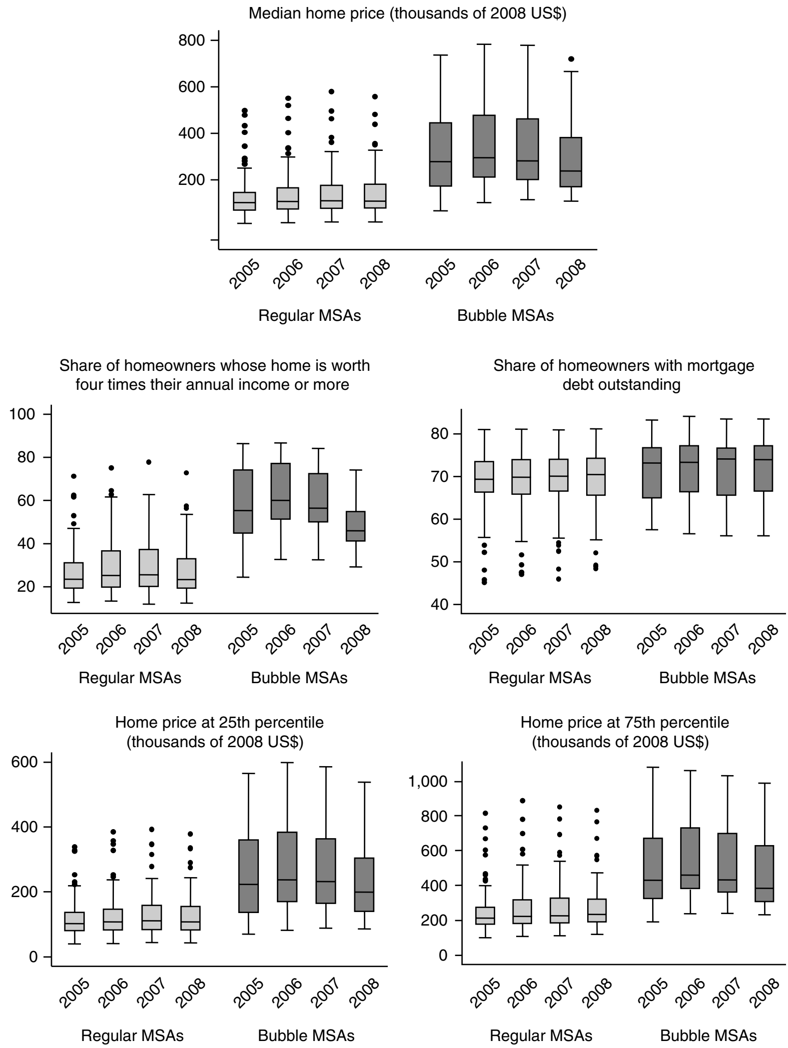

Figure 8.2 Distribution of home prices

implies a larger proportional decline in wealth for these homeowners compared to those owning higher-priced homes.

Concerning the idea that a housing-price bust hurts homeowners but helps renters, the ACS data as of 2008 do not show evidence of this. As shown in Figure 8.3, the share of renters having housing costs above 30 percent of their income held steady in both bubble and

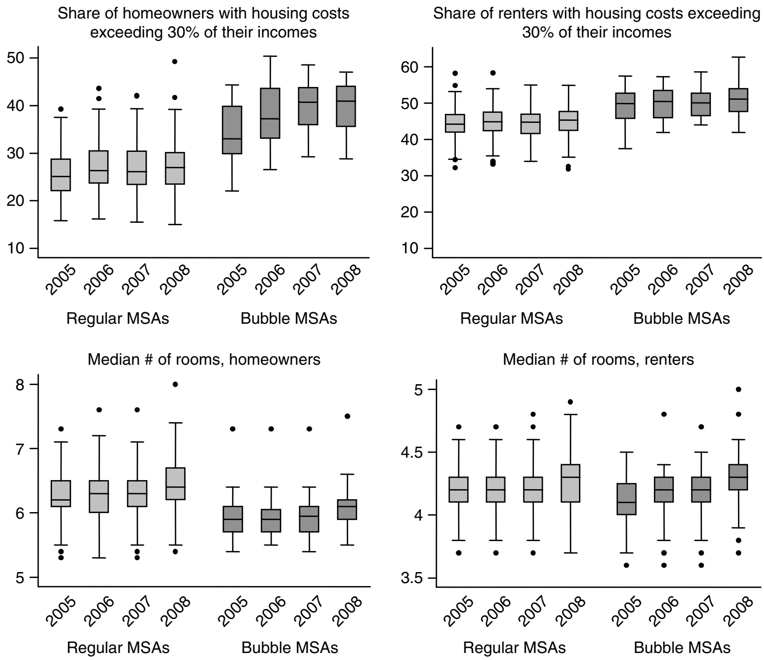

Figure 8.3 Housing finances

non-bubble markets, at around 50 percent in the former and 44 percent in the latter, in spite of rising vacancy rates in both places. This may be due in part to staggered adjustment of rental contracts and/or downwardly-rigid nominal rents, such that rental costs tend not to decline much despite rising vacancy rates (Genesove 2003). It may also reflect some tendency for renters to shift to better-quality rental properties when the housing market weakens: thus, for example, in bubble markets, the median number of rooms for renting households increased from 4.1 to 4.3 between 2005 and 2008.

On the other hand, the ACS data also show a sizable and significant increase in the share of homeowners paying more than 30 percent of their incomes in housing costs: while this share held steady around 27 percent in regular MSAs, it rose from 33 percent in 2006 to 40 percent in 2008 in those which had bubbles. This may reflect a greater prevalence of subprime and/or adjustable-rate mortgages in bubble metros.[21] Many subprime loans started with two or three years of very low payments, followed by a steep increase to a new level based on the prevailing market rate. Whereas the interest rate on a 30-year conventional mortgage had hovered around 5.75% from mid-2003 to August 2005, it moved up to 6.75% over the following year then fluctuated around a higher level.[22] While causes of this rise in the share of homeowners with relatively high housing costs can be investigated further, the ACS data certainly suggest that the financial vulnerability of homeowners in bubble markets had risen just as home prices were turning.

Employment and Unemployment

As discussed above, widespread house-price busts would be expected to reduce employment growth in both bubble and other MSAs due to the wealth effect. Yet bubble metros face extra contractionary pressures due to declining residential investment, declining real estate and financial activity related to housing sales, and declining spending on locally produced goods and services. The ACS data largely confirm this expectation. As shown in Figure 8.4, in the typical bubble MSA, employment growth fell from 5 percent in 2005–06 to virtually zero in 2006–07, while it fell from about 4 percent to 1 percent elsewhere. Employment growth picked back up to 2.8 percent in "other" MSAs in 2007–08, but rose only to 1.1 percent in bubble MSAs. The drag on job growth in bubble MSAs indeed came from loss of jobs in construction and finance, insurance, and real estate (FIRE). While construction employment had been growing vigorously in both bubble and other MSAs in 2005–06, in bubble MSAs, the level of employment dropped absolutely by 4.3 percent in 2006–2007 and fell again by 9.2 percent in 2007–08. In contrast, in other MSAs, construction employment stopped growing in 2006–08 but did not actually decline. The pattern of changes is identical for FIRE employment, although the magnitudes of declines in bubble MSAs were not as severe as in construction. In contrast, growth rates for employment in retail trade and retail services hardly differed between bubble and other metros, contrary to what would be expected if local aspects of the wealth effect contributed importantly to the slowdown.

Unemployment data show who was most affected by the declining labor market. As shown in Figure 8.5, the unemployment rate fell between 2005 and 2006 in bubble metros for virtually all groups shown—then rose significantly in 2007 and again in 2008. In other metros, unemployment rates largely held steady or continued to come down over the whole 2005–08 period.[23] Taken together with the data on employment changes, these results suggest that the decline in real economic activity that eventually became a recession originated in

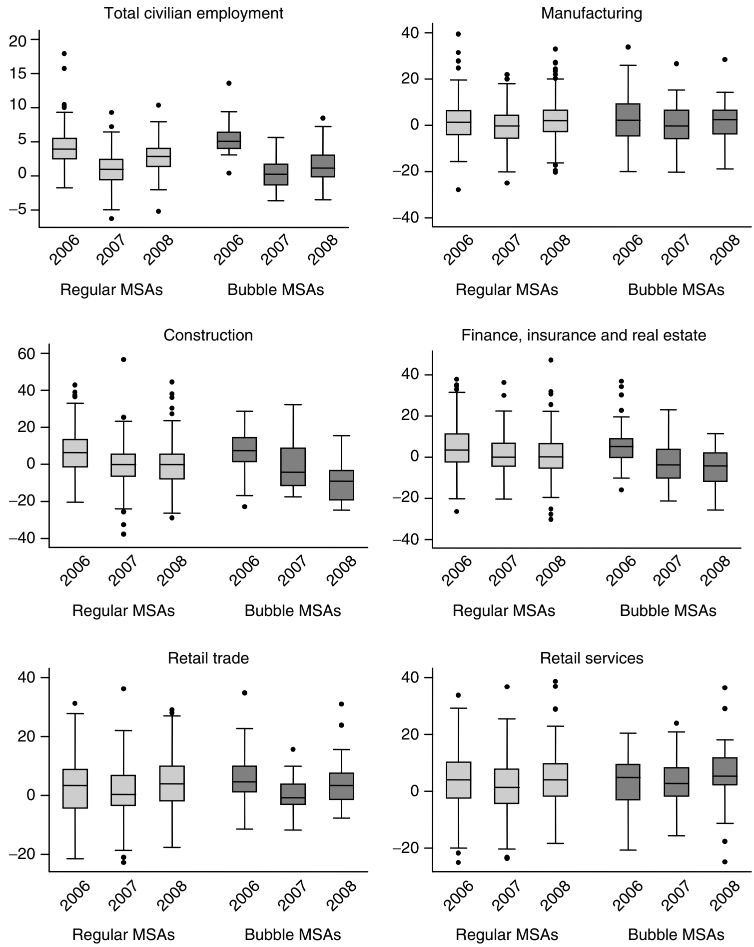

Figure 8.4 Year-over-year percent change in employment

metropolitan areas where housing-price bubbles had burst.[24] Within bubble MSAs, we see a pattern often found in aggregate contractions: increases in unemployment rates were larger for workers who had not completed their high school diplomas than they were for those who had, and in turn increases were larger for those with high school diplomas than they were for college graduates. Similarly, increases were larger for black workers than for Hispanic workers, which were in turn larger than those for non-Hispanic whites. These results are consistent with much previous research finding that aggregate downturns

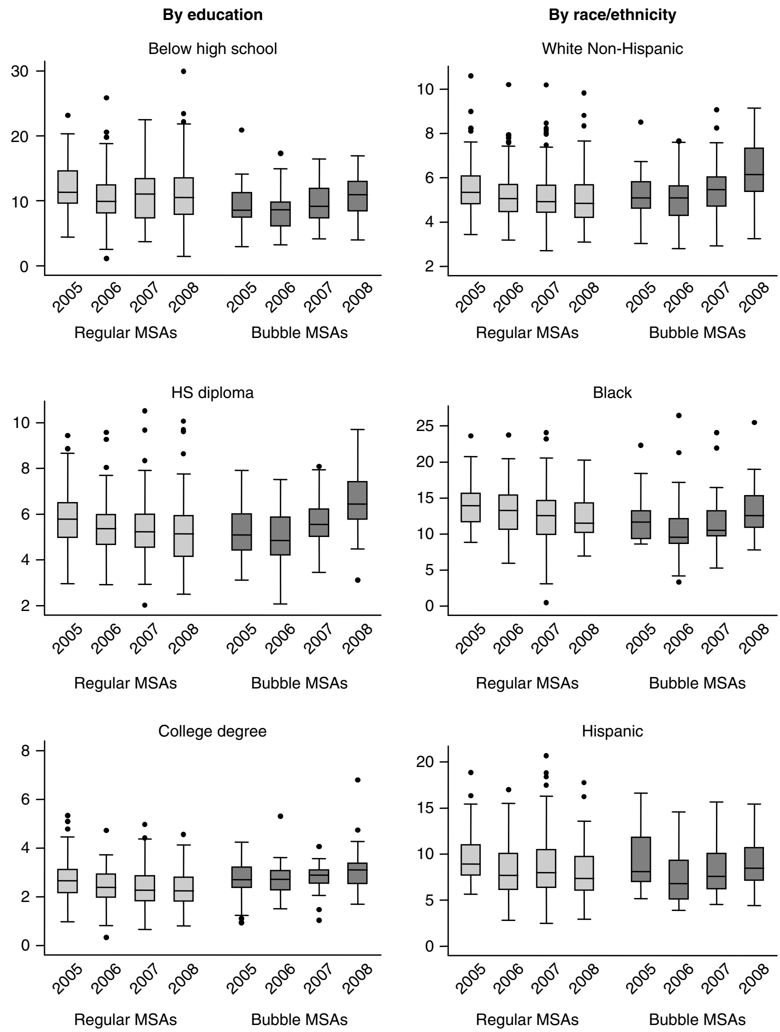

Figure 8.5 Unemployment by education and by race/ethnicity

have particularly detrimental effects on employment and incomes for less-educated workers and minorities (Blank 1989, Hoynes 2000, Spriggs and Williams 2000, Cherry and Rodgers 2000).

Homeownership

According to estimates from the Current Population Survey, the overall U.S. homeownership rate increased from 64 percent in 1994 to a historic high of 69 percent in 2004, then fell back to 67.8 percent by 2008; in metropolitan areas, the rate peaked at 67.4 percent in 2005–06 then slipped to 66.4 percent by 2008.[25] As shown in Table 8.2, the ACS data for metros with populations of 250,000 or more show slightly different trends, with mean and median homeownership rates not peaking until 2007. The bursting of the housing-price bubble would lead us to expect homeownership to fall by more in bubble metros than elsewhere, as falling prices reduce prospective owners' incentives to shift from renting to owning and existing owners' incentives to move to better homes—instead creating incentives to postpone such transitions until prices "bottom out." Additionally, bubble areas would be expected to have a higher incidence of departures from financially unsustainable homeownership arrangements. The ACS data show that indeed the 2007–08 decline in homeownership was larger in bubble metros than elsewhere. The average homeownership rate came down by 1.1 percentage points in bubble metros, but only 0.5 percentage points elsewhere. The median decline was 1.4 percentage points in bubble metros, versus 0.5 percentage points elsewhere. Still, this difference between the two types of metros is relatively modest, and the fact that homeownership also fell in "regular" MSAs suggests that other factors independent of local housing-market conditions were shifting interest in it—such as rising mortgage interest rates, tightening of lending standards, and/or dissipation of the popular narrative that homeownership is always and everywhere a wonderful investment (Shiller 2007).[26]

Perhaps surprisingly, declines in homeownership rates did not differ markedly across households with differing characteristics: for most types of households in bubble metros, the rate declined by about 1–1.5 percentage points, while it fell by around 0.5 percentage point for most types of households in other MSAs. However, more pronounced declines occurred for two specific groups. In bubble MSAs, homeownership rates fell more steeply for black and Hispanic households than others—a finding which is consistent with other studies finding subprime lending to have been concentrated in areas that experienced bubbles and that had relatively large black and Hispanic populations (e.g., Mayer and Pence 2008).[27] In regular MSAs, there were significant and relatively large declines in mean and median homeownership among households where the householder had less than a high school education. While the explanation of this is at present unclear, it is consistent with other evidence in the ACS data of deteriorating circumstances for this group (see below).

Table 8.2 Homeownership rates

		Regular MSAs						Bubble MSAs					
		2005	2006	2007	2008	change from peak	p-val. of change	2005	2006	2007	2008	change from peak	p-val. of change
Overall	mean	68.1	68.4	68.6	68.0	–0.5*	0.00	65.7	66.1	65.8	65.0	–1.1*	0.002
	median	68.2	69.0	69.1	68.6	–0.5	0.64	65.8	66.3	67.1	65.7	–1.4*	0.018
By education of householder													
Less than HS	mean	55.8	55.3	54.8	52.5	–3.2*	0.000	52.1	52.4	51.7	50.6	–1.7*	0.000
diploma	median	55.9	55.8	54.7	53.2	–2.7*	0.010	49.7	50.5	49.3	50.3	–0.2	0.105
HS diploma	mean	65.9	66.0	65.9	65.6	–0.4*	0.012	63.9	64.2	63.9	63.0	–1.3*	0.000
	median	66.4	66.6	66.1	66.1	–0.5	0.161	63.4	63.6	64.1	62.0	–2.1	0.105
College degree	mean	78.1	78.8	79.4	78.7	–0.7*	0.012	77.6	77.1	76.9	76.1	–1.5*	0.000
	median	78.4	79.1	79.5	79.1	–0.4	0.815	79.1	78.2	78.5	77.6	–1.5*	0.018
By race/ethnicity of householder													
Non-Hispanic	mean	73.9	74.2	74.3	73.8	–0.5*	0.001	72.1	72.1	71.5	71.3	–0.8*	0.051
white	median	74.5	74.6	74.6	74.0	–0.7	0.350	72.2	71.8	72.7	71.3	–1.4	0.376
Black	mean	41.6	43.0	43.3	42.8	–0.5	0.514	44.1	44.3	44.5	42.4	–2.2+	0.096
	median	43.0	43.4	44.1	43.4	–0.7	0.947	43.5	45.0	46.4	41.2	–5.2	0.210
Hispanic	mean	44.7	44.6	46.3	46.1	–0.2	0.766	51.0	52.4	53.1	51.7	–1.3*	0.042
	median	44.4	44.9	47.0	46.0	–1.0+	0.079	52.3	54.4	54.3	52.2	–2.2*	0.040

Notes: * = statistically significant at a 5% level. + = statistically significant at a 10% level. For differences in means, p-values come from regressions. For differences in medians, they come from continuity-corrected Pearson Chi-square tests.

Poverty and Inequality

Table 8.3 and Figure 8.6 show results from the ACS on poverty. Whereas poverty rates were flat in regular MSAs, they rose in metros with bubbles. In terms of differences across households, the data do not show clear trends, possibly in line with previous research finding that disaggregated poverty rates do not co-move as closely with aggregate economic conditions as one might expect (e.g., Hoover,

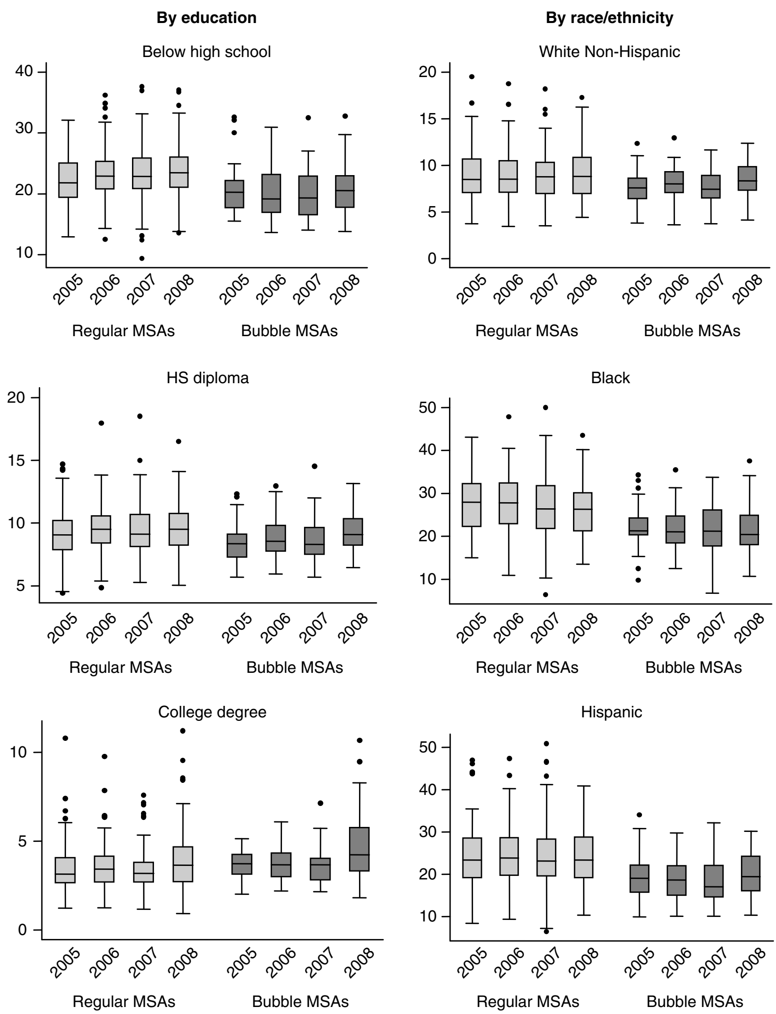

Figure 8.6 Poverty rates by education and race/ethnicity

Table 8.3 Measures of poverty and inequality

		Regular MSAs					Bubble MSAs						
		2006	2007	2008	2006–2008 change	p-val. of change	2006	2007	2008	2006–2008 change	p-val. of change	Diff. in 2006–08 change between bubble & regular MSAs	p-val. of diff.
Measures of poverty													
Share of population living below poverty line	Mean	13.3	13.1	13.2	−0.083	0.48	12.3	11.9	12.7	0.4+	0.069	0.5*	0.052
	Median	12.8	12.8	12.8	−0.036	1.000	11.4	11.1	12.4	1.0	0.239		
Share of HHs receiving cash assistance	Mean	9.5	9.2	9.9	0.403*	0.041	6.4	5.9	7.1	0.7*	0.001	0.3	0.272
	Median	8.6	8.7	9.6	0.993	0.138	5.7	5.5	6.5	0.8	0.239		
Measures of inequality													
% of income going to top 25% of HHs	Mean	48.2	48.4	48.5	0.3*	0.000	48.7	48.9	48.8	0.1	0.720	−0.2	0.376
	Median	48.2	48.5	48.4	0.2	0.711	48.7	48.7	48.4	−0.4	0.480		
% of income going to top 5% of HHs	Mean	20.6	20.9	21.1	0.4*	0.000	21.3	21.7	21.3	0.0	0.920	−0.4	0.223
	Median	20.6	20.8	21.0	0.4+	0.084	21.0	21.0	20.7	−0.4	0.814		
Gini coefficient	Mean	0.446	0.448	0.449	0.003*	0.000	0.448	0.450	0.450	0.001	0.578	−0.002	0.492
	Median	0.445	0.448	0.448	0.003	0.458	0.448	0.451	0.445	−0.003	0.814		

Notes: * = statistically significant at a 5% level. + = statistically significant at a 10% level. For differences in means, p-values come from regressions. For differences in medians, they come from continuity-corrected Pearson Chi-square tests.

Enders, and Freeman 2008). Focusing on changes in bubble MSAs, between 2007 and 2008 the poverty rate rose by about 1 percentage point for almost all groups, although it held steady for families where the householder was black. In other MSAs, the poverty rate for households where the householder had less than a high school education moved steadily and significantly upward from 2005 to 2008. While it is unclear what the cause of this is, along with rising unemployment and declining homeownership, it suggests some fundamental erosion in livelihoods for this group.

Table 8.3 also shows results for measures of income inequality available in the ACS: the shares of income going to the top 25 percent and the top 5 percent and the Gini coefficient. All three measures rose between 2006 and 2008 in regular MSAs, whereas they were flat in those with bubbles. Evidence of flattening is consistent with the Census Bureau's annual estimates of income inequality from the Current Population Survey, which show the income share of the top quintile and the Gini coefficient having plateaued in 2006.[28] In future work, we plan to examine whether trends such as the decline in FIRE employment and incomes contributed to this.

Summary and Conclusions

To summarize, this study has six key findings with respect to the distributional effects of the housing-price slump up through 2008. First, in metropolitan areas where housing price bubbles burst, prices slumped somewhat more on the lower end of the home-price distribution than at the upper end. Second, declining housing prices have not lowered housing costs for renters in a broad-based way. Third, 2006–07 saw substantial declines in construction and FIRE employment in metropolitan areas where housing-price bubbles had burst—consistent with Case and Quigley's prediction that the most powerful mechanism transmitting effects to the broader economy would be the income and employment channel. Fourth, increases in unemployment rates in metros where bubbles burst were most pronounced among households with less education and/or minorities, as is usual in aggregate downturns. Fifth, while homeownership rates have slipped everywhere, some of the largest decreases occurred for black and Hispanic households in metros where bubbles had burst. Finally, poverty rates increased in bubble metros between 2007 and 2008, while holding steady elsewhere; although trends across groups are not clear cut, the rate may have risen differentially for households of Hispanic origin.

Taken together, these findings suggest that declines in key elements of economic well-being have been concentrated among those without good resources for withstanding financial distress. An important implication from a monetary-policy perspective is that the risks of failing to check a housing-price bubble as it is forming are asymmetrically distributed: if the bubble subsequently bursts, adverse effects fall on a wide range of households, with the most costly and difficult ones (job loss, a spell in poverty, significant troubles with creditors, loss of a home, etc.) tending to fall on people whose economic lives and material living standards are anyway less secure. While it can be argued that several elements of the present housing-price bust are unusual and unlikely to be repeated (notably, the extraordinary relaxation of lending standards associated with subprime mortgages), other cases when booms and busts in home prices have been associated with aggregate fluctuations are not difficult to find, as when the "credit crunch" that followed the 1980s real-estate booms on both coasts contributed to the 1990–91 recession (Bernanke and Loan 1991). The present paper underlines the importance of incorporating concerns with misalignments in asset prices into the *modus operandi* of monetary policy, whether by interest rates (Taylor 2007) or some other means (Brunnermeier, Crockett, Goodhart, Persaud, and Shin 2009; Farmer 2010).

Acknowledgments

We are grateful to Karl Case, Robert Lerman, and participants in an ASE session on "Socio-distributional effects of the financial crisis" at the 2010 Allied Social Science Association meetings in Atlanta for their valuable comments on an earlier version of this paper. We also thank Ren Farley, Lisa Neidert, and Al Anderson for their expert guidance in the use of the American Community Survey data.

Appendix

Appendix Table 8.A Metropolitan areas classified as having had housing-price bubbles

	Peak index value (1995=100)	% decline from peak thru 2008:Q4
Metros classified as having bubbles under both narrow and broad definitions		
Bakersfield, CA	280.4	–35.8
Cape Coral-Fort Myers, FL	308.3	–43.5

Continued

Appendix Table 8.A Continued

	Peak index value (1995=100)	% decline from peak thru 2008:Q4
Deltona-Daytona Beach-Ormond Beach, FL	291.7	–25.3
Fresno, CA	286.2	–32.6
Las Vegas-Paradise, NV	258.5	–37.1
Los Angeles-Long Beach-Santa Ana, CA	338.4	–24.0
Miami-Fort Lauderdale-Pompano Beach, FL	332.9	–28.9
Modesto, CA	312.3	–49.4
Naples-Marco Island, FL	370.1	–41.9
Oxnard-Thousand Oaks-Ventura, CA	325.4	–29.2
Palm Bay-Melbourne-Titusville, FL	279.5	–31.1
Port St. Lucie, FL	292.7	–33.7
Riverside-San Bernardino-Ontario, CA	332.7	–40.1
Sacramento-Arden-Arcade-Roseville, CA	291.3	–34.1
Salinas, CA	356.6	–43.5
San Diego-Carlsbad-San Marcos, CA	322.4	–26.0
San Francisco-Oakland-Fremont, CA	313.2	–20.4
Santa Barbara-Santa Maria-Goleta, CA	346.9	–31.4
Santa Rosa-Petaluma, CA	302.1	–27.6
Bradenton-Sarasota-Venice, FL	309.5	–35.9
Stockton, CA	308.7	–51.7
Vallejo-Fairfield, CA	314.8	–42.8
Visalia-Porterville, CA	252.6	–27.8
Metros classified as having bubbles under the broad definition only		
Jacksonville, FL	270.5	–12.0
Lakeland-Winter Haven, FL	256.1	–17.2
Ocala, FL	271.3	–17.6
Orlando-Kissimmee, FL	284.5	–21.9
Pensacola-Ferry Pass-Brent, FL	230.8	–14.2
Phoenix-Mesa-Scottsdale, AZ	295.6	–22.4
Providence-New Bedford-Fall River, RI-MA	259.0	–11.0
Reno-Sparks, NV	252.0	–24.9
San Jose-Sunnyvale-Santa Clara, CA	315.7	–14.7
Tampa-St. Petersburg-Clearwater, FL	291.3	–23.3
Tucson, AZ	242.6	–12.2
Washington-Arlington-Alexandria, DC-VA-MD-WV	277.7	–14.6
Worcester, MA	246.1	–10.3

Notes

1. See, e.g., Bernanke (2002), Rudebusch (2005), Lansing (2005), Kohn (2008), Mishkin (2008).
2. In the words of San Francisco Federal Reserve President Janet Yellen (2009), it is now “patently obvious . . . that not dealing

with certain kinds of bubbles before they get big can have grave consequences."

3. Notably, see Krusell, Mukoyama, Sahin, and Smith (2009), and also Barlevy (2004) and Imrohoroglu (2008).
4. It is also likely that the housing-wealth effect has strengthened over time due to greater opportunities to cash out gains in home equity via mortgage refinancing (Muellbauer 2008).
5. Earlier research by Sheiner (1995) and Englehart (1996) found some evidence that higher home prices could reduce spending by prospective homeowners, due to the need to save for a down-payment. This offset has likely become less important in the past decade, as down-payment requirements slipped.
6. Authors' computations from the 2008 Consumer Expenditure Survey.
7. Details of estimates are available in the working paper version of this paper. Note that Carroll, Otsuka and Slacalek's estimates of the wealth effect are on the high side. Case and Quigley (2008) argue that there is an asymmetry in the housing-wealth effect, such that a given decline in housing wealth may reduce spending by less than a comparable increase boosts it.
8. Using data from the Consumer Expenditure Survey, Bostic, Gabriel, and Painter (2009) find that changes in housing wealth especially increase spending on non-durable goods. Note that, whereas their study aimed to characterize effects of wealth on consumption, ours is on its effects on production and employment; given the differential importance of imports across categories of goods, it is not clear that higher spending on nondurable goods necessarily means higher domestic production of them.
9. Whereas residential investment had been adding half a percentage point to growth of real GDP in 2003 and 2004, in 2007 and 2008 its contraction pulled GDP growth down by more than 1 percentage point. Figures from the Bureau of Economic Analysis, National Income and Product Accounts Table 1.5.2, as of December 15, 2009.
10. Data from the Bureau of Labor Statistics' Occupational Employment Statistics, 2005–2008.
11. The ACS makes numerous efforts to contact respondents who do not initially reply, resulting in eventual response rates of 97–98%.
12. In 2001–2004, the ACS sample included 800,000 households and was intended to represent areas with populations of 1 million or more. In 2005, the sample size was increased to 3 million households, with the intention of representing areas with populations of 65,000 or more.
13. The analysis also excludes data for Puerto Rico.
14. Note that, for the 11 largest MSAs, the FHFA provides data for metropolitan divisions within the MSA rather than the MSA itself. In these cases, we computed price changes for the MSA as population-

weighted averages of changes for the metropolitan divisions. Note that, in any event, all divisions within a given MSA had the same categorization in 9 of the 11 cases.

15. See the Appendix for details.
16. In the Census definition, the "householder" is the person (or one of the persons) in whose name the housing unit is owned or rented. If a married couple owns the home jointly, either spouse may be the householder. People who undertook some college studies without completing a degree are included with high-school graduates.
17. The householder is considered to be Hispanic if he/she answers "yes" to the question, "Is this person Spanish/Hispanic/Latino?" He/she is considered to be black if he/she checks the option "Black/African Am./Negro" in response to the question, "What is this person's race?" A person is considered to be non-Hispanic white if he/she checked "White" in response to the question, "What is this person's race?" and checked "No, not Spanish/Hispanic/Latino" in response to the question, "Is this person Spanish/Hispanic/Latino?" See Grieco and Cassidy (2001).
18. This result is consistent with research using two decades of data from the American Housing Survey by Ferreira, Gyourko, and Tracy (2008), who find that, on balance, negative equity tends to reduce household mobility rather than increase it.
19. Note that, unlike the FHFA data, home prices in the ACS are self-reported, include both single-family homes and other types of property, and are not repeat sales measures. Goodman and Ittner (1992) find that self-reported prices generally correspond reasonably well to commercial valuations of property. It is possible that accuracy is lower in periods when prices are changing unusually.
20. For example, the median decline-from-peak for the 20 metropolitan areas covered in the S&P/Case-Shiller data was 37.4% for low-tier homes versus 19.4% for high-tier homes through the end of 2008.
21. Dell'Ariccia, Igan, and Laeven (2008) found that lending standards declined particularly in markets with larger home price increases. Mayer and Pence (2008) also find some evidence of this, but they also note that some markets with housing booms did not see large increases in subprime lending, such as the Northeast.
22. Also around this time was the beginning of the run-up in energy prices, which may have affected housing costs of homeowners more than those of renters.
23. For comparison, data from the Bureau of Labor Statistics' monthly household survey show the civilian unemployment rate rising after March 2007.
24. In December 2008, the National Bureau of Economic Research declared that the recession had started in December 2007.
25. http://www.census.gov/hhes/www/housing/hvs/annual08/ann08ind.html.

26. Note that this is also consistent with several studies finding that in the years before the bubble burst, housing-market dynamics were increasingly governed by common aggregate factors, rather than regional or local variables, suggesting an importance of credit-market changes or other national-level factors (see, e.g., Fu 2007 and Del Negro and Otrok 2007).
27. See Coleman, LaCour-Little, and Vandell (2008) on the difficulty of establishing directions of causalities between housing prices and subprime lending.
28. U.S. Census Bureau, Current Population Survey, 1968 to 2009 Annual Social and Economic Supplements. http://www.census.gov/hhes/www/income/histinc/IE-1.pdf.

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Chapter 9

Gender Equality in U.S. Labor Markets in the "Great Recession" of 2007–10

Caren Grown and Emcet Tas

Introduction

Both in the academic literature and the popular press, the 2007–2010 recession[1] has come to be known as the "Great Man-cession" (Thompson 2009, Wall 2009, Perry 2010). Analysts have used two pieces of evidence to support this claim: first, that job loss hit males harder than females in 2007–09 in all racial and demographic groups; and second, that the female-male "unemployment gap" is larger in this recession than in previous recessions. For instance, as shown in Figure 9.1, men's and women's unemployment rates were roughly the same when the recession started, at 5.1 percent for males versus 4.9 percent for females. By the third quarter of 2009, they had risen to 11 percent for men and 8.3 percent for women (Sahin, Son and Hobijn 2010). This 2.7 percentage-point difference exceeded the maximum gap in the previous three recessions (Perry 2010). Looking over the long term, this finding is even more striking because, before the 1980s, the unemployment rate for women tended to be higher than that for men, both during normal times and during recessions.

While these facts seem to support the sound byte that the 2007–10 recession is a "man-cession," is this really the case? This paper argues that when the analysis is extended to cover a wider range of labor-market indicators and factors such as race and ethnicity as well as gender, the picture is considerably more complex. We illustrate this argument using data from the U.S. Bureau of Labor Statistics' Current Population Survey (CPS), a monthly survey of about 60,000 households that asks questions about the labor-market status of all individuals age 16 or over living in the household,

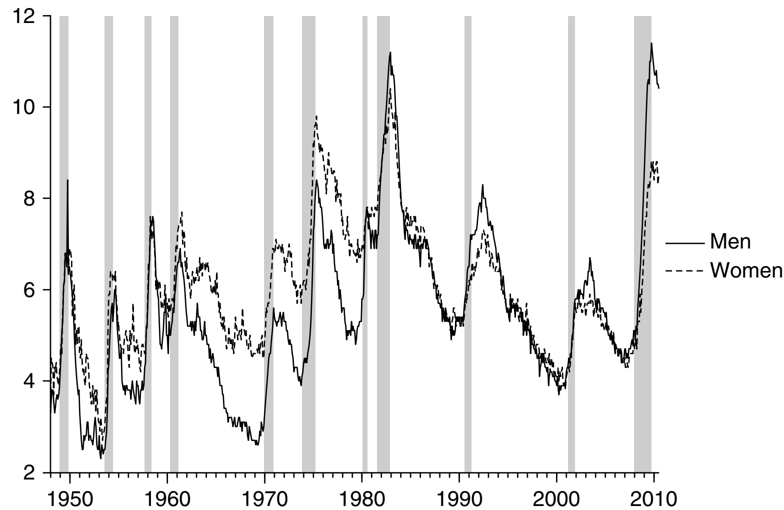

Figure 9.1 Unemployment rates by sex (%)

Source: Current Population Survey, seasonally adjusted data. Shaded areas represent the NBER recession dates.

supplemented by data on payroll employment by industry from the BLS's Current Employment Statistics (CES). Our analysis shows that, when differences between men and women in their experience of the 2007–10 recession are examined via a broader range of indicators and in historical perspective, the "man-cession" story is far too simple. Several groups have been differentially affected by the recession, both within and across genders, with burdens falling especially on African American and Hispanic males and females and on single mothers. Moreover, the "man-cession" story is problematic because it detracts from the larger struggle for women's equality in economic life. Labeling the greatest economic downturn faced by the U.S. economy since the Great Depression as a "man-cession" leads to misidentification of the most vulnerable groups who should be the explicit beneficiaries of economic recovery policies. It also masks the fact that key gender gaps—in earnings, underemployment rates and other dimensions—continue to persist and merit policy attention and resources to redress.[2]

The paper is organized as follows. The next section presents a range of labor-market indicators from the CPS showing how men and women have fared over the "Great Recession" in terms of labor force participation rates, conventional unemployment rates, unemployment durations, and unemployment rates that take into consideration "discouraged workers" and people who are involuntarily working part-time for economic reasons. The third section reviews hypotheses as to why men's and women's employment levels would change differentially in recession, using establishment data from the CES and other employment-related data from the CPS to gauge their validity. Finally, the fourth section briefly discusses whether federal and state government responses to the recession adequately address the needs of workers hardest hit in the current period and concludes with some implications for recession and recovery policies.

Labor Market Outcomes for Men and Women in the Current Recession

In attempting to characterize differential impacts of recession on men and women, it is important to look across a relatively broad range of labor-market indicators and to disaggregate by other dimensions of diversity within the population in order to develop a balanced and accurate understanding of these impacts. Whereas the discussion of the "man-cession" has emphasized the gap between male and female unemployment rates that opened up as the economy fell into recession, it is important to review a range of statistics such as labor force participation rates, unemployment durations, and "marginalized" workers in order to unpack the recession's full impact on men and women.

Labor force participation rates. Changes in men's and women's labor force participation rates in the 2007–10 recession must be understood in terms of two longer-term trends: namely, the secular decline in men's labor force participation since the 1950s and the sustained rise in the women's rate, which started around that time but leveled off in the late 20th century.[3] As shown in Figure 9.2, after the recession started in late 2007, the labor force participation rate for men slid appreciably; for women, the rate held up well into the recession and only started slipping in 2009. This is consistent with anecdotal evidence of women making extra efforts to find or remain in paid employment to avoid income interruptions for their households.

Unemployment rates. As shown in Figure 9.3, the recession caused unemployment rates to rise for workers of all genders, races and ethnicities. As tends to be true at other times, during the recession, unemployment rates within each gender were highest for African Americans, next highest for Hispanics, followed by whites and Asians. For African American men, the rate rose from about 10 percent when

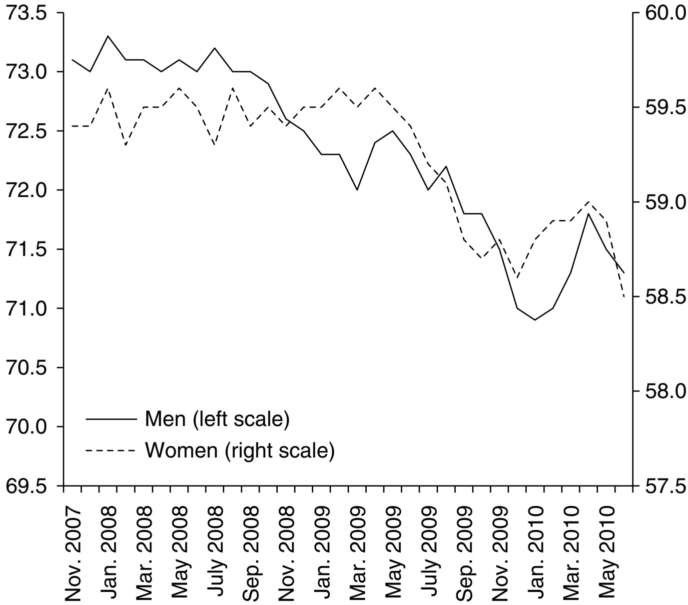

Figure 9.2 Labor force participation rates for men and women
Source: Current Population Survey, seasonally adjusted data.

the recession began to about 20 percent in early 2010, while the rate for white men rose from about 5 to 10 percent. However, comparing all men to all women obscures the fact that some groups of women have experienced significantly higher rates of unemployment than some groups of men. In particular, throughout the period unemployment rates have been 2–4 percentage points higher for black and Hispanic women compared to white and Asian men. For example, in the second half of 2009, unemployment rates averaged 9.5 percent and 8.2 percent for white and Asian men respectively, compared to 13.5 percent and 11.9 percent for black and Hispanic women respectively. The data also show that the so-called gender gap in unemployment was not uniform across groups. Among African Americans, the gap between the unemployment rates of men and women was sizable and persistent after the recession intensified in the fall of 2008, averaging almost 5 percentage points from that time through January 2010. For whites and Asians, the gender gap in unemployment averaged just over 1 percentage point over this period (note that the data are not seasonally adjusted, so some temporary increases in gaps are seasonally related and should not be over-interpreted). For Hispanics,

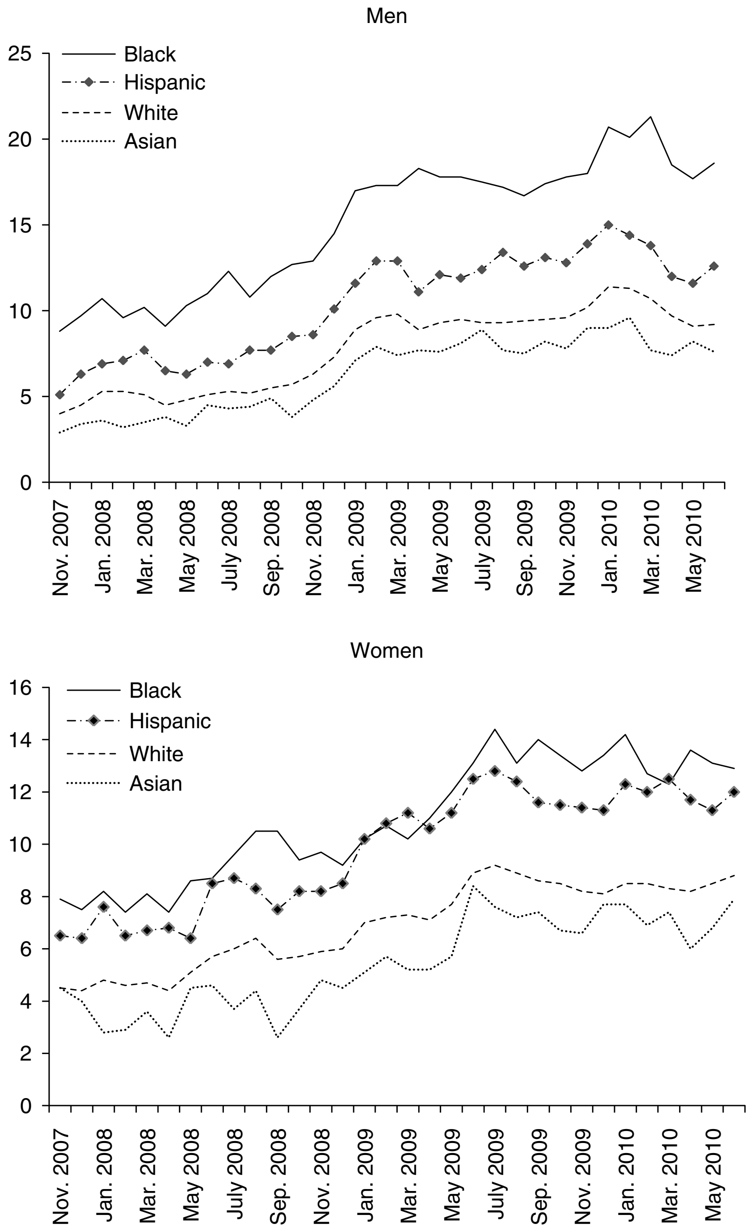

Figure 9.3 Unemployment rates for men and women, by race and ethnicity

Source: Current Population Survey, seasonally unadjusted data.

male and female unemployment rates tracked each other closely until mid-2009, when the rate leveled off for women but continued to rise for men. Again, this does not paint a uniform picture of men doing worse than women across socio-demographic groups.

Figure 9.4 shows unemployment rates for men and women by age and education. While the gender gap in unemployment was relatively modest for people aged 25 years and older, it was much larger among those aged 16 to 24 whose lower levels of skill and experience tend to make their unemployment rates relatively high. But again, looking across gender and age categories, the unemployment rate for women ages 16 to 24 has been considerably higher than that of men ages 25 and over. In terms of education categories, the unemployment rates of women and men with college educations show little difference during the recession, both remaining at relatively modest levels between 2 and 4 percentage points, while the gap between women and men who did not complete high school was for the most part fairly small. In contrast, the gap has been more notable for men and women with high school diplomas but no college degree, widening to almost 4 percentage points in later 2009. Still, the rate for men with high school diplomas always remained below the rates of both men and women who did not complete high school.

Another notable finding emerges with respect to marital status, specifically differences between married men and women living with their spouses versus women maintaining families on their own. As shown in Figure 9.5, the unemployment rate for women maintaining families on their own moved from about 7 percent at the outset of the recession to a high of 13 percent at the end of 2009. For married men living with their spouses, the rate rose from 2.7 to 7.5 percent over this period, which is indeed a larger increase than was experienced by married women living with their spouses (for whom the rate rose from 3.1 to 6.3 percent). But this should not divert attention from the much higher rate for single mothers, who often have no other income earners to rely on in times of crisis and few other adults to help with unpaid caregiving. State-level evidence confirms that women maintaining families on their own have been particularly vulnerable to declining labor-market conditions during the downturn. For example, the California Budget Project estimated that unmarried women with children were nearly twice as likely as their married counterparts, both male and female, to be unemployed in California in 2009; moreover, their average weekly hours of work declined more than at any point in the last 20 years, diminishing their total earnings (Anderson 2010). Additionally, married women in California

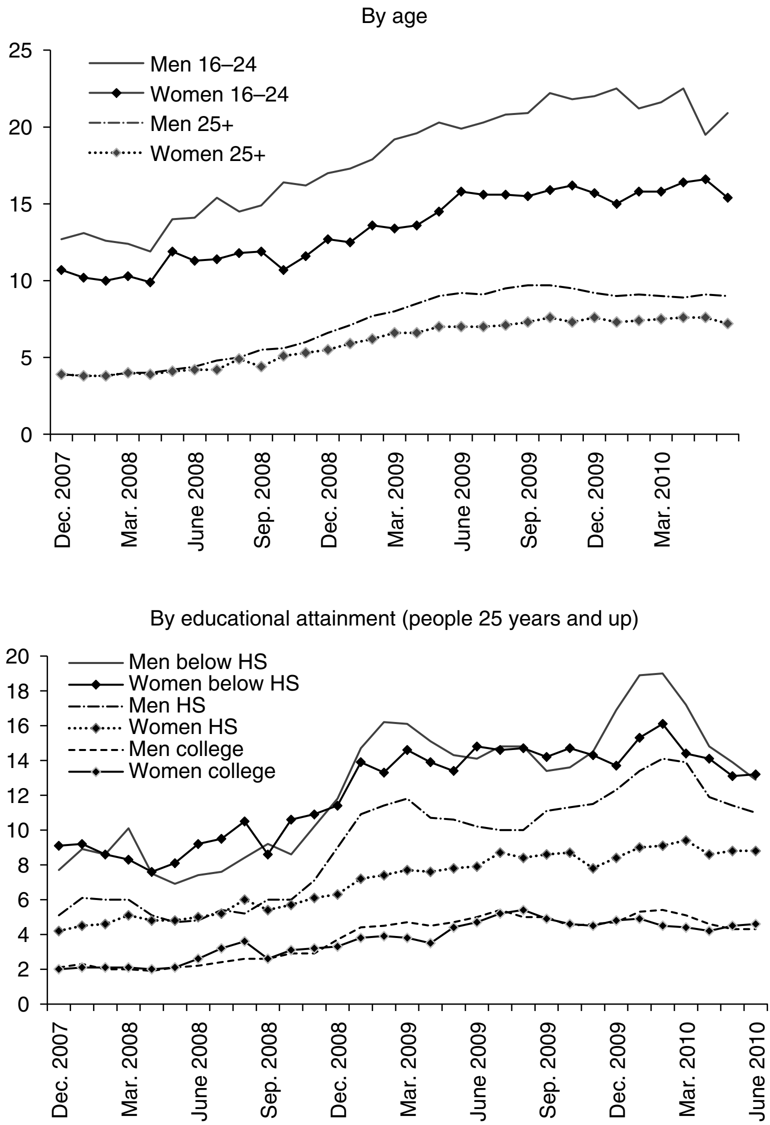

Figure 9.4 Unemployment rates by gender, age and education (%)

Source: Current Population Survey. Data on unemployment by age is seasonally adjusted; that on unemployment by education is not.

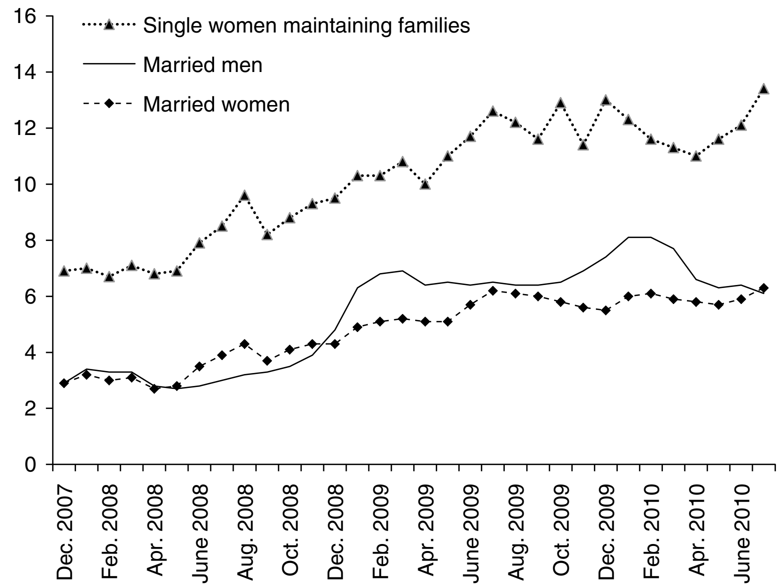

Figure 9.5 Unemployment rates for married men and women and single women maintaining families (%)

Source: Current Population Survey, seasonally unadjusted data.

increasingly became the sole breadwinners for their families as their husbands lost their jobs; the number of married-couple families with children relying solely on the earnings of wives increased by 77.7 percent between 2006 and 2009 (Anderson 2010).

Unemployment duration. As shown in Figure 9.6, average durations of employment rose sharply for both men and women after the 2007–10 downturn began. A key difference from previous recessions is that average durations for men and women have tracked each other closely in the most recent downturn. Traditionally, average durations of unemployment were longer for men than they were for women, although the difference between the two has steadily narrowed since the 1980s. In the years before the 2007–10 recession, average durations of unemployment fluctuated around 15 to 17 weeks for both men and women; as the economy contracted, average durations of unemployment doubled to around 35 weeks for both. This underlines that, conditional on becoming unemployed, the difficulty of exiting from unemployment did not appear to be any different for women than it was for men.[4]

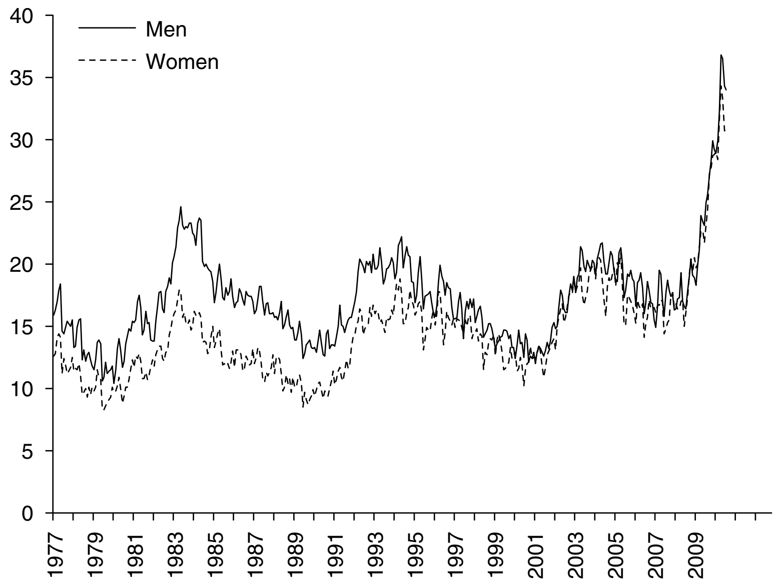

Figure 9.6 Average duration of unemployment for men and women (in weeks)
Source: Current Population Survey, seasonally unadjusted data.

Discouraged and marginally attached workers and those involuntarily working part-time. Standard unemployment rates are computed for workers who are considered to be either "employed" or "unemployed" according to BLS definitions;[5] only employed and unemployed people are counted as active labor force participants. However, there are also workers who are willing and able to work and who have looked for a job in the recent past but who stopped looking for one reason or another, and so are classified as being out of the labor force. Moreover, some employed persons may be working fewer hours than they would like, especially when labor market conditions are weak. Thus, the BLS also computes a range of alternative measures to capture these other possible dimensions of labor underutilization (see Bregger and Haugen 1995 or Haugen 2009 for details).

In particular, the BLS identifies two categories of people who are "marginally attached to the labor force": "discouraged workers," who have looked for a job within the previous year, but stopped looking at least one month before the time of the survey due to discouragement over job prospects; and "other marginally attached workers," who cite other reasons for having stopped looking, such as more family responsibilities, going to school, ill health and discrimination in the labor market.[6] In addition, the BLS categorizes part-time workers who work less than their preferred number of hours due to "economic reasons" (e.g., weak business conditions or inability to find a full-time job) as "involuntary part-time workers" while those who work less than their preferred hours for non-economic reasons (e.g., personal or family obligations) as "voluntary part-time workers."[7] Economic downturns would be expected to boost the ranks of discouraged and involuntary part-time workers in particular, as labor-market conditions are what cause people to wind up in these categories. Working part-time can be especially disadvantageous given evidence that it lowers future earnings relative to workers who were continuously employed full-time, and because part-time workers do not receive key benefits such as health insurance, vacation or sick leave, and pension coverage (Sum, Khatiwada, and Palma 2009; Tienda et al. 2010).

Table 9.1 shows rates of labor underutilization for men and women workers, using the BLS's alternative measures of unemployment, underemployment, and the labor force. Not surprisingly, all measures show declining opportunities to work for both men and women over this period, with the broader measures of labor utilization being 0.5 to 5.5 percentage points higher than official unemployment rates. Yet there are some important differences by gender. The broadest measure of labor underutilization is U-6, which differs from the official unemployment rate by counting not only those officially defined as "unemployed" but also all marginally attached workers and workers employed part-time involuntarily in both the numerator and the denominator. For men, this rate rose from 9.2 percent in December 2007 to 16.8 percent in May 2010—an increase of 7.6 percentage points, versus a 5 percentage point increase for the official unemployment rate (note that these numbers differ somewhat from those given earlier because the BLS does not adjust the alternative measures of labor underutilization, so seasonally unadjusted estimates of official unemployment are reported here for comparability). Over the same period, the rate for women rose from 8.1 percent to 15.3 percent, an increase of 7.2 percentage points, compared to a rise of 4.1 percentage points for the official unemployment rate. In other words, the extra increase in unemployment experienced by men is not as large when labor underutilization is measured broadly (7.6–7.2=0.4 percentage points) as it is according to the official unemployment rate (5.0–4.1=0.9 percentage points). Moreover, the number of marginally attached male workers increased by 56 percent between December

Table 9.1 Alternative measures of labor underutilization, by sex

		Men			Women		
Rate	Definition	Dec. 2007	May 2010	Change	Dec. 2007	May 2010	Change
U-1	Persons unemployed 15 weeks or more as % of labor force	1.6	6.7	5.1	1.5	5.1	3.6
U-2	Job losers + persons who completed temporary jobs as % of civilian labor force	3.2	6.8	3.6	2.0	4.5	2.5
U-3	Unemployed workers as % of civilian labor force (*official unemployment rate*)	5.1	10.1	5.0	4.4	8.5	4.1
U-4	Unemployed + discouraged workers as % of (labor force + discouraged workers)	5.4	10.8	5.4	4.6	9.1	4.5
U-5	Unemployed + discouraged + other marginally attached workers, as % of (labor force + discouraged + other marginally attached workers)	6.0	11.3	5.3	5.2	9.8	4.6
U-6	Unemployed + discouraged + other marginally attached workers + those employed part-time involuntarily, as % of (labor force + discouraged + other marginally attached workers + those employed part-time involuntarily).	9.2	16.8	7.6	8.1	15.3	7.2

Source: Current Population Survey. Data are not seasonally adjusted.

2007 and May 2010, while the number of marginally attached female workers increased by 78 percent. More tellingly, the number of involuntarily part-time employed women, increased at a much higher rate than men. Voluntary part-time employment for men increased during this recession by 24 percent but fell by 4 percent for women. Thus, taking a broader view of ways in which declining labor market conditions have affected people's opportunities to work mutes the estimated differential effect of the recession on men versus women.

Explanations for Changes in Employment and Unemployment

Several hypotheses have been put forward to explain the differential gender impacts of recessions. First, women workers tend to be concentrated in industries and occupations that are relatively insulated from cyclical variations in output and employment, which is thought to protect them relative to men in economic downswings (the "industry/occupational segmentation" hypothesis). Second, women bear the brunt of cyclical variations in employment, being shed disproportionately in downswings and recruited intensively in upswings (the "reserve labor force" hypothesis). Third, as cheaper labor, women replace male labor in economic downturns (the "substitution" hypothesis).

The first hypothesis is the most popular explanation for the patterns of male job loss in both current and past recessions. For instance, Perry (2010) argues that men are overrepresented in the industries that have been most adversely affected by the current recession, especially construction and manufacturing, while women are overrepresented in the sectors that were least affected, namely, education, health care, and government. Goodman et al. (1993) explored gender differences in employment changes during the 1990–91 recession and concluded that they result from men's concentration in cyclically-sensitive industries and occupations. Similarly, Williams (1985) argued that the differential effects of the downturn in the early 1980s were due to the recession's impact on the goods-producing sector in which the male proportion of employment was relatively high.

Examining first the industry segmentation hypothesis, Table 9.2 shows data on payroll employment by gender in both goods-producing and service-providing industries for the most recent downturn, taken

Table 9.2 Change in payroll employment

	Men's share of employment in Dec 2007	Percentage change in employment (Dec 2007–May 2010)		
		Overall	Men	Women
Total nonfarm	51.2	–5.3	–7.1	–3.5
Goods-producing sectors	77.2	–18.1	–18.4	–17.2
Construction	87.5	–25.2	–25.7	–21.3
Manufacturing	71.1	–15.0	–14.4	–16.7
Service-producing sectors	46.3	–2.9	–3.5	–2.4
Health and education	22.7	5.1	5.1	5.1
Government	43.0	2.7	4.2	1.6

Source: Current Employment Statistics, seasonally adjusted data.

from the BLS's Current Employment Statistics. Consistent with Perry's argument, sectors in which men constitute a relatively large share of total payroll employment (especially manufacturing and construction) experienced relatively large declines in employment after the recession started. In contrast, employment in health and education, in which men constitute relatively small shares of payrolls, actually grew a bit over the period.

Yet this analysis neglects two other important dynamics to which attention should be paid. First, unlike in previous recessions, this different distribution of men and women across industries did not insulate women from losing jobs absolutely in the 2007–10 recession. In earlier recessions, women's payroll employment tended to hold steady (or even increased) when men's dropped, but in the most recent recession women's employment also fell absolutely: the level of women's payroll employment came down by 3.5 percent between December 2007 and May 2010. Second, within industries the extent of job loss or gain for women tended to be quite similar to that of men. For example, between December 2007 and May 2010, payroll employment in manufacturing dropped by 14.4 percent for men and 16.7 percent for women, while that in health and education rose by 5.1 percent both for men and women. These numbers also cast some doubt on both the "reserve labor force" and "substitution" hypotheses as general phenomena.

A brief look at the limited information available on workers in the lower parts of the income distribution provides additional insight on the relevance of the latter two hypotheses for this segment of the labor market. As shown in Figure 9.7, between 2007 and 2009, the number of part-time workers paid at or below the federal minimum wage increased at similar rates for men and women—but the ranks of female workers paid at or below the minimum wage had become twice as large as ranks of male workers by 2009. As a result, the difference between the number of women in this category and the number of men rose from 451,000 workers in 2007 to 745,000 workers in 2009. The magnitude of this gender gap in part-time employment at or below minimum wage was 50 percent lower in the previous recession, averaging about half a million in 2000 and 2001, and it was even lower and more or less constant during the 2002–2007 expansion.

Overall, this evidence indicates that the most insecure form of employment, in part-time minimum-wage jobs, tends to increase more for women than it does for men during recessions, which does in fact provide limited support for the substitution and reserve labor force hypotheses. Nevertheless, it is important to bear in mind that

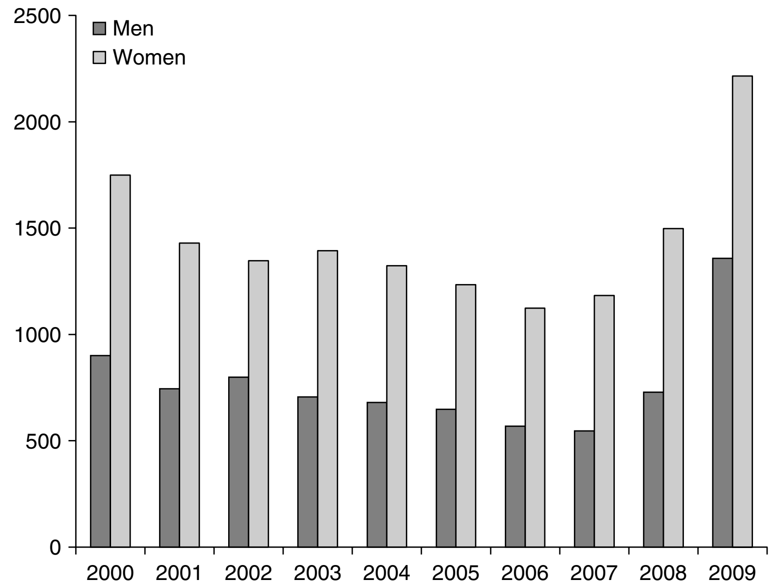

Figure 9.7 Part-time employed wage and salary workers paid hourly rates at or below minimum wage (thousands of workers)

Source: Current Population Survey.

the role of these two possible explanations on aggregate employment of men and women is difficult to assess because of the secular upward trend in female labor market participation in the period since World War II (which may be moderating the impact of cyclical variations) and the growing similarity between the cyclical changes in the unemployment rates of male and female workers since the 1980s.

Impact of the American Recovery and Reinvestment Act (ARRA) on Males and Females

In this last section, we examine whether the response to the recession by federal and state governments addresses the needs of the groups of workers who have been hardest hit by the current recession—African American and Hispanic males and females, young and less educated females and males, and single mothers. In response to the severity of the recession, the U.S. government passed a $787 billion stimulus plan in 2009, the American Recovery and Reinvestment Act (ARRA), which consisted of individual tax cuts and similar payments; business tax incentives; state fiscal relief; aid to those most directly hurt by the recession through expanded access of the unemployed to programs such as Temporary Assistance for the Neediest Families (TANF), food stamps, Medicaid, and Unemployment Insurance; and direct government investment spending on infrastructure, health information technology, and research on renewable energy.

Evaluations of the stimulus funds have generally been positive, concluding that unemployment would have been higher overall in the absence of government support. A recent report from the Congressional Budget Office (CBO 2010) estimated that in the first quarter of calendar year 2010, the ARRA's policies lowered the unemployment rate by between 0.7 percentage points and 1.5 percentage points, increased the number of people employed by between 1.2 million and 2.8 million, and increased the number of full-time-equivalent jobs by 1.8 million to 4.1 million—compared to what would have been observed in the absence of the package. Because of the short-term nature of the package, the CBO expects these effects to increase further during the second half of 2010, but then diminish in 2011 and fade away by the end of 2012.

In practice, it is difficult to evaluate the impacts of the package across genders.[8] States and agencies are not required to report sex-disaggregated information, although a handful of states are attempting to track spending by sex, such as Vermont, Massachusetts, and California. A few state-level studies have attempted to gauge the potential gendered employment impacts and impacts of the stimulus on family resources. Albelda et al. (2010) examined ARRA's impacts in Massachusetts and found that aspects of the Act benefit men much more than women: men benefit more than women from funds directed toward physical infrastructure improvements and "green economy" funding, two sectors where women's employment is limited. Funds allocated to tax benefits, support to unemployed workers, and workforce development are likely to impact males and females roughly equally. One area that is likely to benefit women differentially is the sizable portion of spending to states to stave off cuts in "social" infrastructure, such as Medicaid and education.

While the ARRA may have saved jobs, the stimulus funds have not been enough to offset declining state revenues due to the recession, and states have consequently made a number of spending cuts in services, including cuts in health care and K-12 education (30 states), and services to the elderly and disabled (25 states and DC) (Center for Budget and Policy Priorities 2009). These cuts will likely affect males and females differentially in terms of jobs, access to services, and time use.[9] California represents a stark example of these gender effects. The state faced a massive state budget shortfall of $59.5 billion for 2008–09 and 2009–10 as the recession deepened and state revenues plummeted. In response, state policymakers reached two budget agreements in 2009 that included more than $30 billion in state spending reductions, including deep cuts to the California Work Opportunity and Responsibility to Kids (CalWORKs) Program, the Supplemental Security Income/State Supplementary Payment (SSI/SSP) Program, and the In-Home Supportive Services (IHSS) Program—three programs that together provide cash assistance and services to 2.8 million low-income Californians (Graves 2010). Women comprise roughly 60,000 (61.8 percent) of the adults enrolled in these programs, and the majority of caregivers to recipients of In-Home Supportive Services.[10] The governor has proposed even deeper cuts to these programs in 2010–11. Analysts have pointed out that these reductions in public services, reductions of cash income, and loss of jobs are likely to affect women disproportionately (Graves 2010). But there is likely to be a fourth, less visible effect: an increase in women's unpaid work, both to stretch reduced household income to make ends meet and to provide care to those who formerly received public assistance. Unfortunately, time use survey data are not available to determine the extent of this latter effect, but analysis of the California budget suggests that current state policies will do little to mitigate these adverse effects.

Conclusion

Throughout the paper we have argued that the characterization of the current recession as a "man-cession" is not correct. Digging deeper into the data reveals a much more mixed picture, where notable findings include that African American and Hispanic women had higher unemployment rates than white and Asian males; female workers age 16 to 24 fared much worse than prime-age males; the unemployment rate for families maintained by single women was two times greater than the unemployment rate among married men and married women; and women lost over 10 times more jobs in the current recession than they did in the previous two recessions, compared to 2.3 times more jobs lost by men.

The descriptive evidence illustrates that simple female-male comparisons of unemployment yields partial results and potentially misleading policy conclusions. In that regard, the limited federal and state-level evidence suggests that post-crisis policies have so far addressed the needs of women sporadically and only in an indirect way, while the various dimensions of vulnerability for women and the specific needs of the hardest hit groups have not been addressed systematically in federal and state level policies. Clearly, future policy efforts must make better use of the growing evidence to develop job creation and income support policies that address the needs of the workers who have been hardest hit. There is also a need for future research on the effects of stimulus funds and state actions that are disaggregated by both sex and race. Such research would be an important counter to catchy but inaccurate sound bytes.

Notes

1. The National Bureau of Economic Research (NBER) defines a recession as a "significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale-retail sales" (Leamer 2008). As of this writing (June 2010), the NBER had not announced the official end date of the Great Recession, so our analysis uses data from December 2007 through the most recent period available, May 2010, and we refer to this entire period as the "2007–10 recession."
2. While a focus on paid work is clearly an important starting point, a broader feminist economic analysis of recessions goes beyond simply analyzing job loss to examine changes in time spent by males and females in unpaid work to provision families and compensate for the loss of jobs and earnings. Many studies of past recessions document that unpaid work intensifies during times of crisis and is often an invisible safety net (Thomas, Beegle, and Frankenberg 2003). Unfortunately, time use data are not sufficiently disaggregated nor conducted over a long enough period of time to conduct a meaningful analysis of changes in male and female time use in the current recession.
3. For empirical evidence and discussion, see Mosisa and Hipple (2006).
4. Analysis of trends in unemployment durations by gender across race and ethnic groups (not shown) indicate that, among males, African Americans and Asians experienced the longest average durations of unemployment, which reached 42 and 38 weeks respectively in 2010. Average durations for white and Hispanic men moved closely together, reaching a high of 35 weeks in the second quarter of 2010 (note that the data are not seasonally adjusted and so contain seasonal swings). As with men, average durations of unemployment among women were highest for African Americans and Asians. The duration of unemployment among Asian women ran up considerably between February 2010 and May 2010, rising from 24.3 weeks to 41.2 weeks, and surpassed that of African American females, which like whites and Hispanics

began to decline in April–May 2010. Overall, women's durations of unemployment, regardless of race or ethnicity, were on average greater than all but those of African American and Asian men. See the working paper version of this paper for details (Grown and Tas 2011).

5. By the BLS definition, persons classified as "unemployed" do not have a job, have actively looked for work in the prior 4 weeks, and are currently available for work.
6. Formally, the BLS defines "discouraged workers" as persons who did not actively look for work in the prior 4 weeks for reasons such as: thinks no work available, could not find work, lacks schooling or training, employer thinks too young or old, and other types of discrimination. "Other marginally attached workers" did not actively look for work in the prior 4 weeks for such reasons as school or family responsibilities, ill health, and transportation problems, as well as a number for whom reason for nonparticipation was not determined. Taken together then, "marginally attached workers" are persons who want a job, have searched for work during the prior 12 months, and were available to take a job during the reference week, but had not looked for work in the past 4 weeks.
7. Formally, "involuntary part-time employees" are those who worked 1 to 34 hours during the reference week for an "economic reason," such as slack work or unfavorable business conditions, inability to find full-time work, or seasonal declines in demand. "Voluntary part-time employees" are those who usually work part-time for noneconomic reasons such as childcare arrangements, family or personal obligations, school or training, retirement or Social Security limits on earnings, and other reasons. This excludes persons who usually work full time but worked only 1 to 34 hours during the reference week for reasons such as vacations, holidays, illness, or bad weather.
8. Public employment, one aspect of the ARRA, shows different trends for men and women over the course of the current recession. According to CES data, after an initial decline until the second quarter of 2008, government employment for men increased steadily and then spiked upward by about 0.3 million workers between February and May 2010, when the stimulus funds kicked in and hiring for the field operations of the 2010 Census ramped up. Public employment for women has been much more volatile, increasing by 0.2 million in the first six months of the recession, then falling by a little less than 0.2 million in the last three quarters of 2009, and finally growing by almost 0.3 million in early 2010.
9. To their credit, some states have protected key services that are important to women, such as child care (Alabama and Arizona).
10. CalWORKs provides cash assistance for low-income families with children, while helping parents find jobs and overcome barriers to employment. CalWORKs primarily reaches children, who make up more than three out of four recipients (77.9 percent). Women

comprise more than three-quarters (77.7 percent) of all adult recipients, and an even larger share (92.5 percent) of single parents who receive cash assistance. The SSI/SSP Program provides cash assistance to help low-income seniors and people with disabilities meet basic living expenses. More than half (57.3 percent) of SSI/SSP recipients are women. The IHSS Program helps low-income seniors and people with disabilities live in their own homes. Women and girls represent 63 percent of recipients, and women comprise nearly four out of five IHSS service providers (Graves 2010).

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Part III

Social Economy and the Economic Downturn: Communities, Needs, and Capabilities

Chapter 10

Recession and the Social Economy

Martha A. Starr

Introduction

Recessions often see an increase in unmet needs for food, shelter, and health care. For many households, a spell of unemployment entails economic hardship, but they can cover basic spending on groceries, utilities, the rent or mortgage, medications, and so forth, using the income of a second earner, accumulated savings, and/or unemployment insurance. But other households, especially those who are economically vulnerable to begin with, tip more easily into difficulties paying for basics of everyday life. In principle, various government programs can help cover basic consumption needs, including food stamps, Medicaid health insurance, unemployment insurance, housing vouchers, and welfare payments. Yet especially in recessions, when people who lose their jobs do not know how long they will be unemployed, it may be awhile before they apply for benefits and begin to receive support, if they are eligible. Moreover, government benefits usually only partially cover spending on basics; thus, for example, many recipients report that their food stamps run out before the end of the month. Additionally, some people with unmet basic needs may not be eligible for government programs (e.g., immigrants with problematic status), while others prefer not to rely on public support.

In circumstances such as these, people often turn to social-economy organizations for help in alleviating unmet basic needs. While the term "social economy" has different meanings in different contexts (see, e.g., Moulaert and Ailenei 2005), in general it refers to economic activity that is (a) oriented to improving social welfare, with a particular concern for disadvantaged groups, and (b) organized neither by the government, nor by privately-owned profit-oriented firms, but rather by private organizations whose activities are governed by logics other than profit maximization. Within the social economy, a highly varied assemblage of actors organizes activities aimed at addressing unmet needs for food, shelter, and health care, including religious, charitable, community, and private voluntary groups. Some operate on a national scale and are exclusively concerned with meeting a basic need; for example, the organization Feeding America, which distributed 340 million pounds of food donated by companies through the national food-bank system in 2009. Others, such as local churches that operate food pantries, are relatively small and conduct needs-oriented work as part of a broader set of activities. Throughout the needs-oriented sectors of the social economy, a very high share of labor hours is volunteer.

Although popular press reports suggest that social-economy organizations have worked overtime to help economically strapped people contend with the 2007–09 recession (e.g., Deparle and Gebeloff 2009; Bosman 2009), to date there has been little research investigating the extent to which unmet basic needs rise in recessions, nor the effectiveness of social-economy organizations in mobilizing to offset them. The role of the social economy in addressing unmet needs has been ideologically charged in recent decades, as it raises questions about the proper scope of government in alleviating hardship and ensuring widespread access to decent consumption standards. In particular, the scaling back of income-support programs, in the face of stagnant earnings in the lower part of the income distribution, suggests to critics that the social economy is filling voids that ought to be filled by the state (e.g., Poppendieck 1999). Yet, as this paper will discuss, that perspective tends to reflect an overly simple understanding of where responsibility for upholding basic tenets of social justice lies, neglecting responsibilities that fall upon individuals, communities, and businesses as well as upon the state. It is also out of line with present realities of government budget constraints and voter distaste for (re)expanding government social programs. This makes it increasingly important to understand how the social economy works, and to investigate how well logics other than public-service delivery and/or profit-maximization do in addressing social problems.

The next section of this paper discusses conceptual issues underlying the role of the social economy in addressing problems of basic needs and lays out how changes in its access to resources in recession might be expected to affect its ability to respond to rising unmet needs. The third section presents available data on changes in unmet needs for food, shelter and health care following the onset of recession in late 2007. The fourth section analyzes the dynamics of the social-economy response to rising unmet needs, taking the specific example of the emergency-food system. The fifth section draws implications for our understanding of the social economy and its ability to support and advance social welfare in advanced-industrial economies subject to aggregate fluctuations, where the costs of these fluctuations tend to fall on anyway vulnerable groups.

Social Economy and Unmet Basic Needs

The concept of "unmet basic needs" is hard to deal with in traditional economic analysis, which is critical of the idea of any hard-and-fast distinction between "wants" and "needs." To be sure, given the complexities of how material goods and services fit into people's lives, it is not straightforward to differentiate between goods and services that are in some sense fundamental requisites of a materially sufficient life, and others that are highly valued but not strictly necessary. For one, some things are perceived as "necessities" because they figure integrally into the prevailing material living standard, so that people doing without them may look odd, eccentric, or deficient (e.g., as not wearing a hat used to be for men). For another, people come to perceive as necessities those things which they consume or use habitually, as they take on the character of natural parts of a materially and socially satisfying life (e.g., a car to get to work, a phone to communicate with friends and conduct personal business, etc.).

At the same time, insisting too much on the social and contextual character of "needs" obscures the question as to whether *some* things are so central to human wellbeing that, especially in societies with sufficient wealth and resources to cover everyone's needs in this sense, there is a social or moral obligation to make provisions for these needs to be met. Various philosophical, psychological, ethical, and religious frameworks offer conceptualizations of basic human needs; important examples are shown in Table 10.1. While they differ appreciably in their specifics, they all have at their foundation a minimalist set of items viewed as so central to human wellbeing that without them people have poor chances of living lives they have reason to value and/or that cannot otherwise be understood as "right" or "good." For example, at the base of Maslow's well-known hierarchy of needs are physiological and safety-related needs; Maslow posited that until these are satisfied people will not be motivated or able to pursue higher-order needs for belonging, esteem and self-actualization. In Nussbaum's elaboration of the human-capabilities framework, bodily health and bodily integrity are understood as two of ten of

Table 10.1 Conceptualizations of basic needs and social responsibility for meeting them

Maslow's hierarchy	Nussbaum's 10 capabilities	Islamic Thought	Catholic Social Thought	Secular rights approaches
Physiological: oxygen, food, water, relatively constant body temperature Safety Belongingness, love, and affection (giving and receiving) Esteem: self-esteem and the esteem of others Self-actualization: a person's need to be and do that which the person was "born to do."	Life of normal length Adequate food and shelter Freedom from assault, freedom of movement Ability to think and reason cultivated by education Full emotional life w/satisfying attachments Ability to conceptualize the good, engage in critical reflection Ability to be treated with dignity by others Ability to live with concern for animals, plants and nature Ability to laugh, play, enjoy recreational activities Ability to participate politically, hold property, secure employment on equal basis with others	*Five Basic Necessities of life (darurat* or *dharuriat):* Physical self: basic items needed to lead a purposeful life (food, clothing, shelter, transport, health etc.) Religion: ability to practice one's religion; for Muslims, the ability to perform the five pillars. Intellect or Knowledge: ability to acquire knowledge, develop one's mind and reasoning power Family Life and Offspring: ability to marry and raise a family Wealth: ability to earn a livelihood, own and maintain property related thereto	*All people have inviolable rights to:* Bodily integrity and means for proper development: food, clothing, shelter, medical care, rest Social security: care in the event of ill-health, disability, widowhood, unemployment, loss of livelihood through no fault of one's own Good education Freedom to choose one's profession Respect and a good name Freedom to investigate the truth, be informed about public events Freedom of speech and publication	*U.N. Universal Declaration of Human Rights, Article 25(1)* "Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing, and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control."
	"In some form all [of the above] are held to be part of a minimum account of social justice: a society that does not guarantee these to all its citizens, at some appropriate threshold level, falls short of being a fully just society, whatever its level of opulence."	Those with means have obligations to help meet the needs of the poor through alms-giving and other actions Unmet needs may reflect deficiencies of values within society that ought to be changed The state should address needs unmet by private individual and collective action	*Principle of subsidiarity*: Governments should undertake only those initiatives which exceed the capacities of individuals or private groups acting independently. They should not replace or destroy smaller communities and individual initiative, but rather should supplement their activity when the demands of justice exceed their capacities.	Governments have duties to respect and uphold human rights. Individuals have responsibilities to promote rights in their own country. Help from private voluntary organizations is welcome, but unlikely to provide widespread access to basic needs as governments can. Wealthy countries have adequate resources to protect rights to basic needs.

Sources: Maslow (1943), Nussbaum (1999: 41–2; 2006: 7), Goolam (2006), Pope John XXIII (1963), U.S. Catholic Bishops (1986), Nickell (2005).

the capabilities people require to be able to lead lives they have reason to value, with access to adequate food and shelter and safeguards on personal safety figuring centrally in these capabilities. Rights-based approaches also posit that all people have fundamental rights to food, water, clothing, shelter, physical security, and health care. Religious traditions such as Catholic Social Thought and Islamic Economic Thought also recognize these items as basic human needs to which all should have access, by virtue of God's intentions for the bounty of the earth. In many though not all of these frameworks, there is also an emphasis on *qualitative* needs related to respect for the agency and dignity of the human person: it is not enough to ensure that the needy are supplied with basic goods and services; they also need to feel like fully participating members of society worthy of respect. Altogether, this suggests a "modest essentialism" (Powers and Faden 2006) in identifying the most basic of human needs, emphasizing the importance of adequate access to food, shelter, clothing and health care in biophysical functioning and social participation, along with positive social identity and self-worth.

These frameworks share a common intuition that the imperative character of basic needs implies some form of social responsibility to ensure they are met, both in an immediate sense (i.e., that food and shelter can fairly readily be obtained by those who urgently need them) and in terms of longer-term projects to eliminate underlying causes of unmet needs. Given the present paper's focus on recession, our interest is primarily in social mechanisms intended to provide immediate access to food and shelter, although we deal with the question of how they relate to longer-term projects later in the paper. These frameworks vary, however, in how they frame the origin of this responsibility and what social agent(s) they understand as having obligation(s) to execute it. Virtually all frameworks implicitly view the state as needing to play a central role in this respect, in so far as "the state" is a primary vehicle for expressing the public will and/or as having natural advantages in conducting redistributive programs fairly and efficiently.[1] Yet several of the needs-related frameworks, especially those grounded in religious and humanistic traditions, take social responsibility for meeting needs to be more widely dispersed. In both Catholic Social Thought and Islamic Economic Thought, individuals are called upon to conduct their lives in ways that incorporate concern for the wellbeing of the needy, with community-based organizations (civic, religious, educational) also expected to mobilize resources to fill basic needs and channel them to the disadvantaged in ways that respect human dignity. Overlapping with the contemporary discourse of Corporate Social Responsibility (CSR), Catholic Social Thought also views for-profit businesses as having obligations to share the fruits of production with the less fortunate, for example, by supporting charitable work in the communities in which they operate (Starr 2009).

Understanding responsibility for meeting basic needs as broadly distributed within society has important practical advantages over understanding it as overwhelmingly the responsibility of the state. For one, it helps maintain reserves of social values that contrast with those of commercial culture, which emphasize emulative consumption, accumulation and display of wealth, and other endeavors rooted in self-interest and material satisfactions. These contrasting values include an *ethic of care*—described by Gilligan (1982) as "seeing and responding to need, taking care of the world by sustaining the web of connection"—and other imperatives to take action to meet the needs of others (e.g., the duty of alms-giving in Islam). For another, it acknowledges that actually existing governments cannot simply be willed to guard against unmet needs, but rather must be charged with this responsibility as an outcome of the political process.[2] Thus, for example, needs-related spending may lose out to other types of programs in contests over funding, and/or the populace may not share the belief that this is properly the role of the state.[3] This underlies Weisbrod's (e.g., 1988) view of why there are nonprofits in market-based economies: If people's social preferences are heterogeneous and politics are majoritarian, governments will provide only those services upon which a majority of people agree; those who want to see more of a given service produced can contribute time, money and resources to private nongovernmental endeavors formed to augment supply above the level determined by political consensus.

It is relatively difficult to gauge the size and scope of the needs-oriented social economy in the United States. One problem is that available data on nonprofit organizations are classified by the general area in which they work, rather than the specific activities they undertake. For example, the Boy Scouts of America is a youth membership organization with quite varied goals and activities, of which one is an annual "Scouting for Food" drive in which local chapters collect canned goods for local food banks. Another is that they use such eclectic mixes of funding, labor, and inputs that it is difficult to assemble a broad picture of the resources upon which they call. Funding comes from federal, state, and local governments, as well as donations from households, foundations, and corporations. A very high share of the labor they use comes from unpaid volunteers. Their inputs are both purchased and donated; for example (as will be discussed further), much of the food distributed through the emergency-food network is donated by businesses with unsold food. Nonetheless, available data suggest that the needs-oriented social economy entails a large number of relatively small organizations that get by on shoestrings, including 33,600 emergency-food programs; homeless shelters, which together maintain over half a million year-round beds; 1,950 shelters for victims of domestic violence; and community health centers, which provided free or low-cost care to 16 million patients in 2007.[4] Still, needs-oriented organizations represent a relatively small segment of the nonprofit sector; for example, of the $250 billion households contributed to nonprofits in 2005, only 8 percent was explicitly targeted to meeting basic needs for food, shelter, and other necessities (Center for Philanthropy, Indiana University 2007). Similarly, among people over age 16 who volunteer, 9–10 percent are involved in collecting, preparing, distributing, and/or serving food (Bureau of Labor Statistics 2010).

Given that the social economy depends on flows of financial and productive resources from businesses, foundations, private donors, volunteers, and governments, it is important to lay out how effects of aggregate downturns on those sectors could affect the ability of the social economy to respond to rising basic needs. First, to the extent that people's willingness to volunteer in needs-oriented work and make donations to support it is a function of perceived needs, rising hardship experienced by others may result in increased volunteering and donations in needs-oriented work. Second, however, declining incomes, increased uncertainty, and declining values of financial assets are likely to reduce inflows of private financial support for the social economy, although needs-oriented work may suffer less than other subsectors.[5] Third, access to funding from state and local governments may also drop during recessions, if (as would be expected) they need to scale back spending in line with their lower tax revenues. Any special fiscal stimulus introduced at the federal level, however, may offset this drop to some degree. Fourth, weakness in the labor market may increase volunteering in recessions, to the extent that opportunity costs of people's time are lower than in normal economic times. Finally, business donations of unsold goods may either rise or fall during a downturn. Supplies of unsold goods may rise initially as aggregate demand contracts, so that inflows of food and other grocery items to social-economy organizations may at first increase. But as companies adjust production and inventory levels in response to weaker economic conditions, they may try harder to keep their margins of unsold goods trim. Conversely, however, increased efforts to demonstrate social responsibility may promote special efforts on the part of businesses to show themselves to be helping to fill unmet needs, so they may divert resources out of other CSR projects into need-oriented contributions. Altogether, then, it is hard to predict *a priori* how vigorously the needs-oriented social economy can respond to deficits in basic needs that may emerge during downturns.

Unmet Needs and the 2007–09 Downturn

Not surprisingly, given the severity of the 2007–09 downturn, many measures of unmet needs rose after late 2007, when the downturn began. As shown in Table 10.2, the national civilian unemployment rate doubled between the fourth quarter of 2007 and that of 2009. Increases in rates were greater among blacks and Hispanics compared to non-Hispanic whites, for whom rates were anyway lowest at the outset; this is consistent with well-established findings in the literature that less advantaged groups experience more unemployment and larger declines in earnings in recessions.[6] The official poverty rate—intended to capture the share of people not able to afford basics of healthy living (based on estimated costs of a nutritionally sufficient diet, household size, and assumptions about the share of food costs in total spending on necessities)—rose from 12.5 percent in 2007 to 13.2 percent in 2008, with the largest increase among Hispanics.

Table 10.2 Changes in correlates of unmet need: Unemployment and poverty

	Unemployment rate (workers aged 16+)		People living in households with incomes below x% of the poverty line			
			50%		100%	
	2007	2009	2007	2008	2007	2008
All	5.0	10.0	5.2	5.7	12.5	13.2
By race/ethnicity of person or householder						
Black	8.7	15.8	11.2	11.4	24.5	24.7
Non-Hispanic white	4.3	9.2	3.4	3.7	8.2	8.6
Hispanic	5.9	12.9	8.2	9.1	21.5	23.2
# of persons (thousands)	7,696	15,267	15,586	17,075	37,276	39,829

Notes: Data sources given in Appendix. Unemployment rates are for "white" rather than "non-Hispanic white."

Numerically, the ranks of the poor swelled by 2.5 million people in the recession's first year. Shares of people with incomes of 50 percent of the poverty line or less, who are particularly likely to be experiencing regular and appreciable deficits in basic needs, also moved up for all groups.

Table 10.3 presents information on access to consumption support and health insurance via government programs. The share of households receiving food stamps moved up by about one percentage point, reaching 8.6 percent in 2008. Despite rising poverty, receipt of cash income support hardly budged, at least partly due to tighter constraints on eligibility imposed in the welfare reform of the 1990s. There was slippage in the share of people having health insurance under an employer-provided plan—although this was offset in good part by increased participation in government health-insurance programs (e.g., the Medicaid program for people with low incomes, SCHIPS programs for children, etc.).[7] The share of newly unemployed workers filing for UI benefits between 2007 and 2009 moved up as the economy ploughed into recession; still, this share was only 40 percent in 2009, reflecting both ineligibility and less-than-full-uptake among people who are eligible (see, e.g., Wenger 2003 and references therein).

Looking more directly at measures of unmet needs, Table 10.4 presents information on insecurities in access to food and health care. The U.S. Department of Agriculture compiles annual statistics on "food insecurity," where households are classified as "food

Table 10.3 Access to consumption support and health insurance

	% of HHs receiving food stamps		% of households receiving cash assistance		% of people covered by health insurance: Employer-provided		% of people covered by health insurance: Government program		% of newly unemployed workers filing for UI benefits	
	2007	2008	2007	2008	2007	2008	2007	2008	2007	2009
All	7.7	8.6	2.4	2.3	59.3	58.5	27.8	29.0	36.3	40.0
By race/ethnicity of person or householder										
Black	18.7	20.3	n.a.	n.a.	49.1	48.3	35.2	37.5	n.a.	n.a.
Non-Hispanic white	5.2	5.9	n.a.	n.a.	65.6	64.8	26.7	27.5	n.a.	n.a.
Hispanic	12.6	14.1	n.a.	n.a.	40.3	40.2	28.3	30.4	n.a.	n.a.

Sources: See Appendix.

Table 10.4 Insecurity in access to food and health care

	% of HHs experiencing some food insecurity in past year		% of HHs with very low food security in past year		% of adults in fair or poor self-reported health		% of persons who didn't get or delayed getting medical care in past 12 mos. due to concerns about cost	
	2007	2008	2007	2008	2007	2008	2007	2008
All	11.1	14.6	4.1	5.7	13.0	12.8	13.5	15.5
By race/ethnicity of person or householder								
Black	22.2	25.7	7.7	10.1	19.3	18.4	14.1	17.5
Non-Hispanic white	7.9	10.7	3.1	4.5	11.6	11.5	13.5	15.3
Hispanic	20.1	26.9	6.6	8.8	17.3	17.4	14.4	17.4

Notes: See Appendix for data sources. Households are classified as "food insecure" if at some time during the past year they were uncertain of having, or unable to acquire, enough food to meet the needs of all their members due to insufficient money or other resources for food. Their food security is classified as "very low" if "at times during the year, the food intake of household members was reduced and their normal eating patterns disrupted because the household lacked money and other resources for food."

insecure" if at some time during the past year they were uncertain of having or unable to acquire enough food to meet the needs of all their members, due to insufficient money or other resources for food. Between 2007 and 2008, the share of households facing some food insecurity rose from 11.1 percent to 14.6 percent, a significant and notable increase. While critics point out that this measure of insecurity captures even highly transitory disruptions in access to food, a narrower measure of households with very low food security—those who had to limit their food intake or disrupt their normal eating habits at times during the year due to lack of money and other resources for food—also moved up, from 4.1 percent in 2007 to 5.7 percent in 2008. Rates rose particularly for black and Hispanic households. Further analysis shows that children rarely have to go without food: adults cut back their own consumption to ensure that children can eat (Mathematica Policy Research 2010). Still, in one of the world's wealthiest countries, any rise in unmet needs for food is obviously disturbing.

With respect to health, Table 10.4 also shows that the share of adults reporting themselves to be in "fair" or "poor" health held steady or even slipped a bit between 2007 and 2008. This is consistent with Ruhm's (2000, 2003) finding that "recessions are good for your health"—because a number of behaviors related to serious health problems (drinking, smoking, driving, work-related stressors that aggravate hypertension) tend to fall off in recessions. However, the final panel of the table also shows that the share of people who didn't get or delayed getting medical care in the past year rose from 13.5 percent in 2007 to 15.5 percent in 2008, suggesting that even if the incidence of health-related problems does not rise in recessions, there may be harder-to-detect lagged effects of slippage in routine care.

Table 10.5 presents information relevant to gauging inadequate access to shelter. While the total estimated number of people who had used emergency shelters or transitional housing programs over the preceding 12 months hardly changed between 2007 and 2008, there were some important shifts in the composition of people entering shelters. For one, the number of individuals entering shelters fell,

Table 10.5 Inadequate access to shelter

	All persons		Individuals		Persons in families	
	2007	2008	2007	2008	2007	2008
# of persons who used emergency shelters or transitional housing programs from Oct. 1 of the given year through the following Sept. 30 (,000)	1,588	1,593	1,115	1,092	473	516
% of total	100	100	70.2	67.9	29.8	32.1
Where sheltered homeless persons were before they acquired shelter (% of people in group):						
Other homeless shelter or place not intended for human habitation	39.4	37.2	43.3	39.4	30.3	25.9
Rented or owned housing unit	13.6	12.5	12.2	11.2	16.8	19.2
Staying w/family or friends	28.3	28.5	24.3	25.8	37.6	42.3
Institutional setting	9.2	11.9	12.1	13.6	2.3	2.4
Hotel, motel, other accommodation	9.6	10.1	8.2	10.0	13.0	10.2

Notes: See Appendix for data sources. "Institutional settings" include hospitals, psychiatric facilities, substance-abuse treatment centers, foster care, prison, juvenile detention centers, and so forth.

but the number of persons in families increased, which is especially alarming given evidence that for children any spell in homelessness has long-term negative consequences (Fertig and Reingold 2008). For another, the share of people entering shelters who had previously been staying in another shelter or sleeping in a place not intended for human habitation fell between 2007 and 2008, while the share coming from their own home or apartment or from staying with friends or family increased. It is suspected that these shifts are fall-outs of the foreclosure crisis, although this is hard to establish. One study found that 4 percent of people arriving at shelters previously resided at an address where a foreclosure occurred, where one half were renters who were evicted and the other were homeowners who were themselves foreclosed (Pettitt et al. 2009).

The Social Economy of Emergency Food

To analyze the response of the social economy to rising unmet needs, we focus on the case of the emergency food system—the network of food banks, food pantries and soup kitchens that aim to supply food to those with unmet needs. The emergency food system is of special interest both because insecure access to food in a wealthy society is troubling *per se* and because statistics on emergency food are relatively good, reflecting the presence of coordinating structures within the system and its integration with various government programs.

In principle, the federal government runs a number of programs intended to guard against unmet needs for food, including food stamps; the supplemental nutrition program for women, infants and children (WIC); the national school lunch program; and others. In practice, however, these programs only go partway toward covering unmet needs for food. Not everyone who meets income criteria for benefits satisfies other criteria for eligibility (e.g., undocumented immigrants). Newly-needy people may not realize they are eligible for benefits, and it takes time to apply. Additionally, benefits are set to cover gaps between what it is estimated the household could afford and its estimated needs, which may not reflect the household's actual unmet needs. Also, some people who are eligible for government benefits do not want to take advantage of them.

Thus, various types of social-economy organizations—churches and other religious organizations, private nonprofit groups, community centers, and various other community programs—operate frontline food-assistance programs, which fall into three categories. *Food pantries* distribute food (primarily packaged) and other grocery products to needy people in their communities, where the latter then prepare the food wherever they live. *Soup kitchens* provide prepared meals to the needy on their own premises. *Emergency shelters* have the dual purpose of giving temporary shelter to people without it, and offering them one or two meals during their stay; examples include homeless shelters, shelters for victims of domestic violence, and temporary shelters for people with substance abuse problems. It is estimated that food pantries serve the largest number of clients over the course of the year: for example, in 2009, it is estimated that 35 million people acquired food from a food pantry, 2.1 million from a soup kitchen, and 1.6 million from an emergency shelter (Mathematica Policy Research 2010: 44).

Of critical importance in provisioning the frontline programs with sufficient food is the system's wholesale backbone, consisting of the large nonprofit organization, Feeding America (previously America's Second Harvest), which collects food donations from companies and distributes them to regional food banks, which in turn distribute them to frontline programs. Food pantries receive about three-quarters of the food they distribute from food banks; for soup kitchens and shelters, the shares are about one-half and two-fifths respectively. What makes the system constitute a "system" is the extraordinary work done by Feeding America and its partner organizations, to collect food and move it quickly and efficiently to outlets with demonstrated capacity to get it to those in need. This entails: identifying and cultivating potential sources of food donations; finding ways to make donations advantageous to companies that produce, distribute, and/or serve food; transporting, storing and delivering food to food banks at maximum efficiency; investing in capital equipment and technologies that increase the efficiency of the distribution network; dealing only with food banks having infrastructure and personnel capable of making full use of food donations; working continually to build knowledge of hunger in America; and soliciting financial donations for capital projects. To the economist's eye, what is striking is that—contrary to the assumption that monetary incentives are required to motivate people and organizations to maximize returns to scarce productive resources—the emergency-food system's efficiency is driven by an overriding *intrinsic* motivation to minimize unmet needs for food. This underlines the false dichotomies put forth in debates about public versus private provision of social services: in plenty of cases, it is not a shortage of pecuniary incentives that causes public-sector inefficiencies, but rather too little sense of the intrinsic value of one's work (e.g., Valentinov 2007).

Table 10.6 shows how the emergency-food system ramped up between 2005 and 2009, as the U.S. economy shifted from healthy expansion to deep recession. Consistent with expectations, three-quarters of all food pantries reported that the number of clients they served had increased in the previous three years; comparable shares for soup kitchens and shelters were 65.4 percent and 54.5 percent respectively. Capacity in all three types of programs expanded over the period: the number of food pantries rose from 18,436 to 23,842;

Table 10.6 Profile of frontline food-assistance programs

	Food pantries		Soup kitchens		Shelters	
	2005	2009	2005	2009	2005	2009
Total # of programs	18,436	23,842	4,514	6,064	2,704	3,728
% of programs serving an increased # of clients in the previous 3 yrs.	–	74.3	–	65.4	–	54.4
Distribution of programs by type (%)						
Religious organization	73.6	71.6	64.7	61.8	43.1	39.2
Other private nonprofit	18.3	19.6	27.9	29.1	50.1	51.0
Government	2.3	2.0	2.5	2.3	1.8	2.3
Community Action Program (CAP)	3.2	2.6	1.8	1.8	1.6	2.4
Other community programs	2.6	4.2	3.0	5.0	3.4	5.1
Use of volunteers:						
% of agencies using volunteers	89.1	92.6	86.4	87.1	71.4	71.8
% of agencies staffed only by volunteers	66.2	67.7	40.5	42.0	10.8	15.3
Avg. # of volunteers	5	6	7	8	9	9
Sources of food:						
% of total food acquired from a food bank	74.2	75.5	49.0	49.6	41.5	41.1
% of programs receiving food from:						
Religious congregation	76.2	80.6	58.7	64.4	56.2	58.1
Federal govt. food programs	68.7	59.8	49.4	41.2	45.9	38.1
Purchases by the agency	53.9	58.0	74.9	75.1	81.4	81.4
Local food drives	49.9	54.5	27.2	31.9	40.3	40.7
Local merchant or farmer donations	40.8	46.3	45.8	48.2	45.0	49.0

Source: Mathematica Policy Research (2010: 349).

the number of soup kitchens from 4,514 to 6,064; and the number of shelters from 2,704 to 3,728. Much of this growth came from secular nonprofit organizations; in all three areas, the share of programs run by religious organizations slipped. Volunteer labor was clearly important in handling increased volumes of emergency food, especially for food pantries where two-thirds of programs have no paid workers at all. This is consistent with national statistics on volunteering which show that, while the share of people age 16+ who did some volunteering in the previous year did not change much between 2007 and 2009, among those volunteering, the share whose main activity was to collect, prepare, distribute and/or serve food rose from 9.2 to 10.3 percent (Bureau of Labor Statistics 2010). The shift toward food-related volunteering came especially from people working full- or part-time; among the unemployed (who anyway volunteer at lower rates), there was no such shift. This suggests that, as the recession deepened, working people sought out ways to help those in need.

A similar picture comes from examining sources of the food distributed by frontline agencies. Shares of food acquired through food banks hardly changed between 2005 and 2009, consistent with direct reports of increased supplies of food acquired and distributed through Feeding America over the period.[8] Thus, there is no special evidence that grocery chains, food producers, or other companies producing basic household staples trimmed back margins of unsold food to get through tough times. At the same time, the steady shares of food coming through congregations, local food drives, and donations from local merchants imply that their volumes also rose, again suggesting important efforts within local social and business circles to respond to rising unmet needs of others.

How well did the emergency-food system do in accommodating needs for food left unmet through money incomes, support of friends and family, and government programs? Available data suggest that, as well as the system did in mobilizing extra resources, it was able only partly to accommodate rising unmet needs for food. As shown in Table 10.7, many frontline agencies had to make adjustments in their programs to deal with increased demand and found themselves stretched thin. Thus, the share of food pantries saying they sometimes or often had to reduce the size of the food package due to lack of food rose from 18.1 percent in 2005 to 24.8 percent in 2009, while the share of emergency shelters saying they had to reduce portion size rose from 6.2 to 10.1 percent. In 2009, about 25 percent of food pantries and 10 percent of soup kitchens said they had to turn people away due to lack of food and/or ineligibility issues (which include limits on the frequency of getting food from the program). In other words, the means used to cope with excess demand for emergency food is *rationing* according to defined measures of need: while criteria vary from outlet to outlet, they generally aim to *share* available food among those who need it, using rules intended to be fair (e.g., limits on the number of visits per month, distributions confined to residents of the area, portion sizes based on household size, etc.). This underlines that, even if the emergency food system has been highly effective in responding to unmet needs created by the recession, the conditions under which it operates—of constant scramble to mobilize resources to operate at right levels relative to need—imply constant challenges navigated by a critical pool of people driven by the ethic of care. Given the difficulties this implies, it is perhaps not surprising that two-thirds of all food pantries and soup kitchens and almost three-quarters of all shelters viewed their futures as uncertain, due to problems with funding, adequate food supplies, and/or staffing.

What do people who receive emergency-food assistance think about what they receive and how they receive it? As Table 10.7 shows, large majorities of recipients are generally satisfied with the amount, variety and quality of food they receive, although somewhat less so at shelters than at pantries and kitchens. Equally important from the point of view of basic needs is that approximately 90 percent of people visiting pantries and kitchens said they were treated with respect by staff always or most of the time; while for shelters this number was lower at 87.2 percent in 2009, it was up from 84 percent in 2005. This reflects the clear, strong and widespread commitment among emergency-food providers to treating the people they serve with consistent dignity and respect. Thus, many adopt some code of ethics that governs their interactions with the people they serve. One such code is the “Code of Ethical Principles and Standards of Professional Practice” of the Association of Fundraising Professionals (AFP) which requires members to “treat all people with dignity and respect,” “foster cultural diversity and pluralistic values,” “demonstrate concern for the interests and well being of individuals affected by their actions,” and “value the privacy, freedom of choice and interests of all those affected by their actions.” Similarly, the Code of Ethics of Catholic Charities USA stipulates that “each person served and engaged with our work will be held in great esteem and with great respect,” and that “decisions should . . . involve those who are capable of participation in decision-making and who will be impacted by those decisions, and should

Table 10.7 Agencies' problems accommodating needs for food and people's satisfaction with the food they receive

	Food pantries		Soup kitchens		Emergency shelters	
	2005	2009	2005	2009	2005	2009
Agencies' problems						
% of programs that, in the past year, had to reduce size of food package or portion due to lack of food "sometimes" or "often"	18.1	24.8	9.4	11.8	6.2	10.1
% of programs that had to turn people away in the past year due to lack of food and/or ineligibility issues given the program's rules	–	26.6	–	9.9	–	43.3
% of programs with uncertain futures due to problems threatening their continued existence (e.g., funding, staffing problems, adequate food supplies)	–	66.6	–	67.3	–	73.0
People's satisfaction with food assistance they receive						
% of people "very" or "somewhat" satisfied with the food they received in terms of:						
Amount	92.6	92.5	92.7	92.1	83.7	85.6
Variety	90.7	91.1	89.4	89.2	78.7	79.0
Quality	93.9	94.0	91.6	90.3	82.9	81.2
% of people who said they were treated with respect by the staff always or most of time	91.6	90.7	91.0	89.0	84.2	87.2

Source: Mathematica Policy Research (2010: 226, 271).

empower those who are most in need" (Catholic Charities USA 2007: 8–9). As such, emergency-food relief agencies generally aim to integrate the basic need for dignity and agency in the conduct of their work.

Discussion and Implications

On balance, the evidence suggests that the emergency-food subsector of the needs-based social economy responded fairly strongly and effectively to rising unmet needs for food during the recession of 2007–09—showing that, just as prospects for earning abnormal profits pull resources into production of commercial goods, imperatives of meeting needs pull resources into the social economy when the economy turns down. That concern for the needs of others is central in explaining this response is suggested by findings which are out of line with incentive-based predictions of how the social economy would respond. For example, companies' donations of unsold food did not drop off as the recession deepened, but rather held steady or rose. Private financial donations may have fallen off as asset prices dropped, but they fell by less than they did in other nonprofit sectors, suggesting a diversion of funding into needs-oriented work. Volunteering rose, but it was employed people, not the newly unemployed, who intensified their involvement in needs-oriented work. These findings underline that, despite the dominance of commercial values in the contemporary U.S. economy, a widely held *ethic of care* provides an appreciable, if not fully sufficient, countervailing force to rising deficits in basic needs.

The case of emergency food highlights some important features of the social economy and ways in which it differs from private and government economic activity. First, in common with private business activity, there is an important element of entrepreneurship in the needs-oriented social economy, with its principals needing to constantly troll for new sources of financing or donations, new strategic partnerships, new operating methods, and so forth, to better meet the needs of people it aims to help. This highlights that "pecuniary motives" are not the only drive behind welfare-increasing changes in the production and distribution of goods and services, and/or in the types of goods and services produced, even if they tend to be emphasized in economic definitions of entrepreneurship. Rather, intrinsic and pro-social motives can also be of critical importance in activities where primary objectives concern helping others, especially when it comes to addressing unmet needs. But second, *un*like private business activity, innovation in the social economy can also take the form of building structures and establishing practices that coordinate activities across organizations, making their joint product higher than it would be if each operated alone. The wholesale backbone provided by Feeding America is an obvious example: by acting as the central coordinator of food donations and the distribution of food among regional food banks, Feeding America is able to mobilize quantities and qualities of food much above what smaller organizations could mobilize on their own and store and distribute supplies at lower cost. Another example concerns the rules used by regional food banks to determine which food pantries and kitchens with which to do business; typically, to ensure that the food they provide goes expeditiously to people who really need it, they will only partner with outlets that maintain regular, decently-equipped operations and run at sufficient scale with sufficient professionalism to make good use of emergency food supplies. These kinds of coordinating structures may be more important in the emergency-food system, versus subsectors of the social economy aiming to address unmet needs for shelter and health care—but the latter too could benefit from creating new structures and practices for solving problems collectively, for example, by bargaining jointly with companies that supply goods and services they need to carry out their work.

This brings us back to the criticism that the emergency-food system and the needs-oriented social economy more generally reflect a social deficiency rather than social strength—because no matter how effective and efficient they may be in addressing unmet needs in the short term, they cannot do much to tackle underlying causes of inadequate access to food, shelter and health care among disadvantaged people and instead leave them chronically dependent on the beneficence of strangers. While this criticism is valid as far as it goes, it fails to situate the problem in context, making it hard to see what to do about it. On one hand, considerations of human agency and dignity mean that long-run solutions to eliminating unmet needs are not a matter of raising the generosity of government programs (food stamps, housing vouchers, etc.)—because people perpetually dependent on the public dole are not able to work and participate in social life on an equal footing with others. Rather, eliminating unmet needs would require sustained and substantial efforts to improve the abilities of disadvantaged people to earn decent livelihoods, live in decent communities, provide their children with decent educations, and so forth. On the other hand, the urgent character of unmet basic needs implies that it will always seem imperative to allocate additional resources to covering presently unmet needs, rather than investing them in programs that would bring down the prevalence of unmet needs in the long run. This is similar to the problem of time inconsistency in hyperbolic discounting models: because consumption today is worth so much more than an equivalent amount of consumption tomorrow, too little will always be set aside to cover future consumption, relative to an allocation that would be optimal in the long run. Thus, the fact that the needs-oriented social economy does "too little" about eliminating root causes of unmet needs reflects an inevitable tension in its position—which is unlikely to be overcome without mechanisms that enforce commitment to a sustained and substantial flow of resources to the long-run project.

One can point to two potentially valuable mechanisms in this regard. The first concerns work-integration programs, which have become important vehicles for reducing poverty and disadvantage in Europe and Canada (Borzaga and Defourny 2001) and are increasing in importance in the United States. In general, work-integration programs are situated in pro-social businesses that create structured employment opportunities for disadvantaged people, providing them with training, skills, and experience as well as a basic wage, enabling them to eventually transition into better jobs for which they have become qualified. Examples include the FareStart program in Seattle, which runs a 16-week culinary program for adults that includes hands-on and classroom training in food service as well as life-skills classes intended to build self-sufficiency; the Pine Street Inn's "Boston Handiworks" program, which offers people exiting from homelessness an 11-week intensive course in basic skills of carpentry, painting, plumbing, and other areas; the Greyston Bakery in New York, for which the motto is "We don't hire people to bake brownies, we bake brownies to hire people"; and Homeboy Industries of Los Angeles, which (among other things) trains former gang members to install solar panels.[9] Such programs effectively combine funds for covering unmet basic needs with investments in human capital and capabilities, improving people's prospects for earning decent livelihoods in the long run. However, the relatively complex combinations of financing on which they depend (donations, government grants, revenues generated by the business) make their operations vulnerable to changing economic and financial conditions. Thus, for example, the recession and fiscal crisis in California caused grants and donations to Homeboy Industries to dry up, requiring lay-offs of 300 paid staff and substantial cutbacks in programs (Becerra 2010). This highlights the seemingly more "discretionary" element of programs that tackle root causes of unmet needs, versus those which address them in the short run.

Thus, a second possible mechanism to guard against underinvestment in human capital and capabilities concerns setting up mechanisms to stabilize inflows of funding for social-economy work.

Needs-oriented social-economy organizations in effect have to scale their activities up or down according to both the scale of the problems they aim to address and inflows of financial and other resources. Although they can redouble their appeals for resources in the face of rising needs, they are usually not able to build up assets when inflows are high so they have reserves that could be drawn down when inflows drop off, not only because of the urgency of addressing unmet needs in the short run, but also because organizations that do not make timely use of funds look to donors as though they have governance and management problems rather than prudent fiscal practices (e.g., Fisman and Hubbard 2003). Thus, in situations such as that faced by Homeboy, long-term programs have to be cut back when funding drops, so that progress in helping people exit from gang-centered lives is both fitful and pro-cyclical. Here too there are likely to be advantages from creating new institutions and practices to help attenuate these problems. For example, following the model of the emergency-food system, it could be beneficial for needs-oriented organizations running work-integration programs to join together to form coordinating committees within their metropolitan area. These could undertake tasks that could be more efficiently conducted jointly (e.g., fundraising, identifying and working with employers willing to hire people exiting from work-integration programs). They could also establish clear rules and practices for financial management and reporting, and set up and run boards that periodically review the finances and operations of individual organizations and certify whether they meet agreed-upon standards. Greater transparency, oversight, and commitment to good financial practices may increase the ability of individual organizations to build up buffer stocks of funds in good times that can be used to keep programs going when aggregate conditions decline.

A final point concerns the issue of human dignity and chronic dependence on social assistance for meeting basic needs, as happens for people whose incomes are chronically too low to cover basic aspects of material living standards. In the philosophical, ethical and religious frameworks discussed above, people in this situation—even if they can obtain sufficient supplies of food, shelter, and health care—still have unmet basic needs, in the sense that their dependence on the beneficence of others implies lack of agency and inability to participate in social and economic life on an equal footing with others. Certainly this is a reason to tackle the root causes of unmet needs. But it also suggests the importance within the needs-oriented social economy of structuring projects so that the "helped" are not passively dependent on and subject to the social preferences of the "helpers". As discussed, this point is widely recognized in the needs-oriented social economy, with many organizations already following codes of conduct or ethics obligating them to treat those they seek to help as equals deserving of dignity and respect. Still, this idea at times is left in the domain of respectful treatment by the "helpers" of the "helped," which is fundamentally important but not the same as accepting and promoting people's agency and capabilities. In this respect, broader incorporation of practices such as community-based research (in which people from communities having unmet needs help conduct research identifying best ways to address them) and having members of disadvantaged groups participate in the governance of organizations working to improve their lots would be beneficial for reducing qualitative, as well as quantitative, dimensions of unmet needs in the long run.

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Appendix: Data Sources for Tables

Table 10.3

Unemployment rate: Bureau of Labor Statistics, Current Population Survey, Q4 of each year (seasonally adjusted). http://ftp.bls.gov/pub/suppl/empsit.cpseed2.txt.

Poverty rates: U.S. Census Bureau and Bureau of Labor Statistics, Current population survey, Annual Social and Economic Supplements. http://www.census.gov/prod/2009pubs/p60–236.pdf.

Table 10.4

Unemployment insurance (UI): U.S. Department of Labor, Unemployment Insurance Chartbook. http://www.doleta.gov/unemploy/chartbook.cfm.

Food stamps and cash assistance: U.S. Census Bureau, American Community Survey.

Health insurance coverage: U.S. Census Bureau and Bureau of Labor Statistics, Current population survey, Annual Social and Economic Supplements. http://www.census.gov/prod/2009pubs/p60–236.pdf

Table 10.5

Food insecurity: U.S. Census Bureau, Bureau of Labor Statistics, and U.S. Department of Agriculture, Current population survey, annual Food Security Supplement (CPS-FSS).

Self-reported health, deferral of needed health care: Centers for Disease Control, National Health Interview Survey, Series 10 reports, Nos. 238, 240, 242, 243. Available at: http://www.cdc.gov/nchs/nhis/nhis_series.htm.

Table 10.6

All figures from U.S. Department of Housing and Urban Development, "2008 Annual Homeless Assessment Report to Congress," using data from the Homeless Management Information System (July 2009). http://www.hudhre.info/documents/4thHomelessAssessmentReport.pdf.

Notes

1. Thus, for example, J.S. Mill ([1848] 1909: 969) remarked that "Charity almost always does too much or too little: it lavishes its bounty in one place, and leaves people to starve in another." See also Lynn (2002: 58), who argues that "public policy is more likely than private charity to ensure well-financed, equitable, efficiently administered, and uniformly available social services."
2. See, for example, Dawson's (1994) review of Doyal and Gough's (1991) *Theory of Human Need.*
3. In fact, there does appear to be dispersion of opinion within the U.S. populace in this respect: In response to a 1998 Gallup poll that asked, "Which one of the following groups do you think has the greatest responsibility for helping the poor: churches, private charities, the government, the families and relatives of poor people, the poor themselves, or someone else?" 32 percent of respondents said the government, 28 percent said the poor themselves, 20 percent said churches and charities, 12 percent said families of the poor, with the remaining 8 percent saying "someone else" or "no opinion" (Gallup News Service 1998).

4. Data from Mathematica Policy Research (2010), U.S. Department of Housing and Urban Development (2009), National Network to End Domestic Violence (2007), National Association of Community Health Centers (2009).
5. Navarro (1988) analyzes income elasticities of corporate donations.
6. See, for example, the collection of papers in Cherry and Rodgers (2000).
7. See Holahan and Ghosh (2004) and Cawley and Simon (2005) on changes in health insurance coverage in the 2001 recession.
8. See, for example, Feeding America (2009).
9. See Jordan (2009).

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Chapter 11

Beyond the Wasteland: A Report from Detroit

Bruce Pietrykowski

Introduction: Detroit's Long Economic Crisis

The current economic crisis has jolted industrial towns throughout the United States. The media quickly descended on Detroit, Michigan, in order to paint a portrait of an industry in crisis and a city that continues to be ravaged by industrial decline. A sampling of news headlines captures the media representation of Detroit:

> "Dead End in Detroit"
> "Blue-Collar Workers Hanging on by Thread"
> "Motown Blues: What Next for Detroit?"
> "Detroit is Facing Scary New Normality"
> "America's Slow Ground Zero: Detroit, Urban Ghettos and Terrifying Unemployment"[1]

In 2009, Time, Inc., the parent company of *Time*, *Fortune*, *Sports Illustrated* and *Money* magazines, announced a year-long focus on Detroit. The corporation even purchased a house in Detroit for its reporters to use as a base that year. The rationale given by the editor-in-chief was:

> Because we believe that Detroit right now is a great American story. No city has had more influence on the country's economic and social evolution. Detroit was the birthplace of both the industrial age and the nation's middle class, and the city's rise and fall—and struggle to rise again—are a window into the challenges facing all of modern America. From urban planning to the crisis of manufacturing, from the lingering role of race and class in our society to the struggle for

better health care and education, it's all happening at its most extreme in the Motor City. (Huey 2009)

Without a doubt the city of Detroit is at the epicenter of the economic crisis. Press reports seek to tell a story of a battered economy. Too often they conflate the identity of Detroit residents with that of the automotive corporations that for many years dominated the economic landscape. But there is more to the story of the declining fortunes of a once great American city. The large-scale abandonment of Detroit by transnational corporate capital opens up opportunities for re-crafting economic and social relations distinctly different from those shaped by the dominant economic logics of profitability, growth and competition.

The city of Detroit's population of 900,000 is down from over 1.2 million in 1980. Currently, the official unemployment rate stands at nearly 23 percent. Including discouraged workers and part-time workers seeking full-time work, that figure rises to nearly 37 percent.[2] The seeds of the region's economic decline were planted at the time of the golden age of automotive hegemony. Heavy reliance on the production of consumer durables left the Michigan economy vulnerable to minor shifts in consumer demand. Throughout the second half of the twentieth century, the auto industry largely determined the fortunes of the regional economy. However, a series of transformations shifted production and jobs away from Detroit as capital began to adjust to the post-war capital-labor accord first by decentralizing production—opening new assembly facilities outside Detroit—and then by introducing automated technology in the 1950s and 1960s (Sugrue 2004, Meyer 2002, Hounshell 1984). In the 1970s and 1980s this spatial transformation of automobile production took the form of increased competition from Japanese non-unionized transplant facilities, which were opened in mostly rural locations in the Midwest and increasingly in southern states. Domestic manufacturers, in turn, built upon their earlier moves into the southern states, and a veritable cluster of assembly and parts producers emerged along the north-south routes of I-75 and I-65 (Rubenstein 2001, Klier and Rubenstein 2009). This spatial re-alignment of auto production away from Detroit, together with more recent global shifts in auto-related foreign direct investment toward the emerging markets of China and India, illustrate the ways in which capital mobility seeks a "spatial fix" in response to limits on the expansion of profitability (Harvey 1982, 2001). Discussion of the spatial fix focuses attention on the dynamic nature of capital flows toward new spaces of value creation. Yet attention also needs to be paid to the places that capital abandons, the spatially broken landscapes of accumulation.

The steady long-term decline in the city of Detroit's manufacturing sector, measured by the number of firms and jobs, illustrates that the deindustrialization of Detroit has been decades in the making (Figure 11.1). The city now has only 10 percent of the manufacturing workforce it had in the 1950s. The decline in manufacturing employment came at Detroit in waves (Table 11.1). For instance, in the 1970s production labor employment continued to shrink much more dramatically than did work in administrative, managerial and support staff positions. However, in the decade that followed, precisely when the automotive companies were beginning to reap record profits due largely to the success of the sport utility vehicle (Bradsher 2002), the white collar workforce in Detroit downsized by 78 percent.

The severity of the automotive sector's decline was not limited to the city of Detroit. Both the Detroit region and the state of Michigan suffered a massive hemorrhaging of auto jobs throughout the first decade of this century. Since 2000 both the Detroit metropolitan area and the entire state of Michigan lost over 50 percent of the jobs in auto assembly and parts production (Table 11.2). Furthermore, it

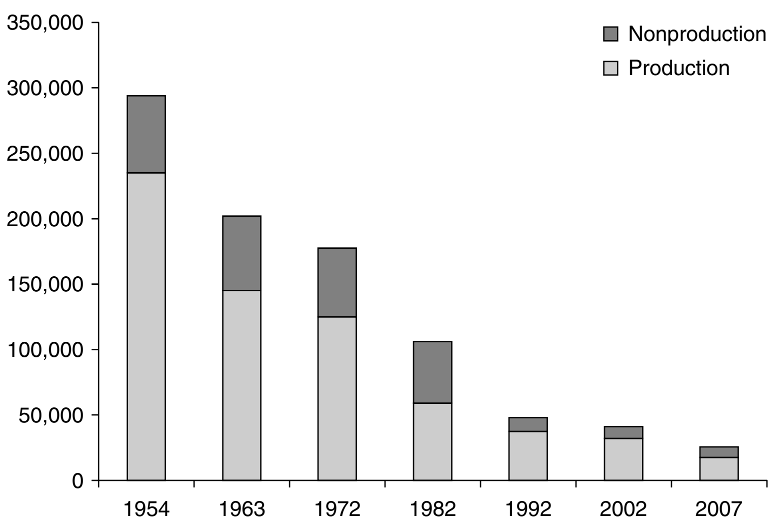

Figure 11.1 Total manufacturing employment, number of workers, City of Detroit, 1954–2007

Sources: Sugrue (1996), U.S. Department of Commerce, Bureau of the Census. *County and City Data Books* (Washington, DC: 1988, 2000, 2005, 2007).

Table 11.1 Percentage change in manufacturing employment over selected intervals, City of Detroit

	1954–63	1963–72	1974–82	1982–92	1992–02	2002–07	1954–2007
Total employment	−32.3	−10.1	−41.4	−55.1	−19.9	−39.6	−92.3
Production workers	−39.1	−11.0	−53.3	−36.7	−19.1	−42.5	−92.6
Non-production workers	−7.8	−7.8	−14.1	−78.1	−22.8	−28.6	−91.2

Sources: Sugrue (1996), U.S. Department of Commerce, Bureau of the Census, *County and City Data Books* (Washington, DC: 1988, 2000, 2005, 2007).

Table 11.2 Employment in motor vehicle manufacturing and parts production, 2000–2009

	Michigan		Detroit MSA	
Year	Employment (thousands)	% change from previous year	Employment (thousands)	% change from previous year
2000	324.8	1.3	175.6	2.6
2001	295.5	−9.0	162.6	−7.4
2002	277.3	−6.2	157.4	−3.2
2003	256.6	−7.5	147	−6.6
2004	243.9	−4.9	138.9	−5.5
2005	226.3	−7.2	130.5	−6.1
2006	206.8	−8.6	119.1	−8.7
2007	188.2	−8.9	111.1	−6.7
2008	158.1	−15.9	94.9	−14.6
2009	116.7	−26.2	70.7	−25.5
2000–2009		−64.1		−59.7

Source: Department of Labor, Bureau of Labor Statistics, Current Employment Survey (CES), State and Area Employment, Hours, and Earnings

is unlikely that the majority of these jobs will re-materialize during the course of a more generalized economic recovery. One indication that this is the case can be seen in the sheer scope of extended mass layoffs taking place in the automotive sector. Since 2003 over 1 in 5 long-term mass layoffs in the United States can be traced to the motor vehicle sector. In 2006 over 4 in 10 auto sector workers faced extended mass layoffs. While long-term layoffs represented less than 15 percent of Michigan's transport sector workers throughout most of the 2000s, beginning in 2008 they became increasingly common such that by 2009 over one-third of all of Michigan's transportation manufacturing workers were placed on extended layoffs. Historically, auto workers faced plant shutdown and layoff in the wake of model changeover and plant re-tooling. In this largely unionized segment of the industry workers facing layoff at one plant could often transfer to another plant. During the heyday of Michigan's auto industry that meant that a UAW worker could find a job at another local plant. However, increasingly these transfer opportunities presented Michigan workers with the difficult decision to leave family and friends in order to take a job at a plant in another part of the country. If social networks depend on the length of time an individual resides in a city or neighborhood and informal networks are effective forms of job search, especially for workers who lack a college degree (Bayer, Ross and Topa 2008), then relocation may have negative effects on employment stability during turbulent times in the auto industry. Yet as the decade progressed, the massive contraction in the auto industry meant that workers could no longer depend on even these increasingly precarious job preservation strategies.

As the Detroit region becomes less attached to the fate of the global auto industry, the ability of union wage jobs to buoy local area wages has also weakened. The Center for Automotive Research (2010) has estimated that every auto sector job is responsible for the retention of ten other jobs through the supply chain and through product market sales and servicing. Yet the pressure placed upon the UAW to meet or underbid the labor costs of its assembly rivals from Korea, Japan and parts component firms from southeast Asia and China diminished the pattern-setting strength of organized labor. These factors have shifted the traditional balance of power between capital and labor in Metro Detroit.

From Employment Crisis to Housing Crisis

The long-term dismantling of the manufacturing sector in Detroit set the stage for the housing crisis. The Detroit housing market, particularly the suburban communities of Oakland and Macomb counties, witnessed a building boom during the first half of the 2000 decade. Meanwhile the city of Detroit's housing market saw renewed interest in downtown loft living and close-in neighborhoods (Schabath and Heath 2004). As the area's reliance on the auto sector waned, the collapse of incomes generated by automotive employment, together with income losses resulting from the 10 additional jobs that depend on auto sector employment, reached such an extent that families had difficulty making their mortgage payments. Detroit led the nation in foreclosures in the two years immediately leading up to the crisis. The generalized impact of the collapse of the auto industry has been felt in a further reduction in home values. The result has been a shocking decline in the market value of housing in the city of Detroit. In 2000 the median value of a single-family home was $63,600. By February of 2010 the median price of non-foreclosed housing was $15,500. When foreclosed property was included that price fell to a mere $7,005 (Aguillar 2010).[3] Home ownership is the leading source of wealth-holding for working-class Americans. The virtual elimination of home values in Detroit and the reduction in housing demand throughout the region have left many individuals and families on the brink of economic survival.

A typical market-based response to a glut of housing is for speculators to enter in the hope of buying, holding and then re-selling ('flipping') when the market rebounds. Indeed, since rental rates have not fallen nearly as drastically as housing prices (Pelletiere, Rho and Baker 2009), the incentive is strong for buyers to purchase blocks of single family homes intent on converting them to rental housing. In the era of internet real estate listings, Detroit's inexpensive housing market has attracted interest from international buyers (Karoub and Williams 2009). Yet non-local ownership of housing assets means that rental income will flow out of the region, thereby short-circuiting any local spending multiplier associated with rental property.

In response the city created a land bank (Dewar 2006). The mayor, businessman and former NBA star Dave Bing, accelerated a program to rid the city of abandoned homes. The scope of abandonment is massive. A detailed block-by-block survey of most of the city's 140 square miles found that over one-third of the residential lots in Detroit were comprised of either abandoned housing or vacant land (Metzger 2010). It remains to be seen how the city will develop the abandoned parcels. The "economics as usual" approach would be to let falling land values signal profitable investment opportunities for business. The city would then seek to attract large businesses that can benefit from cheap land costs.

The Crisis for Families and the Poor in Detroit

Given the harsh effects of the economic crisis on employment, housing and family income in metropolitan Detroit and throughout Michigan, one might imagine that welfare caseloads have skyrocketed. They have not. While more than one in four Michigan residents receives some form of state support in the form of cash, food, medical assistance, disability benefit or child care support, the average monthly caseload of welfare recipients administered through the Family Independence Program (FIP) actually fell from 2007 through 2009 (Figure 11.2). Even for those individuals who receive benefits the average payment to a family on welfare amounts to only 34 percent of the poverty threshold (Michigan Department of Human Services, 2010). The addition of food assistance brings the level of support up to two-thirds of the poverty threshold. Food assistance rather than cash support has been the primary source of government aid to families and individuals experiencing severe economic hardship in the midst of the economic crisis. Indeed, since 2004–05 the average monthly food assistance caseload has expanded by 82 percent from about 343,000 to 624,000 in 2008–09—among families not receiving public assistance. By contrast the food assistance caseload among those receiving public assistance has risen by 3 percent over the same time period. This condition of falling welfare rolls coupled with increasing food assistance caseloads is cause

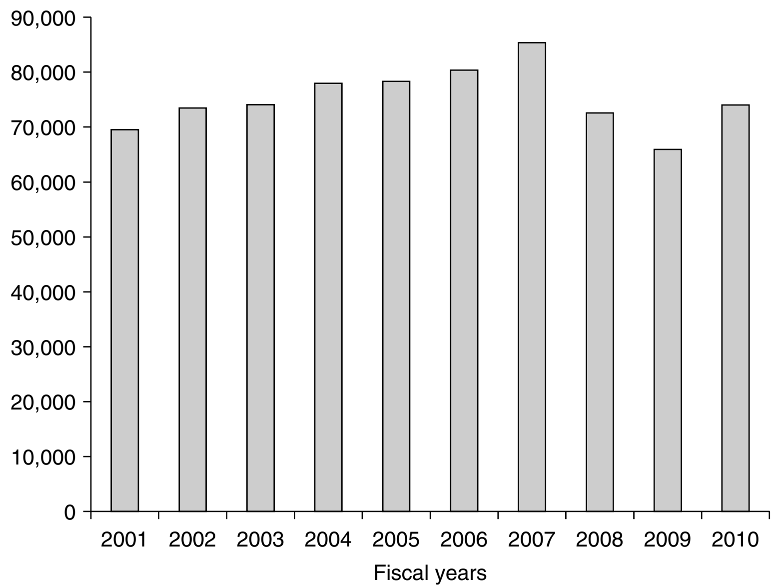

Figure 11.2 Number of average monthly caseloads, Family Independence Program (FIP), Department of Human Services

Source: Michigan Department of Human Services, Budget Division (2010, 15). As of November 2009, the FIP-Regular caseload was 78,029. The figure for FY2010 reflects appropriations.

for alarm. The fact that welfare reform provided incentives for states to reduce the number of people on public assistance by, in part, not increasing funding as caseloads rise is one problem. That food assistance is not similarly structured helps to explain the rise in food stamps (DeParle 2009).

Another source of food support in addition to food stamps is the federal school lunch program. The percentage of children in the Detroit public school system who qualify for free or reduced school breakfasts and lunches rose from 63 percent in 2000 to 78 percent in 2009.[4] School meals and food assistance are often recognized by economists and policymakers as an income support. Far too little attention is paid to the way that food assistance flows through the local food system. In Detroit and increasingly in cities throughout the country, efforts to build sustainable, local food systems are causing people to reevaluate long-cherished economic principles such as specialization and economies of scale in agriculture that resulted in (often artificially) inexpensive food (Pollan 2007).

The "Economics as Usual" Responses

The combination of massive unemployment, falling home values, vacant and abandoned housing and rising poverty in the face of declining state and local revenue has created depression-level crisis conditions in Detroit and surrounding communities. In the past, the primary redevelopment strategy involved business recruitment/retention largely through tax breaks, tax abatements, wage subsidies and other incentives. Detroit and its suburban counterparts have endeavored to recruit firms such as Compuware and the MGM Grand Casino, to build professional football and baseball stadiums, and to retain auto-related employment such as General Motors' world headquarters in downtown Detroit. The goal is to bring in clusters of large employers making specialized products for the global marketplace (Porter 1987). The strategy assumes that capital investment will generate short-term employment through construction of new facilities or through the rehabilitation of existing physical capital. Afterward, new employment will generate an income multiplier that will exceed the value of the tax breaks. If local and regional tax differentials are a significant determinant of firm location decisions then communities, acting to reduce the costs of private firm production, can expect that companies will then choose to locate or remain there.

Yet, although abatements have been regularly used across the country since at least the 1970s, there remains serious disagreement over whether they have the desired effect. Indeed, they can have adverse consequences for a city if they result in higher tax burdens for the non-subsidized business sector and if they fail to reach and maintain the promised levels of employment (Peters and Fisher 2004). Most tax abatement requests are approved yet most municipalities have no compliance mechanism that would allow for an evaluation of the claims made by the applicant (Sands, Reese and Kahn 2006). Significantly, few communities explicitly require that companies implement policies to enhance community capability in return for tax abatements—similar to a practice known as Community Benefit Agreements (CBAs). CBAs such as committing to establishing job training programs for local residents, providing seed money for start-up businesses oriented toward meeting local needs, and paying locally established and monitored living wages to all of their employees would begin to redistribute the benefits toward local residents.

A second approach toward local economic revitalization is to focus on human capital development either by improving the educational achievements of local residents or creating an environment conducive to attracting "knowledge" workers. This human capital approach has been promoted by both economists (Glaeser and Saiz 2004) and policy analysts (Florida 2003). The motivating idea is that the nature of economic value-creation has shifted permanently from goods production to information processing, generation, filtering and concatenation. Those occupations associated with these tasks require high levels of education. According to human capital theory, education conveys skill which, as the direct equivalent of productivity, commands a wage premium. Therefore, high-skill, high-wage workers create growing, innovative local economies (Glaeser and Saiz 2004). The net can be cast wider to include individuals who are involved in knowledge dissemination and information interpretation (journalists, bloggers) as well as information brokers (publishers) and information culture workers (writers of novels and screenplays). These, together with the computer, information technology, scientific and intellectual workers make up the "super creative class" (Florida 2003). If a city can attract and retain those individuals—together with a cadre of creative enablers in law, finance and public relations—then it can be assured of economic growth (Florida 2003, 2005). In response, cities across the country have tried to find ways to position themselves as "creative" or, in the case of Michigan, "cool" cities (Peck 2005).

A final approach toward local economic revitalization in the "economics as usual" toolkit can be found in "economic base" theory (Andrews 1953, Hoyt 1954, Thompson 1965). This perspective analyzes a city's capacity for economic growth in terms of its ability to attract and retain export-oriented businesses. Those industrial sectors that generate a surplus of jobs over the national share of employment in that industry are determined to be serving markets beyond the range of the local economy. They are export-oriented businesses. Those sectors that meet only local needs are non-basic industries. And those industries for which local employment falls short of the national cohort share of employees in that industry are import-oriented. Just as in the case of the nation-state, the goal is to promote export-oriented growth. In this way cities can be depicted as city-states within a competitive environment of trade based on comparative advantage. City planners and economic development officials are charged with identifying and then expanding their city's specialized export industries in order to trade with other cities for those goods and services for which it lacks a comparative advantage.

These three strategies—(a) recruitment of large-scale firms and clusters of specialized firms; (b) human capital and creative class driven growth; and (c) export-oriented economic development—all focus on making land and labor appropriate to the needs and demands of global capital. They also assume that the only development path possible relies exclusively on capitalist firms and organizational structures premised on profit maximization. Detroit presents some examples that counter this development narrative.

Detroit's Community Economies

Creative Grassroots Land Use: Cultural and Agricultural Production

One way in which Detroit is resisting the dominant logic of large-scale corporate development is in the variety of approaches that have evolved around the use of vacant land. For example, the cultural re-appropriation of abandoned housing by the artist Tyree Guyton resulted in an art installation known as the Heidelberg project, an on-going artistic endeavor first begun in 1986. Located on Heidelberg Street on the city's near east side, Guyton employed salvaged appliances, toys and dolls to decorate the lawns surrounding brightly painted houses, many of which are abandoned (Figure 11.3). The houses and outdoor exhibits are a commentary on waste, reclamation, redemption, race, and abandonment. The Heidelberg project is located in a residential neighborhood several miles from the museums and galleries downtown. In the census tract containing the project, nearly

Figure 11.3 Example of a Heidelberg project house
Source: Photo by author.

three-quarters of the parcels are vacant and over one-quarter of the housing stock is abandoned. And yet the project is a contested space. Even though the neighborhood is not identified as an especially prime target for reinvestment, the city singled out the Heidelberg project for demolition in 1991 and then again in 1999 (Che 2007). Since the art is embodied in the housing itself, visitors must travel to the site. Not unlike the value of commodity housing, the surrounding urban environment is a part of the context within which the Heidelberg project is displayed. Would the aesthetic value of the project be diminished if the surrounding neighborhood gentrified? This is a provocative question. It troubles the notion that there is an inherent complementarity between knowledge workers and cultural workers and their products/performances. In Detroit, the relationship is often dialectical and fractious. With the added dimension of race—Detroit's population is over 80 percent African-American—the notion, crucial to the creative-class development strategy, that high-tech growth requires social/ethnic diversity tends to break down.[5]

Another effort to make alternative use of space in Detroit centers on food security and environmental sustainability. Given Detroit's high unemployment and a poverty rate of over 33 percent, access to nutritious food is an urgent concern. Government food assistance programs play a role, as do local non-profit organizations such as Gleaners Food Bank. Gleaners' most recent study of hunger in metro Detroit reveals a 58 percent increase in the number of residents served since 2006. Of those receiving assistance, 77 percent are living below the poverty level and 57 percent also received food stamps, clearly indicating the insufficiency of government assistance to poor and needy families. Forty-two percent of recipients had to choose between buying food and paying their utility bill. In order to fill some of the unmet needs for adequate food, Detroit's neighborhoods and non-profit community organizations have built upon long-standing urban gardening programs.

Like other cities across the industrial Midwest, Detroit's urban farming initiatives have drawn active participation by community members (Schilling and Logan 2008). However, given the scale of Detroit's abandonment and land vacancy, urban agriculture is used as both a metaphor for and the material manifestation of an alternative economy (Solnit 2007, Dowie 2009). Repeated depictions of Detroit as post-industrial beg the question of what is to come after large-scale manufacturing industry. Typically, the answer has been to identify a "proper mix" of export-oriented services—entertainment, tourism, Information and Communication Technologies (ICT) and financial services. But these alternative trajectories retain the city-as-nation-state metaphor as well as relinquishing control of community assets to "foreign direct investment." Increasingly, the city-as-communities metaphor is being explored and urban farming is a productive space within which community can be enacted. As the labor and human rights activist Grace Lee Boggs concluded, the turn to urban farming is a move to invigorate neighborhood economies and to engage local residents in production activity oriented toward the creation of sustaining/sustainable products (Boggs 2007, 2009). It also has the effect of focusing on the sustenance of bodies—both the physical body and the body politic—through cooperative labor.

The agriculture movements in Detroit involve individuals and groups with a variety of objectives and practices. For instance, the farm-to-school program of the Food System Economic Partnership (FSEP) provides students with a higher proportion of locally grown fruits and vegetables in their school meals while simultaneously offering local farmers a stable source of demand for their products. Another community-based organization, the Black Community Food Security Network, works with local schools to educate students about the food system and trains students in soil testing and gardening. Earthworks, a project of the Capuchin monks' soup kitchen, provides produce to various community food pantries and also promotes community activism through the dissemination of sustainable farming practices. The Detroit Agricultural Network and Greening of Detroit support and train neighborhood garden groups throughout the city and is actively involved in gardening projects in the Detroit public schools. Detroit's farming initiatives include four primary types: (1) subsistence farming, (2) "truck-farm" projects, (3) specialty or niche agricultural production, and (4) large-scale technology-intensive farming.

Subsistence farming is small-scale gardening intended to grow produce for community consumption. In many of these farms, the work is undertaken collectively and the produce is distributed based on need. Most of these farms occupy city-owned land and so, in the absence of zoning changes that recognize agricultural production as a legally conforming land use, the long-term viability of these gardens is dependent on the city's calculation of the expected return from alternative uses. Subsistence farming is not market-oriented and so the crop variety often reflects the ethnic and racial culinary traditions of the participants. While the surplus at some gardens is sold in weekly farmers' markets, the primary aim of these farms is to partially meet local need.

I refer to the larger gardens as "truck farms" to the extent that they re-establish a connection between local farming and local markets, albeit on a smaller scale than many of the earlier twentieth-century farms located near major cities. Here the goal is to market produce but also to develop ongoing social relations of consumption (Pietrykowski 2009). The benefit of knowing the direct producer engenders trust and ties of solidarity that often provide benefits that can overcome price differentials when compared with the products of commercial farms and agribusiness (Thilmany, Bond and Bond 2008). "Grown in Detroit" is the marketing brand used by the local farming collective to establish identity at the local farmers' markets. The brand is used in partnership with local restaurants supplied by the collective.

Some agricultural projects in Detroit focus on particular products. For instance, bee-keeping is a growing segment of the agricultural sector in Detroit, and honey is locally produced and sold at retail and farmers' markets. This niche production sector is more closely aligned to the traditional market to the extent that it attempts to occupy a link in the commodity chain. An area for future development lies in food processing and manufacturing that would localize the food commodity chain. Micro-breweries are an example of this segment of the market. One case of localizing the commodity chain involves a local historical museum. The museum contains several active farms and actively promotes culinary heritage tourism. In response to a local brewer's request the museum is planting special heirloom varieties of hops to be used in the beer. In addition, in response to increased demand for agricultural expertise, the museum is starting an apprenticeship program in heritage crop cultivation.[6]

The final type of agricultural initiative involves the transformation of large swaths of vacant and abandoned property into commercial agriculture and forestry. This proposal generated fierce opposition from community activists who see it as a return to a neoliberal agenda using land as an input to generate export-oriented goods. The proposed farms—Hantz farms, named after the financial services CEO backing the project—would use high-tech production methods in order to produce maximum yields per acre. In addition, Hantz envisions the farms as sites to demonstrate new technologies intended to attract innovators and potential buyers of new agri-tech equipment. For example, he intends to build vertical gardens of the type appropriate for densely populated urban areas (Whitford 2010). Hantz's farms would signal a return to the tradition of economies of scale and mass production. It is not clear how many individuals would be employed in these high-tech farms, nor what the prevailing wage would be.

Another apparent need of Detroit's food system, identified by many who live outside of the city, is for a large, national grocery store chain within the city limits (Gallagher 2007). There are local, independent grocery stores in the city. The question being debated is whether national chains are necessarily the only solution to the problem of "food deserts"—inadequate access to healthy and nutritious food at affordable prices (Berg 2009). According to the conventional wisdom food deserts can only be replenished by large mass-market supermarkets be they Wal-Mart or Whole Foods. Yet there exists a variety of local, community-based alternative institutions for food provisioning. Farmers' markets are increasing both numerically and in the number of months they remain open throughout the year, given advances in and dissemination of greenhouse and hoop house growing technologies. Also, a state-wide pilot project to increase the purchasing power of food stamps used to buy produce at farmers' markets is improving accessibility to local, healthy food during the economic crisis. A direct response to the "food desert" situation has come from the United Food and Commercial Workers Union in conjunction with MOSES (Metropolitan Organizing Strategy Enabling Strength), a regional organization representing churches. They propose the development of a worker-owned supermarket (Ten Eyck 2009).

In addition, the city and state have partnered with area philanthropies to commit $1 million dollars to improve the quality of food offered at existing, independent neighborhood grocery stores (Aguilar 2010). This recognizes that local grocery stores and mom-and-pop markets often function as neighborhood institutions whereas large chain supermarkets are more apt to be characterized as enterprise institutions. This distinction is made by Sanchez-Jankowski (2008) in his study of the determinants of neighborhood resilience. He noted that different social groups congregated in neighborhood institutions at different times and that social interaction reinforced social norms, promoted and even transformed social identity and fostered group cohesion and solidarity. The store as neighborhood institution is embedded in the social life of the community. Local social cohesion was enabled through the extension of credit to loyal customers. The store as enterprise, by contrast, is organized around the principle of retail exchange and the owner or manager actively discourages socializing as an interference with the business of buying and selling. Seen in this light, the debate over the type of grocery store that Detroiters shop at involves much more than the typical metrics of price, convenience and quality.

Re-Valuing Skills

The sharp decline in manufacturing jobs in Detroit has exacerbated the already pronounced shortage of good-paying jobs. While the food sector of the economy involves some of the lowest-paying jobs in the region it is also a growing segment. So while Detroit continues to compete for high value-added occupations with other cities and regions, another opportunity is to improve wages and working conditions for those in the low-wage service sector. One example of this is the work being done to shift the balance of power between capital and labor in the restaurant industry.

The current Federal minimum wage for restaurant servers is $2.13 per hour; in Michigan the comparable wage is $2.65. The experience of workers in the restaurant industry provides a useful lens through which to examine the impact of the economic crisis on the lives of the working poor. A recent study of the Detroit restaurant industry revealed that employment in this sector is growing in spite of the economic decline and while it, too, has recently shed jobs it has done so at a slower rate than the rest of the economy (Southeast Michigan Restaurant Industry Coalition 2010). Indeed, since 1990 the share of employment actually increased in full-service restaurants compared to fast-food establishments. The Detroit restaurant industry is predominantly female and young and more heavily represented by workers of color than the region's overall labor force. Survey data reveal that nearly 40 percent of Detroit's restaurant workers earn incomes that put them below the poverty line. There is racial segregation between jobs in the "front" and "back" of the house—the social, public spaces of the restaurant versus those areas of the restaurant generally out of customers' sight—but low wage workers can be found in both the front and back. However, the occupational job ladder almost never extends opportunities for promotion from the back of the house to the front of the house. Significantly, not all restaurants are on the low-wage, no-promotion path. A segment of the restaurant industry is able to pay living wages to their employees and to provide opportunities for training and promotion. Some of these "high-road" employers have joined with worker rights groups to promote fair labor practices that raise industry standards and efficiencies in order to create high-wage high-productivity jobs for workers.

One of the workers' rights groups in the forefront of this effort is the Restaurant Opportunities Center (ROC). ROC was founded in New York City by workers at Windows on the World in Manhattan's World Trade Center. They went on to organize for better working conditions for restaurant workers throughout New York and in 2005 they opened a worker-owned restaurant, Colors. The restaurant serves food that represents their diverse culinary heritage. The restaurant also serves as a culinary school providing instruction to low-wage workers who otherwise would be unable to afford tuition at many of the city's private cooking schools. Plans have been announced for a similar worker-owned and operated restaurant to open in downtown Detroit.

The example of the restaurant industry in Detroit suggests paths out of low wage employment by transforming restaurant management practices and by creating internal promotion opportunities. In addition, localizing food processing and manufacturing results in the retention of jobs that hitherto relocated up the supply chain to non-urban locations (Lane, Moss, Salzman and Tilly 2003). Overall, the campaign to recognize the value and worth of restaurant-worker labor is part of a larger project to reevaluate the current economic model wherein labor's worth is attached to the wage commanded without recognizing that labor markets themselves are socially constructed in ways that privilege the contribution of some individuals (for example, creative-class knowledge workers) over others (for example, creative-class cultural workers).

Local Production/Consumption

Another way the Detroit economy also lies in opposition to economics as usual is in the possibility for economic development in sectors that are not export-oriented but instead are community-serving. The location quotient (LQ) is typically used to classify industries belonging to the export-sector, city-serving or import sector. The LQ measures the degree to which the local employment share of an industry exceeds or falls short of the national employment share of that same industry. Therefore, an LQ greater than 1 indicates that more workers are employed in that industry relative to the national share of industry employment, so the additional employees are generating exports for sale outside of the city. The opposite is true for LQ measures that fall below 1. Here imports are used to meet local demand left unsatisfied by local employment in that industry. Since a larger employment share appears to indicate a comparative advantage and positive returns to specialization, export promotion is the traditional policy response. Yet import substitution is another viable strategy (Persky, Ranney, Wiewel 1993; Shuman 2006). Import substitution recognizes the possibility that consumers can and do alter their consumption practices to take into account the sourcing of the products they purchase (Markusen and Schrock 2009, Pietrykowski 2009). Local production, provisioning and processing of food represents a cluster of economic activities that define a non-basic, community-serving target for local economic development.

Another conclusion of the "economics as usual" approach toward export-base theory holds that, because of comparative advantage and specialization, export industries comprise the high-growth, high-wage sectors of the local economy. By contrast, import substitution industries should be expected to be skewed toward low wage employment. Using county-level data (Detroit is the largest city in Wayne County with nearly half of the population) location quotients were calculated for 2001 and 2008. Those industries that had LQs greater than 1 with growth exceeding .099 are characterized as export growth industries. Those industries with LQs less than 1 (also with growth exceeding .099) are characterized as import substitution industries. As expected, average employment growth over the period favored export-oriented industries (1 percent versus .08 percent). However, employment growth in the import-substitution sector outperformed national employment growth while the local export industries, on average, lagged behind employment trends at the national level. The wage results indicate that, while the average annual pay in import substitution industries ($52,955) in metro Detroit is lower than the average in export industries ($59,389), it is higher than the county average for all industries ($51,147). This provides support for policies that encourage development of employment opportunities in sectors devoted to meeting local consumption demand.

Conclusion

Detroit's economic downturn began long before the collapse of the housing market and the 2008 financial crisis. The global shift of capital entails, as Harvey declares, "a great deal of self-destruction, devaluation and bankruptcy at different scales and in different locations. It renders whole populations selectively vulnerable to the violence of downsizing, collapse of services, degradation in living standards, and loss of resources and environmental qualities" (2000, 81). But instead of only providing a depiction of the dismantling of Detroit's economy, I sought to explore sites of resistance to "economics as usual" responses to the economic decline by describing alternative paths for human-scale community economic development. For example, highlighting the diversity of organizations and economic structures deployed in the field of urban agriculture, with capitalist for-profit farming being only one possible (and as yet unrealized) form, allows wider scope for participation by political-economic subjects in the local economy. Instead of limiting our attention to entrepreneurs seeking to invest and produce for profit, an expanded role is opened up for those citizens participating through alternative market and non-market processes (Gibson-Graham 2006; Healy and Graham 2008).

Attention to the local level does not deny the reality that cities and regions are unevenly integrated into the global economy. Rather it suggests that spaces are both dependent on and resistant to global capital flows. This study is also not meant to idealize the local. As the typology of Detroit farming practices suggests, not all local production is small-scale and community-based. As Dupuis and Goodman argue, "We have to move away from the idea that food systems become just by virtue of making them local and toward a conversation about how to make local food systems more just" (2005, 364).

Three issues emerged from this account of the Detroit economy in crisis. First, local community groups can actively intervene to construct economic alternatives and to re-appropriate resources that directly meet their needs. Second, the current crisis forces communities such as Detroit to reevaluate the meaning of creative and skilled labor. Some skills, such as the aesthetic, scientific, organizational, caring, and social skills associated with food sector labor—chefs, cooks, nutritionists, farmers, servers—are not valued by the market even though these skills are comparable to many creative-class occupations. As a result a large and growing segment of the local labor market earns an income below the poverty level. Instead, the payment of living wages, the creation of solidarity wages (Bowles, Gordon and Weisskopf 1983), and the establishment of worker-owned enterprises can help to sustain community economies. Third, consumption-driven economic growth can be a viable import-substitution alternative. In fact, the system of local food production and consumption embedded in a moral economy oriented toward meeting community needs is an essential component of an economic alternative that re-values labor and ways of life neglected by the rise and fall of corporate capital in cities such as Detroit.

Notes

1. From *New York Times* (Feb. 17, 2009); *Detroit News* (Feb. 25, 2010); Dissent (Spring 2009); Wall Street Journal (Jan. 12, 2009); *Le Monde Diplomatique* (Jan. 2010), respectively.
2. Bureau of Labor Statistics, Local Area Unemployment Statistics. Note that Michigan's ratio of unemployment categories (U-6/U-3) was used to calculate the comparable figure for Detroit.
3. Home values are difficult to estimate with precision, and differences do exist depending on the time period under study, unit of measurement (all transactions, transactions excluding distress sales, listings, appraisals), and geographical unit (city, Metropolitan Division, Metropolitan Statistical Area). Thus, some home-price indexes, like that produced by the Federal Housing Finance Agency, do not show drops quite this extreme, in part because they cover the Detroit MSA and not the center city alone. Anecdotal evidence of homes being sold for minimal amounts (Barlow 2009) also speaks to the shocking devaluation of housing assets within the city of Detroit.
4. State of Michigan, Center for Educational Performance and Information, Free and Reduced Lunch Counts (http://www.michigan.gov/cepi/0,1607,7-113-21423_30451_36965—,00.html).
5. Florida (2005) notes the lack of statistically significant relationship between high-tech industry location and the percent of the city's population that is African American. He observes that "The results are frankly disturbing" (137).
6. Personal communication with Susan Schmidt, Director of Food Services, The Henry Ford, September 9, 2009.

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Chapter 12

Teaching Financial Literacy in the Wake of the Financial Crisis

Deborah M. Figart

While Americans self-report they have financial knowledge, a basic literacy quiz shows otherwise. According to a national survey of *Financial Capability in the United States* (2009), young adults scored the worst. The same survey reveals that just over 50 percent of Americans report that they have no "rainy day" fund to sustain them for three to six months in case of sickness, job loss, or other emergency. *The 2010 Consumer Financial Literacy Survey* finds that 56 percent of adults over the age of 18 do not keep a budget. According to the Federal Reserve Board of Governors, at the end of 2009 Americans carried a total of $866 billion in credit card debt, reported as consumer credit outstanding. The increase in consumer credit card debt among high school students has been particularly notable (see Scott 2010). Among credit cardholders who do not always pay off their balance in full, 12 percent said they did not know their interest rate (*Financial Capability in the United States* 2009).

A nationwide movement for financial literacy and consumer education has attempted to empower people by teaching basic financial skills and responsible consumption habits (Langrehr and Mason 2005). Such efforts are needed more than ever. Even prior to the current economic and financial crisis, personal bankruptcies in the United States were on the rise, with debt brought on by health care costs and credit cards. The bursting of the housing market bubble and the millions of job losses suffered during the Great Recession that began in 2007 helped fuel record numbers of home foreclosures due to unpaid mortgages. Financial literacy, therefore, has been called by one educator an "imperative in economic hard times" (Allen 2009).

Financial literacy, once the crusade of a nucleus of groups primarily in the public and nonprofit sectors, has caught on with a variety of interests. This sudden upsurge in financial literacy programs may be, in part, traced to the global financial crisis. Financial education can be empowering if that education provides important analytical tools and skills that enable people to evaluate their options critically and understand the economic context that shapes these choices. The danger, however, is that financial literacy is a discourse that resonates with those focusing only on the precipitating causes of the crisis, such as the expansion of subprime mortgages and new forms of securitization. A further concern is that those who are promoting financial literacy in the wake of the crisis have a variety of motives and interests that shape financial literacy curricula. Individual products developed by financial services companies need to be evaluated for neutrality, that is, to ensure that any explicit or implicit marketing of financial products (and branding) and financial education are truly separated.

Financial literacy education, if done appropriately and professionally, can be part of the solution. Empowering critical consumers is important. As heterodox and other critically-minded economists, we need to engage with this growing movement in order to shape the future of financial literacy education. This chapter provides a discussion of the financial literacy movement and educational mandates in personal finance topics, and offers suggestions as to how we might think more broadly about the term "financial capability" and effective pedagogy.

Fixing Mortgage and Financial Markets: Blaming the Victim?

Financial literacy as a movement—for kids, teens, young adults, and adults—has gained support among those analysts in the media, in academe, and in the public and private sectors who place partial blame for the crisis on inadequate or asymmetric information in housing and financial markets.[1] A classic example is Alex Pollock, a resident fellow at the American Enterprise Institute in Washington, DC: "The most obvious and important reform is to make sure borrowers know what they are getting into with their mortgage loan. Borrowers are understandably overwhelmed by the huge stack of confusing documents with small print presented at a mortgage closing" (2008, 39). "This current economic crisis represents a manifestation of poor credit decisions by a public ignorant of the terminology, skills, and strategies to be financial(ly) well," add financial literacy advocates Thomas Lucey and Kathleen Cooter (2009). This view is echoed by finance professor Lewis Mandell, a key player in the financial literacy movement. In a stream of research, he has studied and assessed the impact of personal finance education, especially for youth. Among his commentaries in support of financial literacy is, for example:

> While most economists posited that variety and choice are good for consumers, it was also possible that many consumers lacked the ability to evaluate the new and complex financial instruments and make informed judgments in both choice of instruments and extent and use that would be in their own best long-run interests. This ability was termed financial literacy. (2008, 163–64; see also Mandell 2009)

These poor decisions are not simply personal problems because they impact the efficiency of financial markets. Various remedies for improving the functioning of these markets have been proposed, from strengthening government regulation of financial service providers, to avoiding moral hazards and improving the relationship between risk and rewards—including reducing asymmetric information by educating the next, as well as the present, generation of consumers and investors. Further, increased attention to and funding for financial literacy is based on the argument that informed consumers can help drive out unethical firms.

There is no doubt that the increases in subprime lending and mortgage defaults were a precipitating and significant cause of the financial crisis that began in 2007 and the ensuing economic downturn that has been termed the "Great Recession." Nevertheless, by focusing on fixing individual economic actors to make financial markets work better, our attention may be diverted from the deeper causes and long-term trends that fertilized the ground for the Great Recession: financialization of the U.S. economy, the rise of consumerism and consumer culture, and especially decades of rising income inequality precipitating a squeeze of the middle class and poor (Kotz 2009; Palley 2009; Wray 2009; see also the papers by Pressman and Baker and Wisman, this volume). Recent bubbles in the stock market and housing market, in this view, served to temporarily mask these structural economic problems. Finally, taken to an extreme, the discourse associated with such perspectives can reinforce individual responsibility for provisioning, emphasizing the need for personal savings based on an assumption of a declining social welfare state.

Financial education has backers across the political spectrum, both in tandem with and as an alternative to regulating the supply side of financial markets. For example, Mark Zandi, Chief Economist and co-founder of Moody's Economy.com, Inc., has written extensively about the financial crisis. In *Financial Shock* (2009), Zandi proposes ten policies to respond to the subprime mortgage debacle that precipitated the global financial crisis. These range from policies to facilitate mortgage modifications for troubled borrowers, licensing of mortgage brokers and other regulations governing mortgage lending and foreclosures, and new regulations governing the financial system and accounting practices. His sixth policy step is "Invest in financial literacy." In Zandi's words:

> The nation's general financial illiteracy contributes to a wide range of poor decisions on borrowing, saving, and investment. This may have been less dangerous 10 or 25 years ago when there were fewer financial products to choose from, thus it was harder to make a financially catastrophic mistake. . . . It is both bizarre and tragic that American high schools today are more likely to offer students cooking classes than personal finance courses. Such courses should be required—period. A meaningful investment in the financial acumen of young people would pay enormous dividends by reducing the likelihood that future households will take out bad mortgages and not save adequately for retirement. (2009, 237)

Zandi notes that "A financial calamity of this magnitude could not have taken root without a great many hands tilling the soil and planting the seeds" (2009, 2). While observing that "Wall Street drove the changes in the mortgage lending business" (95), Zandi also asserts that "Financial illiteracy was a fundamental cause of the subprime financial shock" (236). He argues that this ignorance prompted lower-income homebuyers to unduly trust their mortgage brokers to protect their interests. Yet securitization of mortgages led to a diminished sense of individual responsibility among these brokers and a host of other economic actors (126–28).

Similarly, economist Robert Shiller (co-developer of the Case-Shiller Home Price Index) offers that mortgage consumers were not the only ones to blame. Mortgage lenders were also answerable. In *The Subprime Solution*, Shiller writes "Overly aggressive mortgage lenders, compliant appraisers, and complacent borrowers proliferated to feed the housing boom. Mortgage originators, who planned to sell off mortgages to securitizers, stopped worrying about repayment risk" (2008, 6). The bond-rating agencies that rated the new packages of mortgages bundled into Collateralized Debt Obligations (CDOs)—Moody's, Standard & Poor's and others—sought higher profits by placing their highest, AAA ratings on the CDOs so that they could be sold before exploding. This is much like the child's game of hot potato (or musical chairs): the player who is holding the hot potato when the music stops is out. Whoever held the CDO (hot potato) or parts thereof when it was discovered they were almost worthless (time expired) suffered the loss.[2]

By naming the problem the "subprime crisis" in his book title, however, Shiller's book focuses primary attention on the housing bubble as the fundamental, root cause of the financial crisis. In analyzing the bubble, he notes that, "In evaluating the causes of the financial crisis, don't forget the countless fundamental mistakes made by millions of people who were caught up in the excitement of the real estate bubble, taking on debt they could ill afford" (Shiller 2009, BU5). Naive mortgage borrowers did not ask enough questions or were irrationally optimistic. Thus, one of Shiller's proposals is personal finance education provided by both private businesses and the government, which he refers to as "financial advice"; government subsidies of such services could be provided for low-income households. Shiller poses this as a remedy for market failure. "The cost of educating the public about the wisdom of a new form of mortgage is a type of public good, yet the private firm that incurs it may never fully recoup the cost, since the benefits will be shared by all firms that choose to offer the new mortgage" (2008, 132–3).[3]

Other policy proposals are additionally aimed at overcoming market failures, including Shiller's major emphasis on improving the information infrastructure for real estate and financial markets through the use of information technology and mathematical finance theory. Shiller's proposals also suggest policies and regulations to foster new markets as remedies for a variety of risks, specifically markets for real estate futures, livelihood insurance, and home equity insurance. *The Subprime Solution* ends by briefly considering rising income inequality in the United States and other developed countries, but only as a factor in the public backlash against the riches earned within the financial sector, admonishing us against "waging war on the financial elite" (Shiller 2008, 177).

Government is seen as playing a role in providing the financial education that will rectify these market failures. Responding to the financial crisis, the rise in personal bankruptcy filings, and escalating credit card debt, advocates of education in personal finance focus on starting this education in the elementary and secondary schools and continuing such education for adults. Topics to be included in the curriculum are, for example, banking, loans and credit, saving, investing, insurance, and fraud. Such efforts are commendable to provide greater equity in access to financial education.

It is important, however, that financial literacy continues to be coupled with calls for increased regulation of financial markets and strengthening of social safety nets. As one critical observer of an overemphasis on financial literacy notes, “When consumers find themselves in dismal financial straits, the regulation-through-education model blames them for their plight, shaming them and deflecting calls for effective market regulation” (Willis 2008, abstract). Whether the regulations currently being rolled out in response to the crisis are sufficiently effective is outside the scope of this chapter. Of more immediate concern is whether financial literacy proposals can signal a reduced role for government in social provisioning. Toni Williams (2007) refers to this as *responsibilization*. She defines this process as “a form of regulation by which the state holds individuals accountable for aspects of market governance and social security that it used to provide” (227). For example, in the Preface for the *Handbook of Consumer Finance Research*, the editor Jing Jian Xiao claims:

> For several reasons, American consumers are now facing many financial challenges. First, *the social security system will likely be insolvent within the next 40 years* [emphasis added].... These growing social issues recently prompted government and private organizations to sponsor joint efforts of financial education and research. (2008)

The assumption that social security will not be available for future generations, who must therefore rely solely on personal savings, undermines the program’s legitimacy.

Financial literacy is necessary, but not sufficient, for empowering the poor and middle class. The next section outlines the major institutions involved in financial literacy and traces the recent growth in financial literacy mandates. The broad content areas included in financial literacy curricula are also examined.

Emerging Financial Literacy Mandates and Curricula

In order to critically evaluate the financial literacy movement, an overview of its curricular development is necessary background. Two different umbrella organizations have sought to define national standards in economic and financial literacy and advocate for education in economics and personal finance: the (National) Council for Economic Education (CEE) and the Jump$tart Coalition for

Personal Financial Literacy. Both groups operate as non-profit 501(c)(3) organizations with state affiliates and organizational members and partners. The first national (voluntary) standards in economics in 20 content areas were published by the CEE, in partnership with the National Association of Economic Educators and the Foundation for Teaching Economics. In 1998, only three years after its founding, the Jump$tart Coalition issued its first (voluntary) national standards for personal finance education. Topics include, for example: finding, evaluating, and applying financial information; setting financial goals; developing income-earning potential and the ability to save; using financial services effectively; meeting financial obligations (credit, debt); and building and protecting wealth. Meanwhile, more and more individual U.S. states, though their own departments of education, have revised their core curricular content standards to include more economics and personal finance content.

The pace of adoption of personal finance content has accelerated in recent years. This is best evidenced in a biennial survey, *Survey of the States*, published by the CEE. The survey documents the status of economic, personal finance and entrepreneurship education standards in the 50 states and the District of Columbia. Since financial literacy is the emphasis of this chapter, I will highlight the trend in standards for personal finance; the trends for economics and entrepreneurship can be found in CEE (2009). In 1998, only one U.S. state required that a high school course be taken in personal finance in order to graduate with a high school diploma. Between 1998 and 2007, the number climbed to seven. After the financial crisis, the number doubled to 14 by 2009, 13 cited by the CEE with at least one state, New Jersey, adding its requirement after the biennial report went to press. Relatively few states include personal finance content in mandatory testing, as in the subject area tests requisite with the federal No Child Left Behind Act (NCLB); however, adoption of testing in personal finance is also rising. The latest CEE survey indicates that whereas one state tested for personal finance content in 1998, nine states mandated testing by 2009. Since school districts are often under pressure, given limited resources, to “teach to the test,” the real impact of these state mandates may be muted.

Some of the earliest curricula, especially in economics education and pedagogy in K-12 schools, are from state councils of economic education, sited at U.S. colleges and universities, and affiliates of the Council for Economic Education. These centers have developed and refined teaching materials for economics content. The CEE website contains hundreds of lesson plans that are either free or fee-based.

Since the financial crisis, the CEE has moved swiftly to add lessons in personal finance. In 2009 and 2010, the plurality of their workshops for teachers at their New York City headquarters have targeted financial literacy.

A key pioneer in personal finance education is the National Endowment for Financial Education (NEFE), a nonprofit corporation headquartered in Denver, Colorado. According to the NEFE website (NEFE 2010), in the early-to-mid 1990s NEFE evolved from its parent entity, the College for Financial Planning. The College was established in 1972 as the nation's first financial planning educational institution and created the certification process, including testing, for a new profession called a Certified Financial Planner™ or CFP. NEFE introduced a series of lesson plans and ancillary materials in personal finance packaged as the High School Financial Planning Program® (HSFPP) in 1984, which is offered for free. Another early developer of financial education lessons and teacher training is Family Economics & Financial Education (FEFE). Based at the University of Arizona, FEFE is a partnership between the university and a nonprofit credit counseling agency named Take Charge America, Inc., through an endowment gift in 2003 (see FEFE 2010).

In the past decade, there has been a tidal wave of privately-created curricular content that has been uploaded to websites. Even navigating the resources provided by the links on the Jump$tart coalition website would take months! With exceptions in the minority, most content has not been authored by or vetted by school districts, professional teachers, education scholars, and/or professional organizations. Some of this material was developed by educators and non-profits, but much of it has also been created by companies in the financial services industry. Understandably, there has been enormous pressure to bring lesson plans to the public and to educators quickly, often leaving little time for developers to invest in the time, talent, and cost it takes to examine the materials.

In 2002, the U.S. Treasury Department established the Office of Financial Education. According to its website (U.S. Department of the Treasury 2010), the "Office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership and retirement planning." A year later, the U.S. Congress passed the Fair and Accurate Credit Transactions Act of 2003 (FACTA); Title V, termed Financial Literacy and Education Improvement, established the Financial Literacy Education Commission with the Secretary of the

Treasury as its chair. The Office of Financial Education also coordinates the work of the Commission, composed of representatives from 20 federal departments, agencies and commissions. One objective is to ensure the promotion of neutral and unbiased public and private sector resources for financial literacy. The intention is to separate educational content from marketing and branding, so that banks and credit card companies are not pushing their products while they are imparting information. According to Title V, Section 514(D) of the Act: "as the Commission considers appropriate, [the website should] feature website links to efforts that have no commercial content and that feature information about financial literacy and education programs, materials, or campaigns. . . ."

Evolved from the voluntary national standards developed by the Jump$tart coalition, the FACTA outlines topic areas that seem to have coalesced around areas of emphasis, as evidenced by state curriculum content mandates and personal finance education programs. Those areas are:

- Household budgeting and savings
- Managing credit
- Preventing fraud and identity theft
- Understanding banking and competing financial products

Financial education programs and curricula have added both investing (in stocks and bonds) and entrepreneurship to this list, so these subjects are often included in personal finance lesson plans.

Since the recession began in December of 2007, as officially declared by the NBER Business Cycle Dating Committee, the number of public and private developers of financial literacy materials and curricula for use in K-12 education and for adults has skyrocketed even further. Higher educational institutions, including schools of education, economics and finance departments, and professional organizations have not been able to "catch up" and effectively evaluate, vet, and perhaps even rank, the websites and content. A mere sampling of the public and private organizations that offer personal finance curricula are:

- The Board of Governors of the Federal Reserve and the regional Federal Reserve Banks
- Government departments and agencies such as the U.S. Treasury Department, the Federal Deposit Insurance Corporation (FDIC), the Federal Trade Commission (FTC), and the Internal Revenue Service (IRS)

- The New York Stock Exchange (NYSE)
- Major banks such as Wells Fargo-Wachovia, TD Bank, Citigroup, and ING
- Securities industry associations such as the American Financial Services Association (AFSA) and Financial Industry Regulatory Authority, Inc. (FINRA), via their education foundation or non-profit arms
- Securities brokers and financial advisors such as Charles Schwab
- Credit companies such as Visa
- Professional associations such as the American Institute of Certified Public Accountants
- The Museum of American Finance, a Smithsonian affiliate
- Youth organizations such as Junior Achievement and the 4-H clubs

There are hundreds of additional offerings that are linked from the Jump$tart Coalition's and its partners' lists of resources and thousands more to be found just playing around with Google searches. As a Director of a Center for Economic and Financial Literacy at a U.S. higher educational institution and as a Board member of the New Jersey Coalition for Financial Education (NJCFE), I have the strong sense that the cart is before the horse. In other words, those of us involved in financial literacy education and teacher professional development on a day-to-day basis cannot possibly keep up with the materials that are being generated. Yet we are working and will continue to work very hard to review the materials and seek feedback from K-12 teachers.

Toward a Pluralist Approach

Financial literacy has numerous advocates from the private, public, and non-profit sectors. It is also not without critics. In my reading of scholarship in financial literacy, I am finding that the critiques and calls for creative approaches to curricula and pedagogy are coming chiefly from "outsiders," outside of economics and finance departments. Among them is Lauren Willis, a law professor. Willis questions the motives for teaching financial literacy, points to a lack of evidence that teaching personal finance leads students to change their behavior, and argues that financial literacy substitutes personal responsibility for social responsibility for living standards (Willis 2008, 2009). Toni Williams, the critic of personal responsibilization cited earlier, is a law professor in the U.K. Other critics include scholars from schools of education and social workers (see, for example, Lucey 2007; Johnson and Sherraden 2007).

The shortcomings identified by these critics arise, I argue, because some of the recent calls for financial literacy have been grounded in the idea of the perfectibility of markets. That is, it is being linked to the idea that the financial crisis arose from minor, but not systemic, market failures. Such market failures can be eliminated if economic actors better conform to ideals of economic rationality with perfect information. In contrast, if we re-think financial literacy from a pluralist perspective, we can use the insights of behavioral economics, capabilities frameworks, social economics, and critical strands of economics to allow us to broaden our perspective about (a) which personal finance topics to include in a curriculum; and (b) how to approach teaching those topics.

The first premise we should adopt is that markets often operate imperfectly, and humans do not behave with perfect rationality. In fact, scholarly research thus far has tended to show that the impact of financial education on high school students has been quite limited, at least in the short run. Students may be taught how to develop a budget or the importance of saving for future purchases, but this does not mean that they actually budget or save. It is hard to change behavior and even harder to effectively and appropriately measure changed behavior, *ceteris paribus* (see, for example, Fox et al. 2005, Lyons 2005, Mandell 2009, and Lewis and Klein 2009; for contrasting results over a longer period of time, see Bernheim, Garrett and Maki 2001). For some advocates, this simply means starting financial literacy programs at ever-younger ages. Even with perfect information, however, behavioral economics has shown us that economic behavior can be resistant to change.

Being financially literate is not a guarantee that someone will make prudent decisions. One such allegedly smart and savvy person who should have known better is *New York Times* economics correspondent Edmund L. Andrews, author of *Busted: Life Inside the Great Mortgage Meltdown* (2009). As a reporter, Andrews covered the Asian financial crisis of 1997, the Russian meltdown of 1998, the dot-com collapse of 2000, and even the spike in "go-go" mortgages in several articles during 2004. But by 2009, Andrews found himself "underwater" and was facing foreclosure on the mortgage on his home. In the book, Andrews uses his own anecdotal story to illustrate his research and interviews those involved in various aspects of the mortgage bubble. He notes that the bursting housing bubble reached across socioeconomic class lines—income, education level, neighborhood, and region. Andrews ultimately argues that America's mortgage crisis had been brewing for at least 25 years, the result of a trend toward higher debt and greater speculation.

Further, behavior may not change unless there is the capacity to do so. Financial literacy does not mean that an individual or a household has the capability to alter their practices, like taking out a payday loan. That is why more and more educators are beginning to use the phrase "financial capability" rather than "financial literacy." Without capabilities, in the sense meant by Nobel prize–winning economist Amartya Sen, a financially literate populace may not increase savings and investment or reduce debt and risky behavior. For example, an FDIC-sponsored supplement to the January 2009 Current Population Survey conducted by the U.S. Bureau of Labor Statistics uncovers that one in four American households is either "unbanked" or "underbanked," with the percentage rising to roughly 54 percent and 44 percent of black and Hispanic households respectively (FDIC 2009). "Unbanked" means no checking or savings account and therefore a household must rely on alternative, nonbank financial institutions to conduct business: check-cashing places, payday lenders, income tax filers offering cash advances on refunds, etc. "Underbanked" households have a checking or savings account, but utilize nonbank services (e.g., nonbank money orders, pawnshops, check-cashing services) at least once or twice per year. Such services are often located in poor communities and used by those who cannot afford, do not have access to, or are uncomfortable with mainstream banks.

Focusing on financial capabilities instead of financial literacy reframes curricular goals in several interconnected ways. First, it steps back from the assumption, implicit in the Lionel Robbins definition of economics focusing on efficiency, that maximizing consumption is the aim of economic life. This definition can be reinforced by financial literacy curricula that emphasize budgets, savings, and investments as a means to future consumption of desired commodities. In his Tanner Lectures on the concept of living standards, Sen (1987) distinguishes between opulence and capabilities. Commodities are means to other ends. A focus on peoples' "capabilities" means enabling people to fully function and enjoy life—a capacity, in Sen's words, to enjoy something worth doing. The goal of economic life is well-being. In practice, this means that teachers of financial skills need to critically evaluate the pre-packaged curricula to ascertain what financial institutions, companies, or teacher-authors are implicitly trying to sell—and they need to encourage students to do the same. What are the messages about markets? About government? Are multiple perspectives provided and encouraged? Are learners allowed to value financial goals that might deviate from the norm?

Second, capabilities are shaped by social context. In a classic example, Sen notes that a person may own a bicycle, but it may be useless without paved roads, without the physical ability to ride a bike, or without a culture in which bicycle riding is permitted for women. In practice, this means that financial capabilities education needs to recognize that students have different access to economic resources, community values, and social norms. Elizabeth Johnson and Margaret Sherraden (2007) agree that we have done a poor job of teaching financial literacy to disadvantaged youth. Instead of aiming for literacy, these professors of social work suggest aiming for financial capability à la Sen, meaning literacy as well as access to financial policies, instruments, and services. Teaching students about banking is meaningless if they live in a neighborhood without any bank branches (Sebstad and Cohen 2003). Further, a household's personal finances are shaped by economic and financial crises, and trends in poverty, inequality, and health status. Perhaps it is more appropriate to think about a life-cycle savings plan rather than a plan that encourages all households to save as much as possible at all times.

Further, people should be able to pursue different things. Sen's vision of capabilities embraces human diversity. The goal of economic policies and practices is to enable individuals to pursue functionings that each has reason to value (see also Nussbaum and Sen 1993; Pressman and Summerfield 2000; Nussbaum 2003). Thomas Lucey and Kathleen Cooter (2009) warn that there may be an implicit classism in financial literacy curricula that blames the poor for their economic hardship and promotes middle-class norms. Instead, they advocate curricula and pedagogy that "espouses principles of social justice." This involves challenging stereotypes and critiquing "myths of meritocracy." Lucey understands that financial literacy is ineffective without a fully participatory society:

> An equitable financial education effort should acknowledge the different financial priorities in society, develop processes that are consistent with these education needs, and employ cooperative experiential processes to create the awareness of the human consequences for financial decisions. Social educators should explore the moral issues in financial education by fostering classroom dialogues, modeling pedagogies toward equality, and lowering resistance to conversation about economic injustice. (Lucey 2007, 490)

For Lucey, we can incorporate pluralistic values without moralizing about good behavior versus bad behavior (savers are good, debt is bad). Instead, curricula need to acknowledge the existence of alternative financial strategies in different communities. For example, in some immigrant communities, a group of people contribute the same amount into a fund each week, and one person takes home the entire pot. Over time, each person takes home the weekly pot, giving the recipient a lumpsum of savings. While these savings strategies do not have the benefits of interest and insured deposits, they may provide intangible benefits in building trust and community. Amassing personal wealth through individual savings and investment is thus only one, potential objective that can be reflected in financial literacy curricula.

In addition to being pluralistic about the topics we teach, we need to think about how we teach them. In teacher education degree programs, students are trained in differentiated instruction or differentiated learning. In broad stokes, differentiated instruction is best defined as what it is not: one size fits all for all students. Rather, students are diverse and learn in different ways. For financial literacy to be effective, teachers and students must first appreciate the socioeconomic backgrounds and experiences of students. Then teachers must design lesson plans that can be tailored to students' diverse backgrounds and diverse learning styles. For instance, personal finance education needs to find ways to appeal to both urban youth and youth who reside in households with first-generation American immigrants. Households will not necessarily cease relying upon nonbank financial institutions and open bank accounts if residents immigrated from a country where the image of banks was that they were corrupted either by the government and/or by drug kingpins.

One way to approach any personal finance topic might be to start with storytelling. Students have stories about their experiences. They are open, curious, motivated, and engaged when we as teachers validate the stories that come into the classroom (Figart 2010). In teaching about personal finances, just as in pluralist approaches to teaching economics, we can teach more inductively rather than deductively, starting with students' experiences and questions. The objective of such an educational approach, according to Zohreh Emami and John Davis (2009), is to treat students as active moral agents who are capable of deliberation and reflection. We cannot teach students to be critical consumers through passive learning; we must encourage critical thinking about the financial sector rather than a fixed set of "how to" lessons and formulas that are typically learned through rote memorization.[4]

Conclusion

Financial literacy as a movement has surged, partly in response to economic crisis. As a solution to economic instability, it resonates with mainstream economic theory in several ways. First, it focuses on learning specific bodies of information and skills. Second, it seeks and supports individual solutions (preferences), especially financial education that is supposed to lead to financial behavior. Third, personal finance education emphasizes making markets work better. It promotes personal saving and investment that may reinforce a reduced role of the state in social provisioning. In practice, some empirical studies indicate that this approach to financial literacy has had limited impact on behavior.

Rather than walk away from this project, we should work with others to help shape financial literacy education to ensure that it is efficacious. Insights from heterodox and other critical strands of economics can guide us. Political economists, for instance, have examined the roots of the economic and financial crises, zeroing in on more long-term structural problems rather than uninformed consumers. Studying the economy, not just personal finance with an aim toward building a personal portfolio, could promote a just society in the long run. Taking a broader view and likewise including a study of the financialization of the economy and the costs of deregulation may serve both the economy and financial markets in the long run.

This chapter introduced and discussed some approaches that steer beyond the traditional financial literacy model of blaming the victim or individual responsibility. Implicit here is that individuals are part of society. There are many other examples of programs constructed by people who truly understand the needs and capabilities of people in specific communities and work with them in their own terms to develop financial knowledge and capabilities. One alternative educational project is the "What's the economy *for*, anyway?" website.[5] The website is best used for alternative approaches to understanding the economy. It is an ideal resource for teachers in K-12 and higher education. Other organizations, such as the Center for Responsible Lending, are also doing fine work with financial education and third-party credit counseling (see, for example, Abromowitz and Ratcliffe 2010). What is needed, in the wake of the crisis, is the broad, pluralist economic perspective on the structural economic problems that we can provide practitioners of financial literacy, via collaborative projects that draw upon the talents and ideas of those of us training future teachers in schools of education and supportive colleagues in the social sciences and business.

Notes

1. For a critical summary of this approach, see Davidson (2009).
2. Bond rating agencies were once considered as reliable, quasi-independent rating agencies whose evaluations were solid. Beginning in 2000, the agencies starting going public by issuing stock, making them companies in pursuit of profit through a high-volume business of repeat customers looking for high rating for their debt.
3. Shiller also advocates a new standard boilerplate for mortgage contracts.
4. Emami and Davis (2009, 38) remind us that the great scholar of education John Dewey distinguishes between two educational philosophies: one based on learning content and rules and one founded on understanding experience and social interaction.
5. This is a collaboration of the Center for Communication and Civic Engagement at the University of Washington with the Political Economy Research Institute at the University of Massachusetts–Amherst and the Center for Popular Economics. See Center for Communication and Civic Engagement (2010).

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