

CHAPTER ELEVEN

## Borrowing to the Brink

### Consumer Debt in America

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This book has highlighted the ways in which unmanageable debt threatens the well-being of the American middle class. The chapters have described the harms of financial failure from several perspectives. Some authors have explored the experiences in bankruptcy of certain groups, such as homeowners, African Americans, and married couples. Others have chronicled the ways in which unprecedented debt burdens limit mobility and opportunity for groups such as college students and entrepreneurs, and ultimately, for America's middle class.

I now turn to arguing that wealth and debt are significant forces in creating and perpetuating social inequality in the United States. To understand this phenomenon, the social scientific study of wealth, consumption, and debt needs sustained academic and policy attention. This task is urgent. The country is suffering from a deep recession driven by unsustainable levels of household borrowing, and Americans today face increased job and income volatility. These forces have put the prosperity of the middle class at grave risk. Yet wealth and debt are notoriously difficult to measure in conventional social science research, and consumer debt burden as a significant new dimension of social inequality is only now being studied and understood. In America's capitalist economy, borrowing can be a path to prosperity. The bankruptcy data are a powerful reminder, however, that borrowing also can be a path to poverty. The data in this book from the 2007 Consumer Bankruptcy Project (CBP) are an important lens on how household debt crushes the aspirations of some families for middle-class stability and success.

I offer two additional views on debt and the plight of the middle class. These are big-picture observations that situate the somber findings of the preceding chapters in social and historical contexts. First, I document how the rise of easily available consumer credit occurred simultaneously with the stagnation of middle-class incomes. Families today are in a double bind; they earn fewer dollars and are trying to pay more debt. Second, I examine how

the crushing debt burdens of families in bankruptcy are related to the deregulation of the credit markets in the past two decades. I conduct a simple simulation that exposes households that filed for bankruptcy in 2007 to the regulated credit market of the 1970s, a world with hard credit limits, usury laws that capped interest rates, and tighter credit underwriting standards. The results are sobering. Families in bankruptcy today struggle with hundreds of dollars more in monthly payments than the prior generation could ever have borrowed. The findings suggest the potential of regulatory reform of consumer credit markets to reduce the risk and pain that debt imposes on America's middle class.

#### BORROWING TO FINANCE THE AMERICAN DREAM

*Chapter one 1*  
 As ~~the introduction~~ to this book describes, the American middle class is laden with unprecedented levels of debt. These obligations powerfully shape the prospects of families, but of course, consumer indebtedness occurs in the context of other economic and social forces. My exploration of the relationship between debt and middle-class prosperity focuses on the relationship between declining household wages and growing household debt burdens. I argue that in recent decades the middle class has been loaned money as a substitute for being paid an appropriate, productivity-enhanced wage. The American Dream is no longer just about hard work—about getting an honest day's pay for an honest day's work and enjoying the fruits of one's labor. In recent years, the pursuit of the American Dream has been financed with borrowed money. A middle-class lifestyle is now about unregulated interest rates, complex loan products, student loans, and multiple credit card debts. The middle class has been squeezed on both ends; today's working families earn lower wages and must try to service higher debts.

To illustrate the current plight of the American middle class, I provide a simple historical simulation that highlights the dramatic growth in debt burdens of the middle class in the past twenty-five years. In my rudimentary statistical simulation, families who filed for bankruptcy in 2007 are "moved" to a mid-1970s world of regulated credit and are subjected to a regime of credit limits that reflects traditional underwriting standards based on ability to pay. This analysis is designed to provide estimates for two key measures of interest. First, how much of the crushing debt loads accumulated by families in bankruptcy could not have been accumulated in the regulated consumer credit markets of the 1970s? And second, how many families could probably have avoided bankruptcy if the United States returned to traditional lending standards and a regulated consumer credit market? This simple simulation does not address the opportunity costs of borrowing less

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money (would people in a world of regulated credit pursue less education? buy fewer homes? or consume less overall?), but it erases consumer debt that exceeds 1970s regulated thresholds to reveal what household wealth would look like with a return to credit regulation.

The simulation analysis is inspired by a multifaceted argument with five major components:

1. The U.S. middle class has experienced unprecedented declines in real purchasing power since the mid-1970s.
2. Gaps between stagnant incomes and conventional consumption needs have been filled by easily available credit.
3. This influx of consumer credit appeared around the time that middle-class incomes stagnated.
4. Because the United States has experienced very real productivity gains over the past twenty-five years, and middle-class incomes have stagnated, borrowing money substituted for actually getting paid a productivity-enhanced wage.
5. The result of these changes is a middle class that is struggling to maintain financial stability in the face of unprecedented levels of household debt.

The historical and statistical analyses in this chapter help provide a context for the role that the widespread availability of credit has really played in helping families maintain or simulate a social class position.<sup>1</sup> This simulation of social class is one of many forces that have postponed a day of reckoning about the failure of the postindustrial economy to deliver its economic prosperity to large swaths of working Americans. This problem is at the heart of the pain that is confronting the contemporary middle class. An elucidation of the relationship between wages and debts is crucial to helping Americans see that the proud tradition of middle-class prosperity is at grave risk of disappearing.

#### THE BOUNDARIES OF MIDDLE-CLASS STATUS

As Elizabeth Warren and Deborah Thorne describe in Chapter 2, most Americans define themselves as middle class. Despite the disagreements found in popular and academic discourse, Warren and Thorne focus on income, education, occupational prestige, and homeownership as major defining characteristics of the middle class. Sociologists often combine the first three characteristics and collectively label them as contributors to *socioeconomic status*. As in prior work,<sup>2</sup> I define the middle class as households with incomes derived primarily from salaries and wages,<sup>3</sup> with adults who work

in jobs such as lower level managers, nurses and teachers, and small-scale self-employed people running businesses such as car washes and day care centers; who attended or graduated from a four-year college; and whose primary source of wealth is homeownership. While defining the American middle class is a bit elusive, the economic changes in the middle class can be easily seen in hard data.

#### DECLINES IN REAL INCOME DOLLARS FOR THE MIDDLE CLASS

The U.S. economy depends on the purchasing power of the middle class to fuel economic growth; that is, middle-class families buy the goods and services that are the bulwark of the country's economic output. Yet, during the past few decades middle-class incomes have not risen. Since the 1970s, there have been major downward shifts in the real purchasing power of middle-class wages when adjusted for inflation. These wages have declined despite real gains in productivity that we would expect would increase the pay of workers who create that productivity. The remarkable ability of the economy to grow while middle-class wages stagnated came from the widespread expansion of consumer credit during the same period. The purchasing power of the middle class was widely heralded as a public good. Until that pattern hit the breaking point with the financial crisis that began in 2007, middle-class consumption buoyed up the collective economy and produced seemingly relentless upward prosperity in living standards. But in the margins some people were pinched hard, and many, many more were set up for future pain. This era was marked by rising inequality in wealth, a large increase in the numbers of families in bankruptcy, and increased job insecurity. The root of the recession was seeded by the "income/credit squeeze" that characterized household balance sheets in recent decades.

The clearest evidence of the downward pressure in real purchasing power is the change in real median family earnings (Figure 11.1). Median pretax family income (the figure that separates the top half of the income distribution from the bottom half) actually declined slightly between 1971 and 1983 (by \$1,500), grew by \$6,200 (12 percent) during the economic recovery of the late 1980s (1989), and then stagnated. Real median family income in 1998 (the height of the late 1990s economic recovery) was only \$2,400 (4 percent) higher than in 1989. And between 1998 and 2007, the income of the typical family hardly grew at all. By 2007, real median family income was only \$8,700 (16 percent) higher than three decades before in 1971, an average growth rate of 0.4 percent yearly. And almost all of this real family income gain was produced by increased working hours and labor force participation of women.<sup>4</sup>

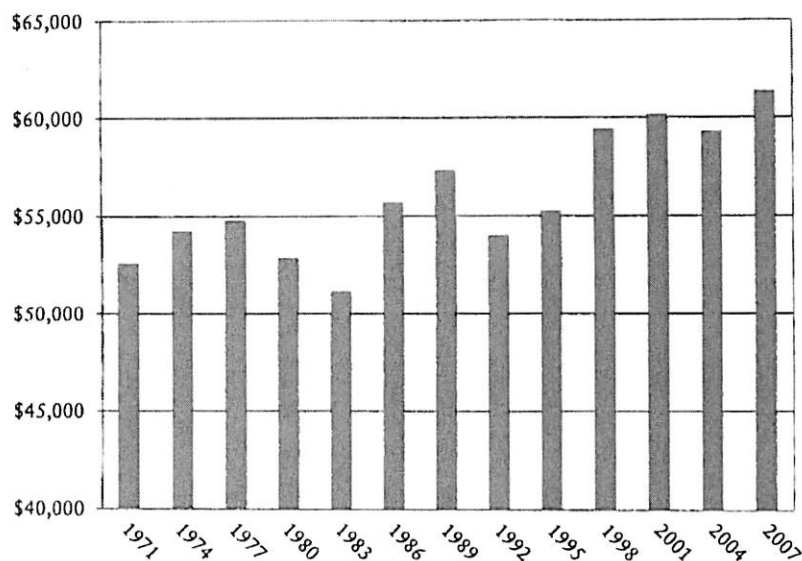


Figure 11.1 Median pretax family income (2007 dollars)

SOURCE: DeNavas-Walt, Proctor, and Smith, U.S. Census Bureau, *Income, Poverty and Health Insurance Coverage*.

The stagnating income and earnings at the middle of the distribution mask the steady trend toward greater income inequality. Figure 11.2 shows that income inequality rose substantially from 1970 to 2006. The top quintile of all families in 1970 received 43.3 percent of aggregate household income. By 2006, the share of that group had grown to 50.5 percent. The pressure on the middle class is revealed by the change in the relative size of the third fifth of the income distribution—those households that made between \$41,000 and \$62,500 in 2006. This middle group's relative share of the aggregate income dropped from 17 percent to 15 percent over the past thirty years. In fact, the shares for all families in the bottom four-fifths of the income distribution have declined relative to the top. During the past three decades, the nation's most well-off families (the top 20 percent) got a bigger slice of the income pie, while the bulk of families (the remaining 80 percent) were served up steadily smaller servings of income to live on.

Despite minimal growth and a decreasing share, middle-class incomes have been strained further by increased expenses for the mainstays of middle-class life—single-family homes, health-care premiums and out-of-pocket costs, child care, and higher education. Adjusted for inflation, the median sale price of a single-family home rose from \$129,000 in 1971 to \$247,900 in 2007 (in 2007 dollars).<sup>5</sup> Even in the midst of the so-called hous-

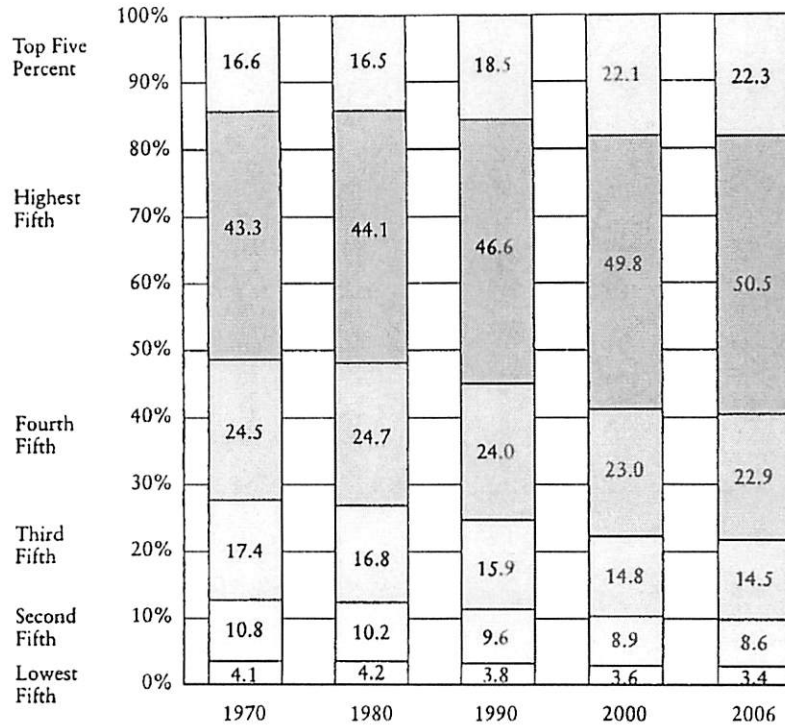


Figure 11.2 Percentage share of aggregate household income received by each fifth and top 5 percent of all households

SOURCE: DeNavas-Walt, Proctor, and Smith, U.S. Census Bureau, *Income, Poverty and Health Insurance Coverage*.

ing collapse, the median home price in 2009 was \$216,000, a huge uptick from the early 1970s that is completely disproportional to the few thousand dollars in increased income during the same period. Undoubtedly, rising home prices were driven by new methods of mortgage financing that were possible only because of the deregulation of consumer credit markets. The effect was to artificially prop up demand for new single-family homes.<sup>6</sup> Family health insurance premiums and out-of-pocket expenses (copayments and deductibles) have risen at a rate twice that of family income since 1996.<sup>7</sup> Today, 22 percent of all American families spend more than 10 percent of their incomes on health care.<sup>8</sup> The costs of children have also skyrocketed. The U.S. Department of Agriculture estimates that middle-income families with children spent 22 percent more in real dollars raising a child from birth to age eighteen in 2009 (\$222,360) than in 1960 (\$182,857 in 2009 dollars). Much of this difference is due to increases in child care and education ex-

penses. Middle-income families in 2009 spent \$37,740 on child care and education before age eighteen, up from just \$3,657 (2009 dollars) in 1960. The costs of attending a four-year public college or university rose by 43 percent from 2001 (\$8,839) to 2006 (\$12,657). All of these price changes far outstrip the meager 16 percent rise in real median family income from 1971 to 2007.

The squeeze on middle-class incomes during the past several decades is not the result of declines in America's economic capacity. In fact, corporate profits soared to unprecedented heights during the same period that incomes stagnated. Throughout the 1990s and early years of the 2000s, companies were making record profits and corporate CEOs were being well compensated. But the economic return to average workers was stagnating, and their relative economic standing was slipping compared with the wealthiest Americans. Corporate profits rose by 8 percent between 1977 and 1987 while median family income rose only 3 percent. In the 1990s and 2000s, profits moved dramatically higher and median incomes flattened further. From 1987 to 1997, corporate profits rose from \$432 billion to \$826 billion (90 percent) while median family incomes rose from \$56,500 to \$57,500 (1.8 percent) (in 2007 dollars). The trend continued even in the face of the 2001–2002 recession and beyond; corporate profits from 1997 to 2007 rose 32 percent while median family incomes rose 6 percent.<sup>9</sup>

Families were also buffeted by greater job instability in the 1990s and 2000s,<sup>10</sup> which translated into more volatility in household balance sheets. Political scientist Jacob Hacker has documented this trend, writing: "Family finances have become much more insecure. Although insecurity dropped in the booms of the late 1980s and late 1990s, the long-term trend is sharply upward. In fact, instability in family incomes was roughly five times greater at its peak in the 1990s than in 1972."<sup>11</sup>

There are numerous and heated public and academic debates regarding the causes of these relative trends,<sup>12</sup> but the trends themselves are not in dispute. In the 1990s and 2000s, middle-class families lost economic ground. The simplest explanations point to the role of globalization and the changing role of international competition.<sup>13</sup> Others point to the massive reorganization of the workplace and the enormous drive of employers to cut employee costs to increase profit margins.<sup>14</sup>

#### MIDDLE-CLASS FAMILIES WERE NOT PAID FROM PRODUCTIVITY GAINS THEY HELPED TO PRODUCE

An alternate explanation for the increased financial pressures on the middle class could be a decline in the overall U.S. economy, but there is strong evidence that the economy generally boosted its productivity during the past

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two decades. Although productivity lagged for most of the 1970s and 1980s, it rebounded in the 1990s, and despite a modest dip in the 2001 recession, it rebounded thereafter and remained strong until the recession began in late 2007. These patterns hold true across different sectors of the economy. But the productivity gains were not used to improve the lot of the average worker. Instead, the wealth from the dramatic boost in productivity went to those at the very top of the income distribution, or corporations used it to engage in activities designed to bolster increases in productivity and profits still further.<sup>15</sup> A simulation powerfully demonstrates this phenomenon.

What would the distribution of earnings for typical workers look like if some of the productivity gains had been distributed to middle-class families rather than given to the wealthiest Americans or diverted back into corporate activities? Two major complications are involved in answering this question. First, there are several ways workers could be rewarded for increased productivity. For example, they could work fewer hours and take some of the compensation as increased leisure time. The data on work hours suggests this did not happen.<sup>16</sup> Americans now work more hours than all others in the industrialized world except for the Japanese. Companies could also have used the productivity gains to hire more workers. In this scenario, the productivity gains would result in more jobs and lower unemployment. Indeed, in the 1990s the United States saw an impressive trend in job growth.<sup>17</sup> But if the number of available jobs was growing at a fast pace, and the workforce was not growing at the same pace, then there should have been pressure for upward wage movement, and this did not occur. In fact, productivity growth eased pressure on employer hiring because fewer workers could do the work that more workers used to do.

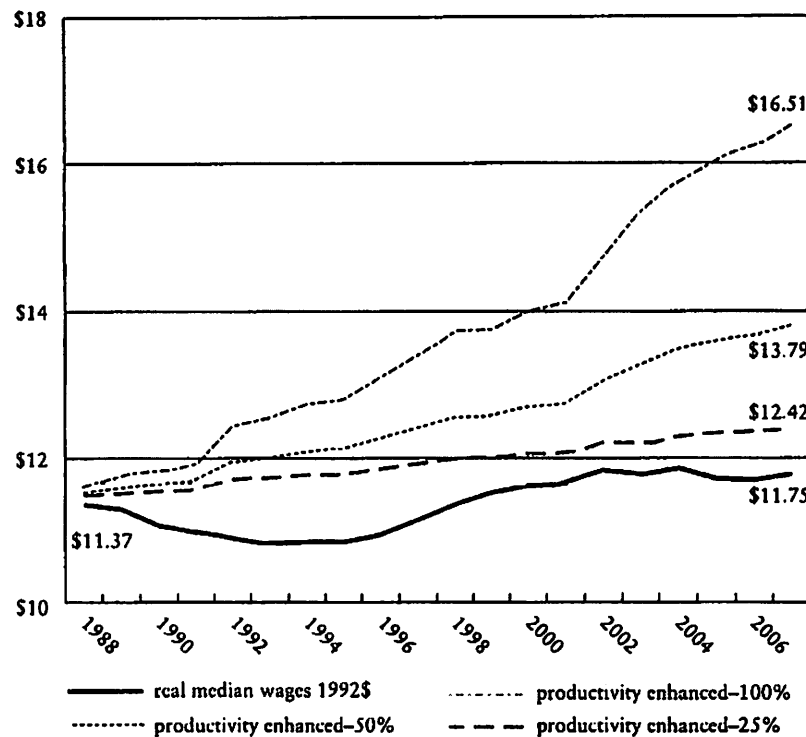
The other option for rewarding workers for productivity improvements is to raise wages. Since it is virtually impossible to make anything other than an arbitrary judgment about the extent to which productivity gains should be divided between average workers and corporations and their owners, I present the simulation results under a series of assumptions, showing how earnings would change in different scenarios.

Radically oriented economists and social scientists might argue that wages should rise in direct proportion to productivity. This is not the same as saying that *all* productivity gains should be redistributed entirely to workers. Instead, workers' earnings should rise in equal proportion to productivity increases. I call this the "100 percent solution." A second approach would be to permit companies to retain most productivity gains for investment in the technological changes needed to remain competitive. Under this assumption, the harm of workers not receiving any wage increase should be compensated for in the long run because the increased investment in equipment, technology, and organizational improvements will yield still more employ-



ment growth and higher wages in the future. But most would concede that even in this scenario, the workers who produced those productivity gains should receive some compensation improvement. As a minimum threshold, I allow workers' wages to rise at a rate that reflects 25 percent of the total gains in productivity and refer to this as the "25 percent solution." A third argument would be that productivity gains are equally the product of labor and capital and accordingly should be shared in half. This "50 percent solution" increases wages at one-half the rate that overall productivity rose.

Figure 11.3 shows the dramatic results of the simulations. Real median wages for nonfarm, nonsupervisory workers rose hardly at all between 1988 and 2007 (\$11.37 to \$11.75 in 1992 dollars). If median wages had risen in lock step with productivity gains, workers' hourly wage would have increased from \$11.37 to \$16.51, a gain of almost 45 percent. Even the 25 percent solution would have produced a 9 percent increase in real mean hourly



**Figure 11.3** Real hourly wages and productivity-enhanced wages for nonfarm, nonsupervisory workers

SOURCE: Author's calculations based on Bureau of Labor Statistics, "National Employment, Hours and Earnings."

wages for nonfarm, nonsupervisory workers over twenty years. That \$1.05 hour would amount to an extra \$2,100 per year in 1992 real dollars. Depriving workers of productivity gains, as corporations did in the 1990s and 2000s, created serious income problems for workers and the middle-class families they support.

Taken together, the data suggest that in the past two decades the story of the financial well-being of middle-class families is one of economic stagnation, or even economic suffering because of growing wealth inequality and income instability. In the face of these hardships, how have middle-class families maintained their lifestyles? How did the United States become increasingly reliant on consumer spending as its economic engine during the exact same period that most Americans had fewer real dollars to support their families?

#### WHAT FUELED ALL THAT CONSUMPTION?: CONSUMER CREDIT

A number of changes contributed to or enhanced the purchasing power of the middle class even though their incomes stagnated in real terms. Among the adjustments workers made were to (1) increase their working hours, (2) reduce their savings, and (3) increase their debt load.

The evidence shows that American workers are supplementing their incomes both by working more hours themselves and by bringing a second wage earner into the family, usually a spouse.<sup>18</sup> From 1970 to 1997 the average number of paid hours of work for married couples rose from 52.5 to 62.8 per week. During this same period, the percentage of families in which both husband and wife worked for pay rose from 35.9 percent to 59.5 percent.<sup>19</sup> In addition, the number of married couples who worked more than one hundred hours a week increased dramatically. These trends are depressing in light of the stagnation of earnings among the middle class over the past three decades. Americans today seem to be working more hours just to keep their heads above water and to stave off any decline in real income.

Families also have coped by living from paycheck to paycheck and eliminating savings, something that Elizabeth Warren and Amelia Warren Tyagi point out leaves people with little or no buffer against the whims of misfortune.<sup>20</sup> According to the Panel Study of Income Dynamics, 25 percent of American families could not sustain a poverty-level standard of living for three months if they were forced to live on their accumulated wealth.<sup>21</sup> Since the early 1970s the personal savings rate has plummeted from around a tenth of income to around zero. If you combine job instability with the lack of savings, many Americans are just a few missed paychecks away from financial ruin or bankruptcy.<sup>22</sup>

To make ends meet, Americans have dramatically expanded their use of consumer credit during the past two decades.<sup>23</sup> Although the recession that began in 2007 had seen some very modest deleveraging by 2010 (U.S. savings rates were near 3.6 percent as of April 2010, and consumer spending had slowed as consumers focused on paying off debt),<sup>24</sup> families still carried very high debt burdens into the second decade of the twenty-first century—a legacy of two decades of stagnant wages that is likely to endure into the future.

Credit card debt is a particularly useful substitute for wages because it can be used to meet everyday or large-ticket expenses. Beginning in the 1980s, the number of credit card users and the levels of debt carried on credit cards began to climb. Average credit card debt per household rose from just over \$3,000 in 1989 to \$7,300 in 2007 (in 2007 dollars). By 2007 a majority of American households were carrying credit card debt from month to month.<sup>25</sup>

Until the credit crunch began in 2008, mortgage lending also skyrocketed in the past two decades. This explosion in mortgage debt was fueled by “innovation” (not to be confused with improvement) in mortgage loan products. Adjustable-rate mortgages, particularly those with low “teaser” rates that adjusted upward dramatically after the first two or three years of the loan, accounted for 31 percent of mortgage originations in 2005.<sup>26</sup> Approximately another 30 percent of originations in 2004 were interest-only loans.<sup>27</sup> By 2005, subprime mortgages represented 20 percent of the mortgage market.<sup>28</sup> Loan-to-value ratios (reflecting the amount of money borrowed relative to the value of the house) averaged around 80 percent for the 1973–2006 period, but the percentage of loans making up more than 90 percent of the house’s value peaked above 25 percent in 1995 and remained above 20 percent until 2007.<sup>29</sup> Increasingly, potential homebuyers were hit with a bewildering array of choices that allowed them to buy houses that they could not afford on their stagnant incomes.

The deregulation of the banking industry during the 1980s set the stage for the transformation of the consumer credit landscape. A Supreme Court ruling removed the limits on the maximum interest rates that lenders could charge, constraints on securities dealings were lifted, and interstate branch banking was allowed.<sup>30</sup> These changes facilitated a dramatic rise in the credit available to consumers and the profitability of lending. Investors have fueled the lending industry by purchasing asset-backed securities that help lenders spread their risk and further maximize profits.

These structural changes in consumer credit coincided with stagnant incomes for the average American worker, producing a situation in which families were trapped in a “work and spend” cycle that grew for years and years.<sup>31</sup> American families were offered more ways to borrow money, and more dollars of credit, against their future earnings. And borrow they did. The percentage growth in consumer credit debt saddled Americans with unprecedented

levels of household debt. The ratio of debts to personal income grew modestly from 1960 (55 percent) to the mid-1980s (65 percent) and then skyrocketed to 133 percent in 2007.<sup>32</sup> Household debt growth has far outpaced growth in real incomes or real household wealth. By 2007, just before the recession hit, 15 percent of U.S. families had debt exceeding 40 percent of their income.<sup>33</sup>

The expansion of credit made possible by deregulation enabled families to “maintain the image of middle-class respectability and the material accoutrements of economic success even as they struggled simply to stay afloat.”<sup>34</sup> Because middle-class families used credit in order to maintain a middle-class lifestyle, any middle-class prosperity observed in the past two decades may be just a debt-driven illusion.

#### THE CREDIT EXPLOSION AT THE HOUSEHOLD LEVEL: 2007 CONSUMERS IN A 1970S WORLD

The overall story of this chapter is of two opposing forces reshaping the American middle class: incomes have stagnated and debt has increased. Taken together, these trends suggest that the American Dream of the 1990s and 2000s was purchased with borrowed money. To see the effects of this situation, I use the 2007 CBP data on families in bankruptcy to roughly assess how much of the heavy borrowing of middle-class families could have been avoided if the United States had not deregulated its credit markets.

Families in bankruptcy epitomize the harms of debt growth as a substitute for real wage growth. As Brian Bucks describes in Chapter 3, these families enter bankruptcy suffering under staggering debt-to-income ratios, despite being largely middle class by sociological characteristics.<sup>35</sup> The CBP reports that debt-to-income ratios of bankruptcy filers rose from 1.4 in 1981 to 3.4 in 2007, and the unsecured debt-to-income ratio rose from 0.5 in 1981 (half of reported income was owed in unsecured debt) to 1.2 in 2007.<sup>36</sup> My simple simulation takes families that filed for bankruptcy in 2007 and examines how much of their debt would be erased in a 1970s world of regulated credit and traditional standards of underwriting. To simulate this 1970s regulated credit regime, I imposed the following conditions typical of 1970s credit constraints on the households that filed for bankruptcy in 2007:

1. A household would have one credit card with a spending limit of \$1,000.
2. A household would have a single mortgage with a payment that did not exceed 30 percent of its monthly income.
3. A household would have car loan payments that did not exceed 10 percent of its monthly income.

My analysis presents a few basic data points to illustrate the growth in consumer debt relative to income. First, I determined how many families who filed for bankruptcy in 2007 had debts that exceeded the 1970s limits set forth above. Second, I examined the characteristics and circumstances of the bankrupt households that exceeded these 1970s credit limits. Third, I calculated how much the debt of the bankrupt households would decline if credit regulation and underwriting returned to the 1970s standards. These data provide a rough estimate for how many of the millions of households that have filed for bankruptcy in recent years could have avoided financial failure if credit use had not ballooned. As I argue above, this use of credit may have been a necessary substitute for families trying to hang on to middle-class amenities in the face of stagnant wages. The simulation provides a way to assess the extent to which the heavy reliance on credit set middle-class families up for financial failure.

As reported in preceding chapters, families who file for bankruptcy are in severe financial distress. Table 11.1 shows the key descriptive statistics for respondents to the 2007 CBP. The average household had \$103,000 in assets and \$148,000 in debts. Given the importance of wealth to life chances,<sup>37</sup> the negative net worth of these households is a grim reminder of the depth of their financial problems. A staggering amount of this debt was unsecured, much of it owed on credit cards. The average household owed more than \$59,000 in unsecured debt; nearly half of their total assets would have to be liquidated just to pay credit card and other unsecured obligations such as medical bills.

Given my hypothesis that credit substituted for wages, the key data are the amounts of debt relative to income. Table 11.1 shows that average

TABLE 11.1  
*Descriptive statistics of bankrupt households in 2007*

	<i>Mean</i>	<i>Standard deviation</i>	<i>Median</i>
Total assets	103,468	150,359	51,580
Total debts	148,225	327,318	87,343
Total unsecured debt	59,653	246,668	33,387
Monthly income	2,603	1,825	2,266
Monthly expenses	2,582	1,817	2,246
Definite medical debt	3,110	16,897	3,110
Definite credit card debt <sup>a</sup>	20,165	30,688	10,004
Rent/mortgage payment	687	643	583
Auto loan payment	160	231	0

SOURCE: Consumer Bankruptcy Project 2007.

NOTE: N = 2432. Values are in dollars.

<sup>a</sup>"Definite credit card debt" is a lower-bound estimate from court records, reflecting specific mention of credit cards, charge accounts, or brand names such as Visa, Discover, etc.

total monthly expenses almost equaled average total monthly income. It is important to remember that these monthly expenses, as reported on the bankruptcy schedules, do not include the debt service payments for dischargeable obligations in bankruptcy, such as credit card debts and other bills. Even with bankruptcy relief, these families barely had enough to make ends meet just trying to make house and car payments and pay other day-to-day expenses such as clothing, medical expenses, and utility bills. Given the lack of disposable income, the average family in bankruptcy clearly has no leftover dollars from its income to pay off its debts.

A closer look at these debt burdens is illustrative. At the mean the mortgage and car payments seem to be well within the 1970s credit cutoffs set forth above; the average household in bankruptcy was spending 26 percent of its income on mortgage or rent payments and 6 percent of its monthly income on auto installment loan payments, and the median auto installment payment was zero. Outstanding medical debts averaged \$3,100, but this was dwarfed by the amount of definite credit card debt (\$20,165). Fully 73 percent of the 2007 CBP sample had credit card debt beyond the \$1,000 1970s "hard line" credit limit (Table 11.2), and 26 percent of bankrupt families had credit card debt that exceeded their yearly incomes.

The situation is less severe with regard to mortgage debt and auto loan payments. Thirty-seven percent of the 2007 CBP respondents had mortgage payments over the conventional 1970s limit of 30 percent of household income, and 27 percent had auto loan payments above the conventional 1970s limit of 10 percent of household income (Table 11.2). The frequency of housing and auto cost debt problems are ~~smaller~~ <sup>smaller</sup> than credit card debt, but they suggest that about one in three bankrupt households in 2007 had collateralized loan payments that would have been impossible under the lending standards of the 1970s.

One of the most telling statistics comes from all three debt measures combined. Only 12 percent of the bankrupt households in 2007 did not exceed one of the three thresholds (credit card, mortgage, or auto). More

TABLE 11.2  
Percentage of bankrupt households in 2007 beyond  
1970s credit thresholds

Excessive debt measure	Percentage
Definite credit card debt > \$1,000	73
Mortgage/rent payments > 30% of income	37
Auto installment loan payments > 10% of income	27
All three debt measures exceed 1970s thresholds	9

SOURCE: Consumer Bankruptcy Project 2007.

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than one third (36 percent) exceeded two thresholds, and 9 percent exceeded all three thresholds.

I next examined the demographic characteristics of the bankrupt households that had debt burdens that would have been impossible just thirty years ago. How have different households responded to the expansion of credit? Table 11.3 shows the results of logistic regression used to predict the demographic characteristics that make it more likely that households in bankruptcy will have credit card debts greater than \$1,000, mortgage payments in excess of 30 percent of monthly income, and auto loan payments in excess of 10 percent of monthly income.

The regression results show that the lack of credit regulation, and the concomitant expansion of credit, had a more pronounced effect on some types of households. Credit card debt patterns are particularly interesting because these debt burdens were so dramatically lower in the 1970s than in the 2000s. The first column of Table 11.3 shows that credit card debt that exceeds \$1,000 is more likely among whites than Hispanic or African American bankruptcy filers. Excessive credit card debt is also more likely among the elderly (those older than sixty-five years). And despite fears about youth addicted to plastic,<sup>38</sup> excessive credit card debt is less likely among those aged twenty-five to thirty-four years. Excessive credit card debt is more likely among all income groups above the bottom quintile.

Table 11.3 also shows how excessive mortgage debt is a particular problem for certain demographic groups. Hispanics seem particularly likely to be bearing heavy mortgage burdens relative to their incomes. ~~The bottom 60 percent of the income distribution is also affected by this problem.~~ These findings are consistent with the expansion of subprime lending to individuals who likely would have been excluded from the mortgage market in the 1970s. The fact that these families are in bankruptcy is a reminder that the so-called democratization of credit did not always lead to improved financial health.

~~The~~ The third column of Table 11.3 examines differences in circumstances associated with excessive auto loan payments. African Americans are less likely than whites to have big auto loans; this may reveal the continued existence of discrimination in auto lending, which is very likely to be an in-person transaction, unlike credit card or mortgage lending. The fourth column examines the characteristics of the worst-off households—those that exceed all three debt thresholds. African Americans are significantly less likely to fall into this severely indebted group. This latter finding suggests that racial differences in credit patterns persist, despite ideas that subprime lending ended redlining practices.<sup>39</sup> People in bankruptcy with bachelor's degrees are twice as likely to be in the severely indebted group as those with high school diplomas. This finding is notable given the belief in the United

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TABLE 11.3  
Logistic regression of demographic characteristics associated with exceeding  
1970s debt thresholds

	Excessive credit card debt (=1)	Excessive mortgage debt (=1)	Excessive auto loan debt (=1)	All three excessive debts combined (=1)
	Exp (B)	Exp (B)	Exp (B)	Exp (B)
Gender				
Male (ref.)	--	--	--	--
Female (=1)	0.99	1.07	0.90	0.97
Marital status				
Married (ref.)	--	--	--	--
Never married	1.27	1.27	0.83	0.76
Separated	0.87	0.91	0.78	0.73
Divorced	1.24	1.14	0.88	0.93
Widowed	1.32	0.97	1.04	0.54
Age (years)				
<25	0.66	0.48**	1.20	0.46
25-34	0.64**	0.82	0.96	0.78
35-44	0.83	0.98	1.02	1.07
45-54 (ref.)	--	--	--	--
55-64	0.87	1.01	0.94	0.85
65+	1.63**	0.88	0.77	0.98
Education				
High school diploma (ref.)	--	--	--	--
< High school diploma	0.67*	0.68*	0.94	0.79
Some college	1.17	1.27*	1.10	1.13
BA	1.34	1.69***	1.49*	2.09***
More than BA	1.09	1.64**	1.14	0.97
Income quintile				
First quintile (ref.)	--	--	--	--
Second quintile \$	1.83***	1.02	1.72***	1.43
Third quintile \$	1.44*	0.82	1.79***	1.16
Fourth quintile \$	1.49**	0.67**	1.63**	1.06
Highest quintile \$	2.42***	0.61***	0.90	0.57*
Ethnicity				
White (ref.)	--	--	--	--
African American	0.44***	0.87	0.71**	0.67*
Hispanic	0.55**	2.33***	1.33	1.52
Constant	2.21***	0.61**	0.32***	0.12***

SOURCE: Consumer Bankruptcy Project 2007.

NOTE: N = 2,432. Standard errors are in parentheses.

\*p < 0.05, \*\*p < 0.01, \*\*\*p < 0.001 (two-tailed tests).

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States that a college degree guards against financial problems (see Chapter 5). One possibility is that increases in student loan burdens, or students using credit cards during college, may be forcing more families to turn to borrowing to make ends meet when it comes time to buy a house or car.

#### THE 1970S WORLD: HOW MUCH DEBT WOULDN'T BE THERE?

The final question I addressed is how much debt of the bankrupt households would be erased if 1970s credit regulations had been in place in 2007 and the preceding years. To answer this, I made artificial changes to the balance sheets of the 2007 bankrupt families to simulate credit markets in the 1970s. I systematically erased credit card debt in excess of \$1,000, reduced mortgage payments to 30 percent of income threshold, and reduced car installment loan payments to 10 percent of income threshold. The results are presented in Table 11.4 and graphically in Figures 11.4 and 11.5.

Overall, a regulated credit market would have made a big difference in the well-being of the families who had to seek relief in bankruptcy in 2007. With less debt, these families would have had hundreds of extra dollars freed for current consumption (see Table 11.4). Eliminating credit card debt in excess of the \$1,000 1970s limit on unsecured debt would lower the average bankrupt household's minimum monthly payments by \$383 and the median household's minimum payment by \$180. Cutting mortgage debt to the longstanding 30 percent of income ratio would lower the average bankrupt household's expense by \$235 monthly and median household's payment by \$80. Lowering car payments would save another \$49. All told, returning to the regulated 1970s credit markets would save 2007 bankruptcy filers an average of \$667 a month, \$260 a month for the median household. This works out to a little more than \$8,000 per year on average and \$3,120 at the median, representing 26 percent of reported average monthly household income and 11 percent of median income, respectively.

Looking at the relationship between the total debt of bankrupt families in 2007 and a 1970s modified debt level for each decile of debt highlights the way in which traditional credit underwriting would reshape families' balance sheets (see Figure 11.4). At the lowest debt levels, eliminating excessive debt above 1970s regulated credit levels reduces overall consumer debt by 62 percent, from \$20,166 to \$7,672. The amount of debt relief decreases considerably for those with the highest debt burdens in 2007 because a smaller percentage of the debt owed comes from credit cards. At the median (50th percentile) of debt, placing respondents in a regulated 1970s credit market would reduce total debt by 33 percent. For families whose debt burdens have pushed them to ~~admit financial failure by~~ filing for bankruptcy, these lower debt levels may have allowed them to keep making ends meet.

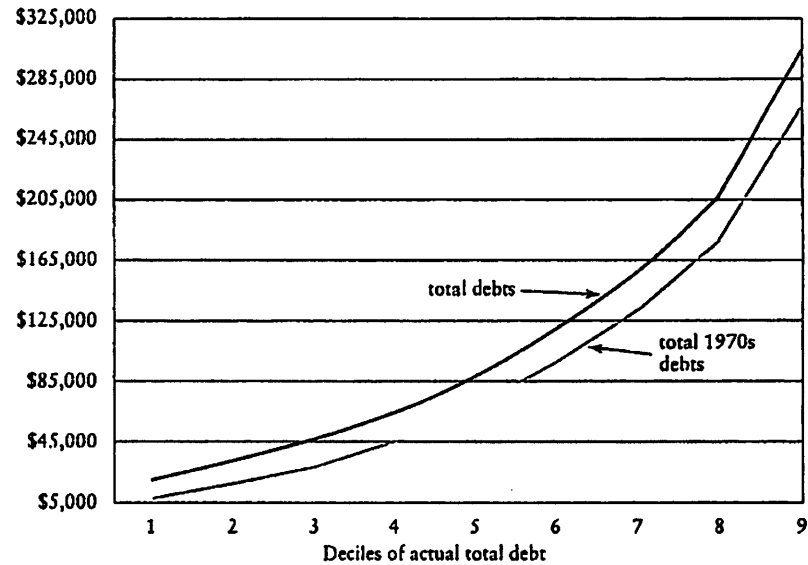
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TABLE II.4  
*Debts of families in bankruptcy before and after simulation of  
 1970s credit markets*

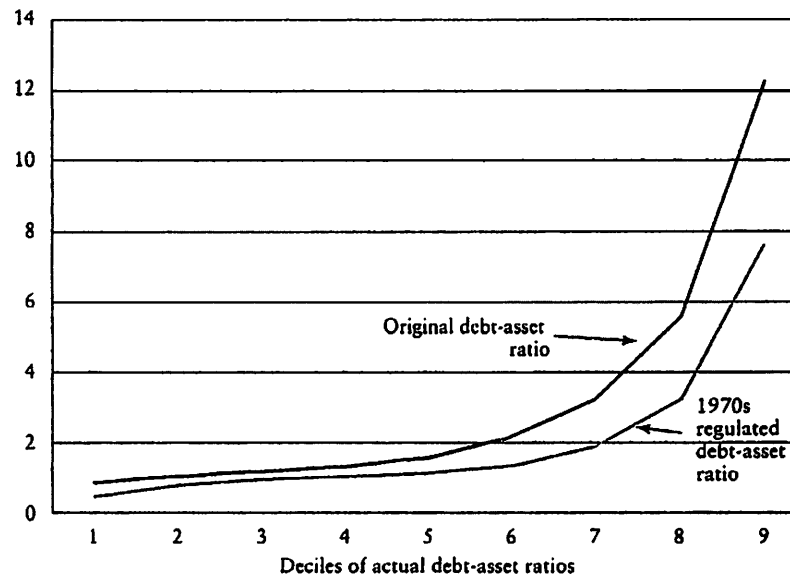
	<i>Mean</i>	<i>Standard deviation</i>	<i>Median</i>
Credit card debt			
Current debt	\$20,165	\$30,689	\$10,004
Average debt erased per household at 1970s threshold	-\$19,165	\$30,402	-\$9,004
Minimum monthly payment on average debt	\$403	--	\$201
Minimum monthly payment on debt at 1970s threshold	\$20	--	\$20
Monthly savings under 1970s thresholds	\$383	--	\$180
Mortgage/rent payments			
Current payment	\$687	\$643	\$583
Average payment erased per household at 1970s threshold	-\$235	\$423	-\$80
New average payment at 1970s threshold	\$452	--	\$503
Monthly savings under 1970s thresholds	\$235	--	\$80
Auto loan payments			
Current payment	\$160	\$231	0
Average payment erased per household at 1970s threshold	-\$49	\$121	0
New average payment at 1970s threshold	\$111	--	\$0
Monthly savings under 1970s threshold	\$49	--	\$0
Total monthly savings under 1970s thresholds	\$667		\$260
Average monthly household income	\$2,603		\$2,266
Monthly savings as % of monthly household income	26%		11%
Increased available income per year	\$8,004		\$3,120

SOURCE: Consumer Bankruptcy Project 2007.

NOTE: Minimum monthly payment on average credit card debt is calculated at 2 percent of the outstanding balance.



**Figure 11.4** Actual total debt and 1970s simulated debt, by decile of actual total debt  
 SOURCE: Consumer Bankruptcy Project 2007.



**Figure 11.5** Actual debt-to-asset ratios and 1970s simulated debt-to-asset ratios, by decile of actual debt-to-asset ratio  
 SOURCE: Consumer Bankruptcy Project 2007.

Figure 11.5 shows households' ratio of debts to assets in the simulated 1970s credit market for each decile of actual debt-to-asset ratio. If we take negative net worth (debts greater than assets) as a signal of financial distress, the 1970s credit market would give a positive net worth to 30 percent of families in the 2007 CBP. For many of these families, such assets could be a sufficient resource to keep them out of bankruptcy. The differences in debts incurred relative to assets are dramatic at all decile levels. At the median (50th percentile), debt-to-asset ratios are reduced from 1.59 to 1.17, a substantial reduction of 26 percent in debts relative to assets. Although these families would still have negative net worth, their situation would be much improved and they may have been able to weather the financial adversity without bankruptcy. At the 80th percentile (which includes the outward bound of catastrophic cases that either have no assets at all or have very high debt levels), the debt-to-asset ratio would be reduced from 5.6 to 3.2, a drop of 43 percent.

The simulation results show that the debts of families in bankruptcy would have been dramatically reduced had they lived during the regulated credit market of the 1970s. Given such reductions, some of these households probably could have retained their middle-class lifestyles without the expense and stigma of bankruptcy. However, even with reduced debts, some families would still likely have filed for bankruptcy because job instability and drastic medical bills or other financial shocks would have caused them to fall into financial distress and to borrow to make ends meet.<sup>40</sup> The simulation also does not answer the question of how actual consumers would have behaved under <sup>^</sup>their reduced ability to accumulate debt. There are opportunity costs associated with the lack of available credit—college classes not taken, homes not owned, cars not purchased, and consumption that would not happen. However, these results do show that, even with current incomes that have not kept up with inflation, today's families struggle with debt burdens that are seriously higher than families could have accumulated in the 1970s.

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#### DISCUSSION AND POLICY RECOMMENDATIONS

The modest analysis in this chapter adds some information to the considerable work of the authors in other chapters of this book. My contribution is to highlight the connection between wage stagnation and debt burdens. Middle-class incomes have experienced no real growth in recent decades, and during this same period easily available credit has been used to prop up middle-class purchasing power. The precarious position of the middle class has been fueled by a deregulated credit market that allowed borrowing to

substitute for earning. Although the United States made dramatic productivity gains in recent years, that wealth went to people near the top of the U.S. income distribution. Middle-class workers have not received those productivity gains in the form of increased wages, and as a partial result, incomes have stagnated. If even part of the productivity increases had been allotted to wage growth, families could have reduced reliance on borrowing or at least could have managed the very high debt loads that now characterize the middle class.

The chapters in this book paint a grim picture of the middle class. No longer a refuge of stability or prosperity, no longer the beneficiary of growth in the overall U.S. economy, the contemporary middle class is struggling. Its families are stressed by debt burdens that would have been unthinkable, not to mention illegal, under regulations that existed just three decades ago. The credit explosion has put the American Dream under intense pressure. The experiences of the bankrupt families described in this book illustrate the hardships and consequences of borrowing to make ends meet. If this situation is untenable, and unacceptable to our social mores about the role of the middle class in American life, what are the lessons for the future?

First, scholars need to continue to emphasize what is at the heart of three decades of CBP research: Americans in bankruptcy are a typical cross section of the middle class, not a deviant group of chronic failures. People in bankruptcy made the decisions that used to lead to middle-class prosperity—they own homes, have a college education, and are employed. We should turn a deaf ear to policymakers who cite a lack of personal responsibility or moral failure for families' credit problems <sup>and who</sup> ~~and who~~ should note that the families in bankruptcy are actually similar to their typical constituents. Families in bankruptcy may have failed not because they made different decisions from their nonbankrupt counterparts, but instead because their borrowing gamble to buy a house or finance college or pay for medical care simply did not pay off. Ill health, layoffs at work, or a need to help out family members may have strained their finances past the breaking point. But the key point is that these bets were placed when the family earned much lower wages (in real dollars) than in prior decades. Without wage growth, these households could not keep up with middle-class lifestyles, ultimately turning to borrowing as a supplement for wage stagnation.

Second, many people in bankruptcy are there because they have attempted to engage in activities that American society and culture value, such as pursuing higher education, starting a small business, and owning a single-family home. If we value these activities as the core of what it means to be in the middle class, then we should consider how to ease the consequences of failure from the pursuit of the American Dream. Legislative reforms to make student loan debt dischargeable in bankruptcy, for example,

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would be a significant step forward in this regard. Another example is to devote policy attention to the way in which the lure of entrepreneurialism will result in a certain amount of small-business failure. Instead of tightening bankruptcy laws for self-employed people as it did in 2005, Congress could recognize that increased employment volatility and the decline in stable manufacturing jobs mean that more Americans will be their own employer—an act that comes with high debt burdens and a risk of financial failure (see Chapter 6). The painful reality exposed in this book is that decisions to pursue the American Dream can themselves push families into bankruptcy. To the extent that middle-class lifestyles are funded by debt and not income, the risks have become greater in recent decades. The families in bankruptcy are a powerful reminder that failure is an outcome for some who pursue the American Dream.

Third, housing affordability played a major role in the financial meltdown that began in 2007. In an environment where average wages have stagnated and an increasing amount of wealth winds up in the hands of very few Americans, buying a house requires a level of borrowing that was not contemplated when a policy of encouraging homeownership was formulated more than fifty years ago. Deceptive mortgage practices and weak underwriting are part of this problem, but basic inflation in the housing market caused by the credit-fueled “housing bubble” is another source of this crisis. Lending people money for homes they probably cannot afford on their incomes affects the price that all buyers must pay and inflates the housing market. The recession triggered by unsustainable mortgage debt has made plain that too much reliance on consumer debt imposes grave risks on our entire economy.

The question remains, however, whether the United States is going to extrapolate this lesson beyond housing, given the fact that overreliance on credit now pervades nearly all middle-class activities, including attending college, buying a car, and starting a business. Regulation of lending provides some insulation from these risks, and the creation of a Consumer Financial Protection Bureau seems likely to change the regulatory framework for consumer credit. A reduction in household borrowing, however, ultimately will force society to contemplate the need to achieve middle-class prosperity. For example, if student loan debt is hampering the well-being of young Americans for decades in the future, the answer might be a reinvestment in public education. But the United States continues to move in the opposite direction, requiring families to borrow for education, rather than spreading such costs throughout society. The effect of such decisions is to concentrate risks in ordinary Americans; this book suggests that the result will be years in the future in which millions of middle-class families will face financial failure and declare bankruptcy.

Finally, as my historical analysis shows, society has lost sight of the primary engine through which a consumer-driven economy grows and prospers: steady, good-paying jobs. These jobs need to limit families' exposure to income volatility and to produce increases in income over time as productivity expands. The implicit model that built the post-World War II consumer economy was that one accumulated debts when one was young (through education, marriage, and homeownership), but that one gradually paid off those debts over the working years while saving money for retirement. This pattern of credit-fueled consumption only functioned, however, when subjected to two conditions. First, credit was limited in ways that were tied to income, and lending decisions were guided by underwriting standards with a record of success. Second, borrowing to fund consumer consumption was an acceptable risk because America's economy continued to expand—with the gains in productivity leading to wage increases for all U.S. workers. The combination of these features allowed the middle-class families of prior generations to pay off their long-term debts with inflation-discounted dollars. During the past thirty years, however, American workers have been starved of the large productivity gains that their hard work generated. Yet consumer aspirations have not changed as incomes stagnated. When society did not downsize the American Dream, a deregulated credit market stepped in to permit consumption to continue and even flourish. The recession of the late 2000s exposes the costs of this pattern. As of 2011, the bills have come due for the consumer debt that defines the modern middle class. How we rebuild and regulate the consumer credit system will play a big role in determining whether the American Dream will remain only a dream in the next decade.