

## 1

## Credit and Welfare in Rich Democracies

Many people these days are no strangers to debt. People borrow money to pay for childcare, to get training, or to take out student loans to attend college and university.<sup>1</sup> They take out mortgages to buy homes, perceived by many as the cornerstone of a middle-class life because homeownership helps build wealth and unlocks access to vibrant labor markets and neighborhoods with good schools. But people also go into debt to address financial gaps that emerge because of volatile incomes, rising expenditures, and limited support from the welfare state. In short, financial markets are now woven deeply into the social fabric of our communities, societies, and economies. They provide opportunities that mitigate how social status, parental wealth, or skills affect socioeconomic outcomes. But as more and more people rely on financial products to borrow, save, and invest, the downside risks become more visible. When the Swiss central bank in January 2015 unexpectedly lifted the peg off the Swiss franc against the euro, which had kept the value of the franc stable by fixing the exchange rate, the repercussions were felt way beyond Switzerland. Homeowners in Eastern Europe who had taken out mortgages denominated in Swiss francs rather than in their local currencies suddenly saw their monthly debt repayments increase by more than 20 percent as the value of the Swiss franc soared.<sup>2</sup> Market volatility affects not only homeowners but also workers and retirees. Many pension systems have moved away from defined-benefit plans – which guaranteed fixed monthly pensions throughout retirement – to

<sup>1</sup> See Maureen Pao, “U.S. Parents Are Sweating and Hustling to Pay for Child Care,” *NPR*, October 22, 2016, and Kara Baskin, “A Mortgage for the Future,” *Boston Globe*, September 15, 2013.

<sup>2</sup> See, for example, Danny Hakim, “Homeowners in Poland Borrowed in Swiss Francs, and Now Pay Dearly,” *New York Times*, January 28, 2019. Patryk Wasilewski, Sean Carney, and Veronika Gulyas, “Poland and Romania Face Strain on Mortgages over Climbing Swiss Franc,” *Wall Street Journal*, January 19, 2015.

defined-contribution plans in which monthly investments in capitalized pension funds yield variable pension payouts based on market returns. In the United States, the Great Recession of 2007–08 wiped out about \$9.8 trillion of wealth as many Americans saw the values of their homes and retirement accounts collapse. Meanwhile, rising levels of student debt in the United States and the United Kingdom prompted Occupy's Strike Debt! group in 2013 to buy off \$15 million worth of American student loans from banks with the goal to free student borrowers by “abolishing” their debt.<sup>3</sup> But this relief proved short-lived as the amount of outstanding US student debt alone has reached a new record of \$1.51 trillion in 2019 (Federal Reserve Bank of New York 2020).

These examples show that small ripples in one corner of the financial market can create tsunamis in households' own financial lives. As debt piles up, borrowers become more and more dependent on stable incomes to make debt payments on time. But despite the global reach of financial markets, household debt levels vary considerably across and within countries. Panel (a) of Figure 1.1 shows that between 1995 and 2015, household debt, measured relative to the size of the economy, has grown in nearly all rich OECD countries, with the notable exception of Germany and Japan. Denmark, Australia, and the Netherlands stand out as the countries with the highest debt-to-GDP ratio in 2015, even higher than other liberal market economies and almost three times as high as Germany's or France's. Panel (b) focuses on debt as a share of households' disposable incomes, thus capturing households' debt burdens, and reveals similarly strong increases over time but large differences across countries. From 1995 to 2015, the debt burdens of Danish households have grown by over 50 percent, while those of Dutch households have nearly doubled, leaving households in both countries with about three times more debt relative to their incomes than German households and over two-and-a-half times more debt than American households.

These cross-national patterns of indebtedness are puzzling because they do not align with country clusters frequently used in the dominant political economy frameworks such as *Varieties of Capitalism* (Hall and Soskice 2001) or typologies of welfare regimes (e.g., Esping-Andersen 1990, 1999). Countries such as Germany and the Netherlands that are typically classified as conservative coordinated market economies have very different levels of household indebtedness. Some Nordic countries share similarly high debt levels with liberal market economies even though this literature typically locates them on polar opposites of the spectrum of welfare states. So why do we see such strong variations in debt levels across countries? Why do some households borrow more than others? And what are the political consequences of rising indebtedness?

<sup>3</sup> See StrikeDebt! (<https://strikedebt.org>) and Adam Gabbatt, “Occupy Wall Street Activists Buy \$15m of Americans' Personal Debt,” *Guardian*, November 12, 2013.

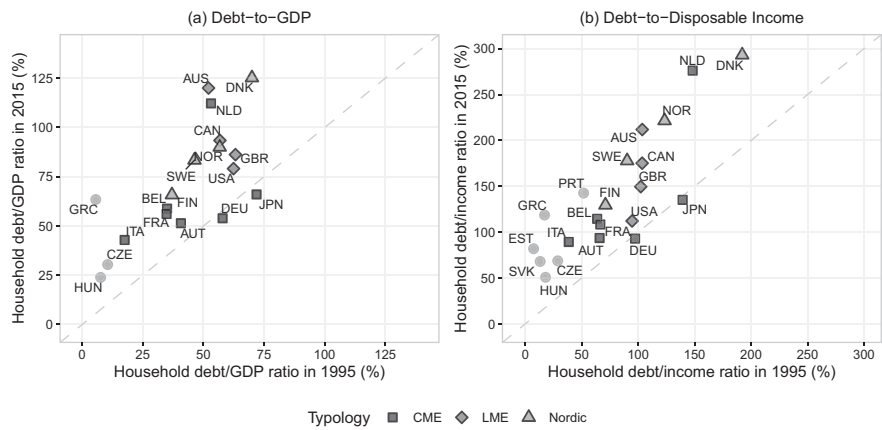


FIGURE 1.1 Household debt ratios in OECD countries, 1995 and 2015

Notes: The markers show country-year observations. Total debt includes the debt of households and nonprofit institutions. Countries located above the 45-degree line have increased their debt ratios from 1995 to 2015, while those below have decreased their debt ratios. Countries on the 45-degree line saw no change. Markers indicate common political economy typologies of Liberal market economies, Conservative coordinated market economies, and Nordic Social-Democratic economies, which are grouped as follows: Liberal market economies (LME): Australia, Canada, Ireland, New Zealand, Switzerland, United Kingdom, and United States; Conservative coordinated economies (CME): Austria, Belgium, France, Germany, Italy, Japan, Netherlands; Social-Democratic (Nordic) economies: Denmark, Finland, Norway, and Sweden.

Sources: Panel (a): BIS Total Credit Statistics (2018). Panel (b): OECD National Accounts (2019).

This book addresses the political causes and consequences of the growing reliance on credit and the expansion of household indebtedness in rich democracies. It sheds light on the fundamental transformation of social rights, responsibilities, and resource allocations that has occurred over the last two decades, as financial markets have emerged as private alternatives to the provision of public goods and services. One important but understudied reason why people borrow money is the gap between the financial costs of fragmented employment patterns and life course trajectories on the one hand and welfare states’ financial protections against social risks and support for social investments on the other.<sup>4</sup> Individuals change jobs more frequently, either voluntarily or because of short, temporary employment contracts. Individuals take time off work to take care for children or elderly family members and to get more education and training. These absences from work lead to income losses and higher expenditures that in many countries are insufficiently or inadequately

<sup>4</sup> The concept of “life course trajectories” captures individuals’ movements between different life stages, from raising children to pursuing education and training to employment and retirement (e.g., Mayer 2009).

addressed by social policies, as I show in Chapter 3. Weak unemployment benefits or unpaid sick leaves, for example, expose Americans to much greater social risks and financial burdens than Danes, who receive more generous unemployment and sickness benefits. Publicly subsidized childcare and paid parental leave reduce the financial costs of having children while helping parents reconcile family life and career choices. In sum, when social policies are insufficient or lacking, individuals must increasingly address social risks and finance social investments themselves by drawing on savings or family support, or by borrowing money and going into debt. The book's main focus lies on the provision of financial liquidity by credit markets, in particular through unsecured, non-mortgage debt.<sup>5</sup>

Consider the case of Frank Walsh, for example, a forty-nine-year-old electrician from Annapolis, Maryland.<sup>6</sup> When Walsh lost his job in 2011, he and his family supported themselves through a combination of various odd jobs and unemployment benefits, but during this time, Walsh also ran up about \$20,000 in credit card debt to make ends meet. The financial shortfall between his prior income and the social policy support he received is sizable, since at the time unemployment benefits in Maryland were about half of the weekly average wage up to a maximum of around \$380, and paid out for a maximum of twenty-six weeks. Or take Raquell Heredia from Fontana, California. She quit her jobs as waitress and bartender because she suffered from severe pregnancy-related morning sickness and her employers did not provide her with paid sick leave. Her new job at a pharmacy offered inadequate maternity leave benefits, so when her first child was born, she decided to leave that job, too.<sup>7</sup> Both examples reflect a grim reality that many Americans face. Unemployment, sickness, and raising a family can pose considerable financial challenges. Many individuals in situations similar to Frank Walsh's turn to credit markets and borrow money to smooth income losses. Raquell Heredia's circumstances, too, are not uncommon for many Americans who would like to take time off work to care for their children but have to take unpaid leave – often risking their jobs because this type of leave is usually not job-protected. Women like her often have little choice but to go into debt.

In other countries, however, fragmented employment patterns and life course trajectories pose much smaller, if any, financial risks to people like Frank Walsh and Raquell Heredia, limiting the need to borrow money. Compared with the United States, Denmark provides low-income Danes with better financial protections against social risks such as unemployment or sickness and

<sup>5</sup> Informal fringe lending markets such as payday lenders and pawnshops are alternative coping strategies but beyond the scope of this book's analysis.

<sup>6</sup> See Binyamin Appelbaum, "The Vanishing Male Worker: How America Fell Behind," *New York Times*, December 11, 2014.

<sup>7</sup> See Claire Cain Miller and Liz Alderman, "Why U.S. Women Are Leaving Jobs Behind," *New York Times*, December 12, 2014.

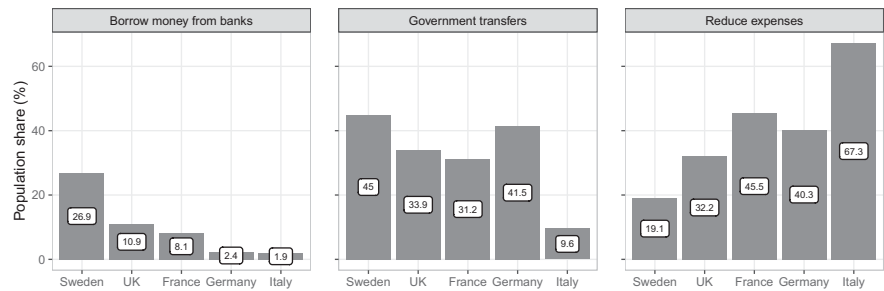


FIGURE 1.2 Dominant ways to cope with income losses across countries  
 Notes: Question: “In the past two years [2008, 2009], have you or anyone else in your household had to take any of the following measures as the result of a decline in income or other economic difficulty?” Respondents could select multiple coping strategies. Source: Own calculations based on LITS Wave II (2010).

social investments through education and family policies. The life of Mette and Christian Miller-Harris, a Danish dual-earner couple from Copenhagen, with a thirteen-month-old daughter, is considerably easier – financially speaking – because the government offers subsidized childcare, paid parental leave, and flexible work hours, which allow Danish parents to both take time off work after childbirth and enroll their children in childcare.<sup>8</sup>

The extent to which welfare states insulate similar individuals from social risks and provide social investments differs considerably across OECD countries. The results are large financial gaps in some countries and much smaller gaps in others. How do individuals cope with these financial shortfalls? Survey data from the Life in Transition Survey (LITS II), conducted in 2010, reveal considerable differences in private means to address financial gaps such as credit markets or expenditure cuts. In the wake of the financial crisis of 2007–2008, respondents across a range of countries, including five Western European ones, were asked how they dealt with declining incomes and economic difficulties. Respondents could choose from several options, including reducing expenses, relying on government transfers, and borrowing money from banks. Figure 1.2 shows the share of individuals in each country that selected any of these options. Government transfers such as unemployment benefits are the most important coping strategy for all households in each of the five countries, even though their use varies from nearly half of all Swedish households to about a third of all British households. With regard to *private* coping strategies, however, the country differences become more pronounced. In Germany, about 40 percent of households reduce expenses (nearly the same share of households that would draw on public benefits) but only 2 percent would borrow from a bank. Sweden displays almost the opposite pattern of

<sup>8</sup> See Lucy Rock, “What Britain Could Learn from Denmark’s Childcare Model,” *Guardian*, February 18, 2012.

how households address economic shocks. Only 19 percent of households cut expenditures, while 27 percent borrow money from a bank. The United Kingdom occupies a middle ground between both countries with regard to private and public coping strategies.

An obvious candidate that would explain the cross-nation variation in households' coping strategies in Figure 1.2 is the structure of the welfare state. In some countries, social policies protect individuals much better from social risks than in others. But there is also considerable variation *within* countries. Around 45 percent of Swedes rely on government transfers while another 27 percent go into debt, suggesting that the welfare state insulates some groups more than others. This insight implies that only considering the structure of the welfare state is not enough to fully understand why and under what circumstances individuals go into debt. The structure of credit markets is equally important. Countries like Sweden, Denmark, and the United States have what I call "permissive credit regimes" that make borrowing money relatively easy for households. Danes and Americans can easily access a broad array of financial products, including mortgages, home equity loans, and interest-only loans, for which borrowers at first pay only the interest but not the principal amount. Credit cards and other bank-based unsecured loans are widely available and used in both countries. Marketing-intense web-based loans and so-called SMS loans, especially popular among young adults, have grown considerably in Denmark during the past decade. Other countries, however, have more restrictive credit regimes that make borrowing fairly difficult for households. In Germany, for example, home equity loans and interest-only loans do not exist. Credit cards are used much less frequently than in other countries and function more like charge cards that have to be repaid in full by the end of the billing cycle. Instead, savings rates among German households are considerably higher.

These differences in welfare state support and credit access shape patterns of indebtedness across and within countries. Figure 1.3 shows that in 1989, a Danish household in the middle income tertile had on average about 20% of unsecured debt relative to their income. That number climbed to 37% in 1998 and 50% in 2012. Among American households in the same income tertile, unsecured debt leverage increased from 20% in 1989 to 27% in 1998 and 31% in 2013. For similar households in Germany, unsecured debt leverage remained at about 11% between 2002 and 2012. Even more revealing, however, is the variation in indebtedness across the income distribution. Unsecured debt leverage is positively correlated with income in Denmark, negatively correlated with income in the United States, and virtually uncorrelated with income in Germany. Put differently: debt leverage is concentrated among higher-income groups in Denmark and among lower-income groups in the United States.

To shed light on the questions I posed earlier and to solve the macro-level puzzles sketched out in Figures 1.1, 1.2, and 1.3, we have to look closer at micro-level data to understand which households go into debt for what reasons

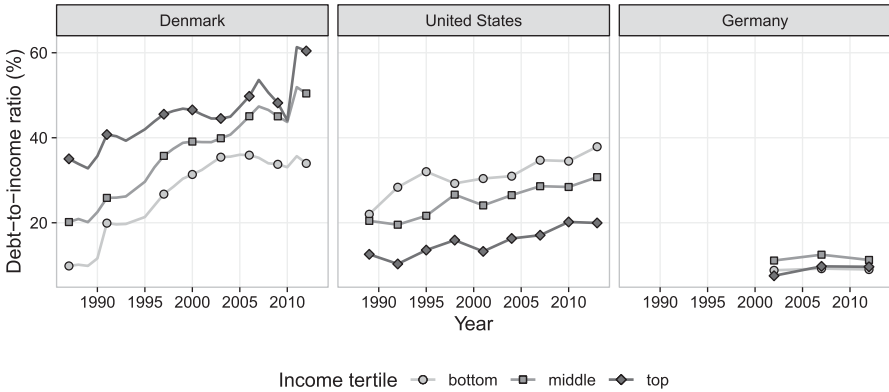


FIGURE 1.3 Unsecured debt leverage in Denmark, the United States, and Germany by income tertile

Notes: Unsecured household debt as a share of disposable income by income tertile. Weighted survey responses. Sources: Own calculations based on Danish full population administrative records, the US Survey of Consumer Finances, and the German Socio-Economic Panel.

and how the particular macro-level constellation of the structure of welfare states and credit markets shapes such borrowing behavior.

THE ARGUMENT: A SOCIAL POLICY THEORY OF EVERYDAY BORROWING

In this book, I offer a new perspective on how financial markets shape political economies, affect the social fabric of our societies, and reach into people’s daily lives. I develop what I call a *social policy theory of everyday borrowing*, arguing that the constellation of welfare institutions and credit regimes shapes patterns of indebtedness across and, perhaps more importantly, within countries. The ways in which welfare states insulate groups from social risks and provide social investments determine individuals’ demands for private means to both address social risks and seize social opportunities. Moreover, the ways in which credit markets shape people’s access to credit determines whether households use credit to bridge financial gaps or finance social investments.

Welfare states distribute resources across individuals, typically from high-income to low-income groups, through poverty relief, social assistance, and redistributive policies to reduce income inequalities. They also provide insurance against social risks and allow individuals to smooth income losses during unemployment, sickness, and retirement. And, finally, welfare states promote social opportunities and mobility and support people throughout the life course by providing social investments in education, childcare, or paid parental leave programs. The transition of Fordist manufacturing economies into flexible knowledge economies has created economic, social, and political



disruptions (Boix 2019; Iversen and Soskice 2019) with profound impacts on individuals' employment patterns and life course trajectories. Some countries have shifted away from social consumption toward social investment policies, most notably in the form of the "embedded flexibilization" approach of the Scandinavian countries (Thelen 2014). Yet welfare institutions in other countries are increasingly at odds with individuals' financial circumstances. More frequent employment disruptions, growing income volatility, and higher expenditures have placed new financial burdens onto individuals' shoulders (Morduch and Schneider 2017; Weil 2014). At the same time, welfare state retrenchment and policy drift have weakened social policy support and created financial gaps in individuals' daily lives. Both trends have shifted the costs from governments onto the shoulders of individuals for not only social risks, as Jacob Hacker (2019) documents, but also social opportunities. These trends have also increased reliance on private coping strategies such as savings and credit. As I show in this book, borrowing is not only a response to welfare state retrenchment. It also helps individuals address the financial burdens of interrupted employment trajectories, educational choices, and raising families.

It may seem surprising to argue that credit markets can fulfill functions that resemble social policies, not least because welfare states were in part designed to respond to market failures and cushion against adverse market outcomes. Yet credit markets mirror welfare states' tasks in three crucial ways. First, they too redistribute resources – although not across individuals but through time, moving resources from the borrower's future self into the present. Credit markets also provide financial liquidity through credit cards, bank loans, payday loans, and home equity loans, helping people address financial shortfalls or meet expenditures. And credit markets allow people to invest in both human capital (e.g., using student loans to finance their education) and financial assets (e.g., taking out mortgages to buy homes).

Whether households go into debt and borrow money to address income losses or finance social opportunities, instead of relying on other private means, depends on the structure of what I call a country's *credit regime*. This concept describes the institutional and policy environment that shapes the breadth and depth of financial markets, the allocation of credit between businesses and households, and regulatory and fiscal policy incentives to borrow money. These factors jointly influence who gets credit in the economy and how easily individuals can borrow money during periods of financial distress. I introduce the concept of credit regimes because it helps explain, in conjunction with the structure of the welfare state, why households in some countries have much easier access to credit than in others. Permissive credit regimes support open financial markets and have larger pools of capital and credit. Close institutional ties between banks and households, combined with political incentives to borrow money, make credit more easily accessible for households. Restrictive credit regimes, by contrast, are less open to global financial markets and have smaller pools of capital. Strong institutional links between banks and



businesses tend to channel credit flows more toward the business sector. In a policy environment that incentivizes saving instead of borrowing, households find it much harder to access credit.

***Credit Markets and Welfare States: Complements or Substitutes?***

The particular constellation of welfare state and credit regime structures shapes how individuals cope with social risks and harness social opportunities. When welfare states address social risks such as unemployment or sickness and provide social investments in education, childcare, or family policies, individuals have little need to go into debt. In these cases, the structure of the credit regime matters little. However, when welfare states are limited and leave people financially exposed, the structure of a country's credit regime determines whether households go into debt to fill financial shortfalls. In restrictive credit regimes, people have limited access to credit and are rarely able to borrow money to address income losses. Instead, they internalize costs and income losses, for example by using their savings, making expenditure cuts, and/or relying on family support. Credit only emerges as a private alternative to welfare states in permissive credit regimes that make it easy for households to borrow money.

The macro-level interaction of credit market and welfare state structures results in three unique constellations, each with a different set of distributive consequences for individuals' abilities to address social risks and finance social investments. A *complementary relationship* between credit markets and welfare states arises when social policies protect economically disadvantaged groups against social risks and provide social opportunities, which obviate their need to go into debt. Instead, borrowing is concentrated among more affluent and economically secure groups that receive less support from the welfare state. Here I use the term "complement" to describe a context where credit markets coexist with comprehensive (but stratified) welfare states and complement each other in the provision of financial support, either privately through access to credit or publicly through government transfers.<sup>9</sup> In other words, credit markets and welfare states co-exist as complements to one another, allowing better-off groups to use credit markets to "supplement" their less generous welfare benefits. Denmark illustrates this case. By contrast, a *substitutive relationship* between credit markets and welfare states arises when weak welfare states push the financial cost of addressing social risks and financing social investments to a much broader range of people, including economically vulnerable ones, who compensate for insufficient or absent social policies by borrowing money. This is the case in the United States. Permissive credit regimes enable complementary and substitutive functions depending on

<sup>9</sup> To be clear, I do not use the term "complement" in the sense that an increase in the use of good A increases the use of good B.

which groups are protected and covered by social policies. And, finally, restrictive credit regimes suppress credit markets, which precludes households from borrowing. Instead, they rely on a combination of welfare state support and private savings, family support, or expenditure cuts. An example of this case is Germany.

### ***Risk Buffers and Social Investments***

These different coping strategies suggest that credit has different functions for different types of individuals. On the one hand, individuals use *credit to address social risks*, for example to smooth income losses during unemployment as Frank Walsh did. Similar to welfare states' social consumption policies (e.g., unemployment and sickness benefits), credit markets provide financial liquidity. But the key difference is that credit markets privatize risks, requiring borrowers to repay their loans with interest. On the other hand, individuals use *credit as bounded social investment*, enabling them to invest in human capital and financial assets with the expectation of economic gains and upward mobility. People invest in human capital by taking out loans for education and other training programs or by compensating for temporary pay cuts when they switch from one job to another, perhaps assuming or hoping that the new job is a temporary step toward a more rewarding career. People invest in financial assets such as their own homes – typically the largest financial asset individuals acquire during their lifetimes – by taking out mortgages. Much like social investment policies (e.g., education, active labor market policies, and family policies) seek to improve individuals' well-being, skills, and family lives, credit can fulfill similar functions by privately providing individuals with the financial means to do so. Credit helps individuals address expenditures for childcare, education, and housing as well as the opportunity costs of forgone income while outside the labor force.

But whether people engage in credit-financed social investments, and whether expectations of upward gains are realized, depends crucially on the structure of opportunity costs. This is why I call this type of borrowing “bounded” social investment. The returns to credit-financed social investments are bounded and constrained by how leveled the social policy playing field is, and what types of opportunity costs are associated with it. Weak social policy support increases the opportunity costs of borrowing money to invest in education or childcare, or to take time off work. Consider the case of childcare: Only households with adequate savings or sufficiently high incomes can afford childcare that is prohibitively expensive – for example if it is not publicly subsidized. In Denmark, government-subsidized parental leave and childcare allow parents to continue to work while their children are in daycare. Although the financial costs of these policies vary across income groups – high-income groups pay more than low-income groups – this is in stark contrast to the United States, where having children and raising a family has become increasingly expensive,