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Bank rules and their impact on inequality

Banking regulation has a profound effect on levels of long-term financial inclusion around the world; US engaged in a failed 'lottery ticket' effort by the US to offer housing to the poor.

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When most people consider the effects of government policy on economic inequality they think of taxes, welfare programmes, charter schools or student loans. But, as we show in our new study of the history of politics in shaping banking policies around the world – *Fragile by design: the political origins of banking crises and scarce credit* (Princeton 2014) – inequality can be affected by the rules of the game under which banks operate. Those rules define, among other things, who gets to be a banker, who gets access to credit and who pays for bank bailouts.



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Although banking policies and inequality outcomes are linked in all countries, the nature of those links differs across various types of political regimes. In autocracies, banking policy tends to be used to preserve the political and economic power of elites, and to tax everyone else. The nature of those policies and their consequences for inequality depend on the fundamental structure of the autocratic regime and, in particular, on whether autocratic power is centralised or decentralised. In democracies, on the other hand, potential debtors can vote and they are therefore able to push for policies that increase access to credit.

Democracies are also less likely to expropriate banks, because there are veto gates that check the authority and discretion of any single public official. The result tends to be a larger banking system that provides abundant and more broadly distributed credit, and therefore tends to promote faster growth and greater equality. But, precisely because politicians must respond to demands for increased access to credit, democracies can and do make decisions regarding banking policies that produce credit booms and busts – whose consequences are negative for inequality.

Inflation tax banking under weak autocracies

Let us take a canonical case of a highly unequal society, Brazil. As we discuss in *Fragile by design*, Brazil has been governed by weak autocrats for most of its history. Its vast geography, isolated locations of initial settlement and prevalence of slave-based cultivation limited the power of the national government and boosted the relative power of local elites. Weak national governments in Brazil found it difficult to raise tax revenue. They were, however, often able to control bank chartering policies. Lacking other resources, the central government used its power over the banking system as a means of inflating its currency so that it could share in the profits of an 'inflation tax'.

Inflation taxation works through a simple mechanism: the government prints money to fund its expenditures. The resulting inflation devalues assets held in the form of cash; which means it is implicitly a tax on cash and cash-like instruments (like zero-interest checking accounts). In an inflation-tax economy, banks are forced to hold primarily government-produced assets, especially zero-interest cash.

Banks and governments share the inflation tax that is earned on checking accounts. When an individual deposits her money in a checking account, inflation starts to eat away at its value. The bank earns income simply by the fact that the checking account is yielding a negative real rate of interest. Some of this income has to be shared with the government – the exact amount depending on the deposit-reserve ratio set by the central bank – but the bottom line is that the banks become the partners of the government in administering the inflation tax.

Economists have long noted that inflation taxation is highly regressive. Poor people tend to hold much, if not all, of their wealth in cash assets bearing zero interest, and thus are the ones who bear the brunt of inflation taxation. The elite, on the other hand, can invest in land, foreign assets and financial assets that pay interest and dividends, thereby enabling them to avoid much of the effect of the inflation tax. It was not a coincidence that Brazil's banking regulation contributed to its enormous inequality of wealth, and that for most of Brazilian history elites did not strongly object. The increasingly unpopular accelerating inflation rate was a major contributor to public demands for democracy and fiscal reform, which ultimately produced a new democratic constitution in 1989 and the successful control of inflation since 1994.

Banking under centralised autocratic networks

Mexico is another example of a country with a long tradition of autocracy, which made the transition to democracy in the late 1990s. In contrast to Brazil, Mexican autocracy often took the form of a highly centralised elite network that controlled politics, economic privileges and the right to own and operate banks. In the late 19th and early 20th centuries, that network was run by the dictator, Porfirio Díaz.

After numerous revolutions and internal struggles, a new powerful network emerged, organised by the Institutional Revolutionary Party (PRI), which dominated Mexico for seven decades. Under both incarnations, banks, not surprisingly, served the credit needs of the elite network, contributing to the wealth gap between rich and poor.

China's banking policies today are another example of the capture of a banking system by an autocratic network. The several hundred elite families that govern China today depend upon their control of the major Chinese banks to finance politically important loss-making state-owned enterprises that could not otherwise obtain funding. For more than a decade, the Chinese government has recognised the economic advantages of liberalising its banking system, but banking regulation cannot serve two masters: competitive banking, with market-determined loan allocations and deposit interest rates would spur growth and opportunity for new businesses, but would also make it impossible to maintain unprofitable state-owned enterprises and their existing employment levels, which are crucial for maintaining control by local communist party officials.

Competitive banking under democracy

In contrast with autocracies, democracies tend to produce relatively abundant credit, which, according to a substantial body of academic research, has tended to play an important role in spurring economic growth. Less well-known perhaps is the evidence showing the linkage within democracies between bank credit and a narrowing inequality gap.

Take Canada as an example. Although Canadian banks were taxed by the government, bank chartering was not monopolised and banks were not overly burdened by the needs of the state. A competitive banking system able to provide credit to all regions promoted economic development, and made credit accessible to all parts of Canada, including to immigrants settling in remote parts of its interior. The regulatory system has also proved to be effective at promoting competition and prudence. Canada revises its bank charters and its banking law every five years, which keeps bankers on a short leash. More importantly, the political process that underlies that regulation is constitutionally structured to limit capture by bankers or other factions that would seek to use banking regulation to shift resources to themselves from the broader public.

Canada's history points to broader patterns that have been documented by a large body of economic research: policies promoting competitive banking not only quicken economic growth, they also reduce inequality. For example, one study of banking in 58 developing countries, by Thorsten Beck, Asli Demirguc-Kunt and Maria Soledad Martinez-Peria, published in the *World Bank Economic Review*, found policies that permit relatively free bank entry – a tendency of developing-country democracies – not only result in greater private credit relative to GDP, they especially promote access to banking by the poor, as reflected in higher participation rates of the population in borrowing or holding bank deposit accounts.

The banking literature also shows a clear link between democratic political institutions and the tendency for freer entry in banking.

This link between competitive banking and reduced inequality is not limited to poor countries. Various studies of the effects of relaxing the limits on bank branching in the US find that when states dropped their restrictions, interest rates fell because banks were forced to compete. As a result, new business formation and economic activity increased. A recent paper by Thorsten Beck, Ross Levine and Alexey Levkov published in the *Journal of Finance* goes even further: it shows that one of the big winners from this regulatory change was low-waged, low-skilled workers, who saw a 5% increase in their incomes, holding all other changes constant. Low-wage workers benefited not because they received bank credit directly, but because business enterprises were able to obtain more credit at a lower cost, expand their operations and hire more workers. That is to say, the government affected income inequality by removing the barriers to competition in banking.

The unintended consequences for inequality of redistributive credit policies

Sometimes democratic governments try to use banking policies as a means of directly addressing inequality. In US history, the initial target of such policies was subsidising agricultural mortgage credit. More recently, as the centre of US population has shifted to cities, residential mortgage credit subsidies for low-income Americans became a major focus of credit subsidies. In essence the idea is to encourage home ownership for people with little or no existing wealth, as a means of jump-starting their wealth accumulation (through growth in home equity) and improving local communities by giving citizens a greater stake in those communities.

Affordable housing policy has used a variety of tools to encourage credit to flow to high-risk mortgages for low-income Americans. During the transition from single-office ('unit') banking to nationwide branch banking in the 1990s, a coalition of bankers seeking to create too-big-to-fail megabanks and activists who sought to build their organisations was formed. The activists testified at Fed Hearings *on behalf of* the bank mergers, while the bankers channelled hundreds of billions of dollars in housing and small business credit through the activist groups. This coalition was strengthened by legislation that induced government-sponsored entities (GSEs) Fannie Mae and Freddie Mac to purchase risky mortgage loans – a point made clear by the activists themselves in testimony before the Senate Banking Committee in 1991.

Fannie and Freddie were initially reluctant to join this coalition, but seeing that they were being outflanked agreed to a compromise, which was embodied in the GSE Act of 1992. They would purchase loans to low- and very low-income borrowers, in exchange for which Fannie and Freddie would be allowed to back their portfolios with paper-thin levels of capital and would be supervised by a department of the Office of Housing and Urban Development, which had no experience as a bank regulator. Over time, the mandated levels of loan purchases by Fannie and Freddie were raised, to the point that by 2007 the vast majority of their purchases fell into the mandated low-income categories.

The increase in these mandates, which took place across both the Bill Clinton and George W Bush administrations, forced Fannie and Freddie to reduce their underwriting standards on mortgages – which led to the acceptance of much lower, and sometimes zero, down payments and the

willingness to accept undocumented claims of applicants' employment and income. The Federal Housing Administration, which insures mortgage credit for low-income Americans, also relaxed its underwriting standards.

The prospect of profiting from housing price appreciation encouraged many (not just the urban poor) to do whatever it took to get access to highly subsidised mortgage credit, including exaggerating their incomes. The mortgage underwriting standards adopted by Fannie and Freddie in order to meet their affordable lending mandates had to apply to *everyone*, not just low-income, urban borrowers. A two-tiered underwriting system was not possible, as it would have been an explicit recognition that the loans the GSEs were purchasing were of low quality. Thus, mortgage standards became debased for everyone, and a large swathe of the US middle class, along with low-income Americans, were given powerful incentives to gamble – and to engage in outright fraud – by virtue of the fact that they could buy a suburban dream house with no money down and no documentation of their income and employment.

Bankers and the GSEs played along with this approach because they received benefits for doing so, including approval of proposed bank mergers, lax regulation (low capital ratio requirements for both banks and GSEs) and too-big-to-fail protection, which became apparent when the banks and GSEs were bailed out by taxpayers.

In contrast to the evidence about the inequality reductions that attend competitive banking policy, these government credit programmes that targeted inequality not only failed to promote a broadening of home ownership, they had disastrous unintended consequences for the poor that have exacerbated inequality. In the wake of the housing collapse, many low-income Americans with large mortgage obligations have faced foreclosure and the loss of both their homes and their accumulated savings, which has only made inequality more pronounced.

The access to subsidised mortgage credit was the financial equivalent of telling a struggling family that the government would only help them if they agreed to devote all of their income to buying a massive, subsidised lottery ticket that had a chance of paying off big, but a much higher chance of wiping them out completely. The lottery ticket was the mortgage. The subsidy was the lax underwriting standards and generous lending terms granted by a banker. The prize was home ownership. The portion of the ticket funded by the family was the income stream they had to devote to the mortgage. By design, many of the families drawn into programmes like this could not win: housing markets are volatile, and the income streams of the poor are, by definition, low and uncertain.

Why democracies make predictable mistakes in dealing with inequality

Reserve Bank of India governor Raghuram Rajan's 2010 book, *Fault Lines*, referred to this indirect approach to addressing inequality as a "let-them-eat-credit" policy. As Rajan and many others since have recognised, this highly indirect and risky approach to addressing inequality reflected the conscious choice to use mortgage credit subsidies, rather than other government programmes, to address inequality. Prominent politicians of both parties – including Bill Clinton, George HW Bush, George W Bush, Barney Frank and Newt Gingrich – were enthusiastic supporters of the lottery ticket approach. In retrospect, these policies seem to have been very unwise, arguably even cruel. Why were politicians willing to take this approach?

Several insights from political science and economics are useful for understanding why and how mortgage lottery tickets became favoured as the means to addressing American inequality in the 1990s and 2000s. First, politicians tend to be short-sighted. Massive public investments in education might reduce inequality much better in the long run, but politicians are in the business of winning elections in the short run. In fact, if they fail to win *the next* election their political careers almost always come to an abrupt end. We cannot emphasise the importance of this simple idea strongly enough: politicians are not in the business of maximising social welfare; they are, and must be, in the business of getting elected.

Now add to this one of the central discoveries of cognitive psychology: people (also known as voters) tend to heavily discount the future (i.e. they will choose to accept a small amount of money today, over a larger amount a year from now). The implication is that any politician brave or foolish enough to fashion a campaign on the basis of what he or she is going to do for the electorates' grandchildren will lose to a candidate who campaigns on the basis of what he or she will do for the electorate *right now*.

If you put these basic insights together you can see why American politicians have strong incentives to frame policies that will result in the redistribution of income in the very near term. They have to offer an immediate solution to a problem that is salient to a broad swathe of the electorate, even if that solution might be counter-productive in the long run. If they fail to do so, they will be defeated by a candidate with far weaker scruples.

There was another important factor that favored mortgage lottery tickets over other inequality-reducing policies, such as educational investments – namely, lower political cost. The funding for the mortgage lottery tickets was not included in the federal budget. Politicians did not have to vote for on-budget expenditures that might raise the ire of taxpayers. Instead, they could provide a combination of mandates and protections that entailed substantial, but unrecognised, public expenditures.

The electorate, in the US and elsewhere, is all too susceptible to claims that government credit subsidies are free lunches. The temptation to make such claims is all the greater when government debts reach unsustainable levels. In the US, the overextended nature of federal government entitlement programmes and the unsustainable implied levels of future federal debts, have redoubled opposition against major new expenditure programmes of any kind. This will make it all the more attractive to pursue off-budget solutions to inequality.

A similar problem is now visible in the UK, which recently enacted its 'help to buy' programme of government mortgage guarantees. The UK's government – which has also been struggling to address problems of inequality in Britain – not coincidentally passed 'help to buy' while simultaneously enacting an austerity budget.

Unfortunately, mortgage credit subsidies often end badly for the poor, and therefore, can be a wasteful and short-sighted palliative for addressing inequality. They are no substitute for the creation of sustained improvements in the skills and job prospects of workers, and the promotion of competitive markets – including credit markets – that provide broad access to economic opportunities.

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