

Collective Action and Economic Justice: A Structural Approach

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Abstract

Adam Smith is well known for his description of how actions taken to further one's self-interest may benefit society. However, Smith emphasized that forbearance, which is the exercise of self-restraint while pursuing personal gain, is a necessary condition for the "invisible hand" to promote the common good. Using the recent subprime mortgage crisis as a case study, I argue that because forbearance is unlikely to result from personal choice or regulatory efforts, grassroots efforts by users of financial services are needed to ensure just outcomes in real estate lending.

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Introduction

One of the most misunderstood concepts in economics is Adam Smith's "invisible hand," which describes how actions taken by individuals to improve their welfare unintentionally benefit others. Although libertarians often cite this metaphor to justify *laissez-faire* economic policies, Smith (1759) recognized that social gains from market activities require self-restraint. As Jerry Evensky (1998) pointed out, Smith envisioned an evolutionary process in which the pursuit of self-interest could promote both moral and economic development. Smith, however, changed his mind after observing how businessmen and their supporters in Parliament used their power to profit at the public's expense. Thus, in his final revision of *The Theory of Moral Sentiments* (TMS), Smith urged business and political elites to lead by example through public acts of forbearance. Given the economic exploitation that characterized the Industrial Revolution soon after Smith's death, however, his message seems to have been largely ignored.

Although financialization has replaced industrialization as the dominant process for generating pecuniary gains, forbearance is perhaps even more critical today to ensure economic justice. Despite the widespread economic losses resulting from the subprime mortgage crisis, Wall Street operators continue to take speculative risks with little concern about the potential consequences to others. Moreover, despite legislation like the Dodd-Frank Act of 2010, regulations continue to be circumvented by creative financiers.¹ Thus, is there any way to restrain profit seeking in the absence of virtuous behavior or regulatory effectiveness?

This paper draws from several strands of institutional economics to address this question. Using a model developed by A. Allan Schmid (2004) that is based on the transactions approach pioneered by John R. Commons (1934), it argues that individual behavior can be shaped by institutional structure. In the case of housing finance, the paper recommends a shift to credit allocation by social values as defined by Charles Wilber and Kenneth Jameson (1990), to be initiated through collective action by citizens rather than by government mandate.

Ethics and the Subprime Mortgage Crisis

The ethical lapses that played a critical role in the recent crisis, such as predatory lending and issuing misleading credit ratings, have been widely discussed in the literature. It is important to emphasize that many of these questionable financial practices were not individual acts of avarice or fraud, but were standard practices that reflected the norms of the institutions in the industry. For this reason, A. Allan Schmid's (2004) Situation, Structure, and Performance (SSP) model of how different institutional structures affect economic outcomes provides an excellent framework for analyzing the sources of unethical behavior and their economic impact.² Formally, the model is:

Situation → Structure → Performance

in which for a given situation – which will be defined below – the model gauges how different institutional structures affect performance. What insights into unethical behavior during the subprime mortgage crisis does this model provide?

According to Schmid (2004, p. 16), “Situation refers to the inherent characteristics of goods and environments that affect human interdependence that must be sorted out by institutions giving order to human transactions.” As this quote suggests, the SSP model is

based on John R. Commons's (1934) notion that transactions are the fundamental units of analysis in economics. In the case of credit transactions, the most important situational condition is asymmetric information. A popular finance textbook (Mishkin and Eakins, 2012, p. 25) defines this as when "...one party does not know enough about the other party to make accurate decisions." Consistent with most discussions of asymmetric information, Mishkin and Eakins focus on lenders, who because borrowers know more than them about the likelihood of loan repayment, must incur information costs to screen loan applicants and to monitor borrowers after the loan has been made.

Next, Schmid (2004, pp. 17) defines structure as "...the institutional alternatives that people can choose to order the interdependencies created by the situation of various technologies." How has this changed for mortgage lending? According to former Federal Reserve official Edward M. Gramlich (2007, 2012), the relaxation of usury laws, the use of mathematical models to evaluate loan applicants, and the growth of securitization to spread risk contributed to explosive growth in subprime lending from 1993 to 2005. Many of these loans were initiated by unregulated brokers, were adjustable rate mortgages (ARMs) with low initial "teaser" rates, were made to borrowers who qualified only if home prices continued their explosive growth, and contained complex contractual provisions. If we redefine asymmetric information as differing levels of knowledge about the outcomes from loan contracts, these practices shift the informational disadvantage to borrowers. For example, ARMs shift interest-rate risk from lenders to borrowers, who are much less capable of predicting interest rate changes than bankers. Moreover, because borrowers are now more likely to default if interest rates rise, the lender securitizes the loan and transfers this burden to investors who may be unaware of the risks involved because of misleading

advice from credit ratings agencies plagued by conflicts of interest. Thus in modern real estate finance, because many lenders receive guaranteed payments and bear neither default nor interest rate risk, they completely avoid the asymmetric information problem.³

Finally, Schmid (pp. 19) describes performance as “who gets what.” The recent boom and bust of the U.S. residential real estate market also has been widely chronicled in both the popular press and in academic literature. The 9 percent average annual increase in home prices from 2000 to 2006 was approximately three times the growth rate during the 1990s, and the homeownership rate peaked at a record 69.2 percent in 2004. After 2006, however, prices plummeted sharply as millions of families found it difficult to meet their debt obligations. According to CoreLogic, there have been 4.4 million foreclosures since 2008, and although the latest report of 52,000 in May 2013 represents 27% decline from a year earlier, it is well above the U.S. average of 21,000 per month from 2001-2006.

The impact of home price declines and foreclosures was disproportionately borne by the middle class – especially black and Hispanic households - who had less wealth to weather these economic shocks and higher debt obligations (Bansak and Starr, 2011). Edward N. Wolff (2013) calculated that although median wealth in the U.S. fell 47 percent between 2007 and 2010, the middle class was more adversely affected because real estate – which declined 24 percent in value during this period – was a larger part of their asset portfolios than for the wealthy. According to McKernan et al (2013), Hispanic families suffered the largest decline of over 40 percent, while black households experienced the sharpest drop in their retirement assets (35 percent), since many were forced to sell their assets in a depressed market to make ends meet. The result of these

developments was a wider gap in wealth as the average net worth of white households reached six times that of black and Hispanic families in 2010.

This combination of risk shifting by financiers and the unjust distribution of the burdens of the financial crisis justify the need for structural changes in the U.S. housing finance system. To accomplish this, two questions must be addressed: What type of institutional adjustments should be made, and how can they be best implemented? Suggestions for each of these will be offered in the next two sections.

Forbearance and Structural Change in Mortgage Finance

As noted in the introduction, the benefits from Adam Smith's "invisible hand" can only be realized if market participants exercise self-restraint, a behavior largely absent during the formation of the housing bubble.⁴ For example, as Gramlich (2007, pp. 110) observed: "Why were the most risky loan products sold to the least sophisticated borrowers?" Further, even experienced investors were deceived, such as in the case of Goldman Sachs, who sold batches of mortgages selected by favored client John Paulson that were destined to fail so that Paulson could bet against them.

Thus, the degree to which transactors exploit informational advantages is important, and as Jens Beckert (2006) argues, forbearance is the key to ethical outcomes. Institutional economists provide useful definitions of forbearance. John R. Commons (1934, p. 19) argued that the dimensions of choice in transactions are performance, avoidance, and forbearance. He defined forbearance as "the choice of a lower as against a higher degree of power in the actual performance." Similarly, Richard McIntyre and Yngve Ramstad (2004, p. 307) wrote: "... the act of refraining from fully exercising one's market power over another despite one's legal right to do so, that is, the choice of

negotiating a transaction on terms less favorable to oneself than one is capable of obtaining legally in order to improve the terms from the perspective of the other transactor.

In order to encourage forbearance, we may return to Adam Smith for insight. In TMS, Smith argued that the sympathy (whose meaning is closer to the definition of empathy today) that one naturally feels towards others attenuates destructive self-interest. According to Smith, we implicitly place ourselves in the position of others and imagine how we would feel in their circumstances. Moreover, the closer we are to others, the sharper this imagination. For example, in his interpretation of Adam Smith, James R. Otteson (2002, pp. 183) discussed the Familiarity Principle, which claims that the degree of benevolence (which is related to forbearance) one feels towards others is a function of the knowledge that one has of them. Put somewhat differently, McIntyre and Ramstad (2004) argue that sympathy is a function of social distance.⁵

For this reason, a structural change that could promote forbearance in mortgage lending is to increase the penetration of community banking in this market.⁶ The findings from a recent study by a team of economists from the Federal Reserve Bank of St. Louis provide evidence to support this recommendation (Gilbert, Meyer, and Fuchs, 2013). This research attempted to isolate the factors that enabled some community banks to thrive during the recent crisis. Some of these are: (a) Closely held ownership, including mutual banking, rather than “absentee ownership” by shareholders; (b) An emphasis on “soft skills” in lending to build relationships with borrowers instead of using quantitative credit scoring models; (c) A focus on community engagement with the goal of long term development and viability rather than lending decisions that aim to boost short-term

profits; and (d) Conservative lending principles. This last point includes following business plans that leverage the bank's expertise and experience, deciding to forgo profits to maintain stability and solvency, and acting quickly when accounts become delinquent. It is also important to note that as a group, thriving community banks held a larger percentage of Community Reinvestment Act loans in their portfolios than poorer performers, suggesting that banking success was not necessarily a result of discriminatory lending. To summarize, thriving community banks in this study sample practice what Irene van Staveren (2013, 419-420) describes as "caring finance," which she defines as "taking a long-term perspective for sustaining these (financial) relationships, and it is concerned with reducing risk from the recognition that finance is vulnerable to a high degree of uncertainty and may affect people in many unexpected ways." In short, forbearance and caring finance are one in the same.

Conclusion

According to Charles K. Wilber and Kenneth P. Jameson (1990), resource allocation decisions can be made through market mechanisms, bureaucratic control, or guided by social values. Although their analysis was of the economic conditions of more than twenty years ago, their diagnoses also apply to recent banking practices. They wrote (1990, pp. 249):

At a fundamental level, the economic problems of the current day originate in a moral crisis and in an inability to control the resulting social conflict. The moral crisis has occurred because of the erosion of the moral base of society. The promotion of an individualistic culture of enterprise, the naïve reliance on government power joined with its use for personal goals, and the shift in the distribution of income toward capital which have characterized recent policies have destroyed any social consensus and have exacerbated social conflict.

Thus, Wilber and Jameson did not expect the self-interested to become virtuous overnight, nor did they have any faith that captured or outmaneuvered regulators could contain their impulses. Instead, they called for the establishment of a new moral consensus based upon what they call central moral values, which are stewardship, jubilee, and subsidiarity. What are these values, and how do they relate to housing finance?

Stewardship is a communitarian view of property rights in which it is morally acceptable for people to own and use property as long as doing so promotes the common good. Jubilee is an ancient Hebrew expression of mercy and compassion that often entails debt forgiveness. Real estate lending through community banks is more likely to promote these values than the activities of large, shareholder-driven banks or the broker/securitization model. As noted in the previous section, thriving community banks are often owned and managed by local leaders who often forgo profits from aggressive lending in favor of longer-term community development, and they are also more willing to work with troubled borrowers.

Perhaps the most important value is subsidiarity, which recommends solving social and economic problems at the lowest social levels. For example, the federal government should not address issues that can be effectively handled by families. Thus, purposeful change will be more successful if it begins at the community level instead of relying on the federal government to initiate reform. This is important because in the age of financialization, public officials are often more concerned about the economic health of banks than they are with households and nonfinancial businesses. Change could be initiated by groups of people who are organized by location, occupation, or other common bond in a “bottom-up” fashion. Community-based lenders are another alternative, with

organizations such as Self-Help, Neighborhood Housing Services, and the Massachusetts Affordable Housing Alliance all supplying affordable credit to lower and middle class households.⁷ The aforementioned community banks are another. However, the number of these banks continues to decline as the banking industry becomes more concentrated (Corner, 2010). What may be needed is greater efforts from community groups to “get the message out” about the benefits of “caring finance.”

In conclusion, a restructuring of housing finance requires achieving a difficult balance between individualistic and communitarian approaches. John Maynard Keynes (1926 (1952), pp. 344) summarized this dilemma well: “The political problem of mankind is to combine three things: Economic Efficiency, Social Justice, and Individual Liberty. The first needs criticism, precaution, and technical knowledge; the second, an unselfish and enthusiastic spirit which loves the ordinary man; the third, tolerance, breadth, appreciation of the excellencies of variety and independence, which prefers, above everything, to give unhindered opportunity to the exceptional and to the aspiring.” How these tradeoffs will be managed will differ by community; however, it is imperative that finance serves the public good rather than being a vehicle to advance the self-interest of the few.

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Endnotes

1. Simon Johnson (2009) describes a finance industry-government “oligarchy,” which like in Adam Smith’s time, furthers its own interests over those of the public.
2. Schmid’s SSP model is somewhat similar to the Industrial Organization (I-O) paradigm, or Structure - Conduct - Performance model, developed by Harvard economist Edward S. Mason (1939, 1949). Mason argued that economists could better explain price movements if they understood the institutional factors that shaped economic choices. The model is based on the observation that structure of an industry is a major influence on the behavior of buyers and sellers, whose interactions determine performance (Scherer (1980, pp. 2). Despite these similarities, Rutherford (2011, pps. 318-319) noted that Mason criticized institutionalists for failing to develop a more “general” theory.
3. See Prasch (2001) for further discussion of the separation of risk from return in the financial sector.
4. It should be noted that many borrowers acted unethically as well. However, this paper focuses on lenders only.
5. See Zalewski (2010) for more on mortgage lending, social distance, and ethics.
6. Bhidé (2010) also proposes structural changes in the banking system to promote prudent lending.

7. See Abromowitz and Ratcliffe (2010) for more details on these and other similar programs.