THE FREEDOM TO FAIL: MARKET ACCESS AS THE PATH TO OVERCOMING POVERTY AND INEQUALITY

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There are two views of markets. In one view of markets, held perhaps most famously by my former colleague Senator Warren, markets are a place where people are trapped, manipulated, and made worse off.[1] If they borrow money, they'll probably borrow too much that they won't be able to repay, and then they'll be out on the street. If they were allowed to choose their own school in a market system, they'd make the wrong choice, and so we have to make that choice for them. The other view of markets is that markets offer a chance. All real market choices involve risks. Sometimes people will fail, but sometimes they will win. They build businesses, their kids get better educations, and they escape poverty and move up the ladder economically.

I am an economist, a lawyer, and a law professor, so I'll address both law and economics. Economics has taught us that the ability to access credit markets is an absolute prerequisite to the formation of new businesses.[2] Most new jobs come from new small businesses.[3] For example, from 1980 to 2012—over a

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1. Paul Glastris, *Elizabeth Warren's Consolidation Speech Could Change the Election*, WASH. MONTHLY (June 30, 2016), http://washingtonmonthly.com/2016/06/30/elizabeth-warrens-consolidation-speech-could-change-the-election/ [https://perma.cc/PC7F-WMBP] (detailing Sen. Warren's view on markets and the United States economy in particular).

2. NAT'L FED. OF INDEP. BUS., RECOMMENDATIONS FOR IMPROVING SMALL BUSINESS CREDIT ACCESS AND FINANCIAL REFORM 2 (2009) ("Bank credit plays an important role in small business success. Without access to bank lending, small business owners would have trouble raising the funds they need to operate and grow their business.").

3. OFFICE OF ADVOCACY, SMALL BUS. ASSOC., FREQUENTLY ASKED QUESTIONS, 1 (Sept. 2009) (finding small businesses comprise 64% of net new private-sector jobs).

30-year period—average net employment growth in big businesses hovered around zero.[4] Net employment growth was entirely in smaller and newer businesses.[5]

The bad news is that employment in firms that are newer (less than five years old) fell from 18 percent of private-sector employment in 1981, and even 16 percent in 1988, down to twelve percent in 2012.[6] Why was that? There are a lot of factors, but certainly one factor has to be that we have not created conditions in credit markets, especially since the passage of the Dodd-Frank Act in 2010, that are favorable to creation of new businesses. Credit markets have tightened up and it has become much more difficult for new businesses to get outside capital.[7]

Most new businesses are not created by raising equity from friends and family. Outside capital is absolutely crucial to the creation of new businesses.[8] New businesses mean more jobs, and new businesses also mean new

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4. BUREAU OF LABOR STATISTICS, BUSINESS EMPLOYMENT DYNAMICS BY AGE AND SIZE OF FIRM (2016) http://www.bls.gov/bdm/business-employment-dynamics-data-by-age-and-size.htm [https://perma.cc/Z7J3-P9L2]. Table 2-A-F shows firms ten years or older with fifty or more employees, and net growth around zero since 1994. *Id.*

5. *See* BUREAU OF LABOR STATISTICS, MONTHLY LABOR REVIEW, HIGH-EMPLOYMENT-GROWTH FIRMS: DEFINING AND COUNTING THEM Tbl. 3 (June 2013), http://www.bls.gov/opub/mlr/2013/article/clayton.htm [https://perma.cc/V2U4-Y29J].

6. BUREAU OF LABOR STATISTICS, BUSINESS EMPLOYMENT DYNAMICS BY AGE AND SIZE OF FIRM (2016) http://www.bls.gov/bdm/bdmage.htm [https://perma.cc/KH4M-YZZ]. Table 6 shows firms younger than five years with approximately 12% of private sector employment in 2012. *Id.*

7. Peter J. Wallison, *Is the Dodd-Frank Act Responsible for the Economy's Slow Recovery from the Financial Crisis and the Ensuing Recession?* 7 (Am. Enter. Inst., Working Paper, 2015), https://www.hillsdale.edu/wp-content/uploads/2016/02/FMF-2015-Dodd-Frank.pdf [http://perma.cc/H3FM-JZ9E] ("Because of their unique role in local economies, increases in the costs of community banks and tightening credit standards after Dodd-Frank are particularly bad news for small business start-ups.").

8. Bill Fay, *Sources of Financing for Small Business*, DEBT.ORG, https://www.debt.org/small-business/sources-financing/ [https://perma.cc/2ZEZ-QVRA] ("Approximately 80 percent of the estimated 27.5 million U.S. small businesses . . . use some form of *credit to help finance their operations*.").

entrepreneurs. And entrepreneurship is a major way that people move up the economic ladder.[9]

So where do people get the capital? How do you get outside capital to start a new business? You need collateral and you have to be able to borrow.[10] What are two ways that economists know small businesses get going? The first important way businesses are started is by using collateral in homes: people take out home equity lines of credit.[11]

The second way is credit card debt.[12] A huge fraction—54 percent—of new businesses are using personal credit cards to finance the business.[13] Not business credit cards, but personal credit cards. Senator Warren looks at credit cards, and she sees people in bankruptcy who have made a lot of bad financial decisions including in how they use their credit cards. In response, the CARD Act[14] was passed. The CARD Act mandates certain terms in credit card contracts and forbids others. The net effect of these restrictions on contractual choice has been that it is more difficult for people to get credit cards. As a result, it is surely true that some consumers are paternalistically prevented from running up credit card debts that they can't pay. But another consequence, forgotten by

9. Jon Thurber, *Inequality is not the issue – growth is*, UCLA NEWSROOM (Dec. 3, 2015), http://newsroom.ucla.edu/stories/inequality-is-not-the-issue-growth-is [https://perma.cc/SR3X-KYWA].

10. Justin Pritchard, *Collateral Loans*, ABOUT MONEY (Mar. 15, 2016), http://banking.about.com/od/businessbanking/a/personalguarantee.htm [https://perma.cc/8EG7-PKWX].

11. *See generally* FED. TRADE COMM'N, USING YOUR HOME AS COLLATERAL (2012).

12. Marco Carbajo, *Which Unsecured Business Lines of Credit are Best for your Business?*, SMALL BUS. ASS'N INDUS. WORLD BLOG (May 21, 2014), https://www.sba.gov/blogs/which-unsecured-business-lines-credit-are-best-your-business [https://perma.cc/B3WQ-25D8].

13. *See* Tamara E. Holmes, *Used wisely, small-business cards can keep business afloat*, CREDIT CARD NEWS, http://www.creditcards.com/credit-card-news/small-business-credit-cards-1269.php [https://perma.cc/K26J-YWUA] (finding that 31% of small businesses used credit cards for financing needs in the past twelve months).

14. Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act), Pub. L. No. 111-24, 123 Stat. 1734 (codified at various sections of titles 15 and 16 of the U.S. Code).

parternalists, is that it is more difficult for people to get credit cards that can be used for starting new businesses.[15]

What about home equity? How do you get home equity? Well, you get a loan, a mortgage. What have we done with the Dodd-Frank Act?[16] As interpreted by the Consumer Financial Proetection Bureau (CFPB), that law's requirement that lenders make loans only to people with a reasonable ability to repay has wiped out the market for mortgages for young people, for minorities, and for anybody who doesn't have an established credit history. We have eliminated the subprime mortgage market. Is that a bad thing for income and wealth mobility and for the creation of new businesses? Yes, it is.[17]

A couple of very recent studies have reinforced this conclusion. During the 2000s, the rate of new business formation was the greatest in places where home prices were increasing.[18] Another study found that every ten percent increase in home equity increased the probability that a household would become entrepreneurial by fourteen

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15. *See* Ralph F. McDonald III et al., *The Credit Card Act of 2009 – Changes will Affect Consumers, Card Issuers, Retailers, Colleges, and Investors*, JONES DAY PUBL'NS (June 2009), http://www.jonesday.com/the-credit-card-act-of-2009—changes-will-affect-consumers-card-issuers-retailers-colleges-and-investors-06-10-2009/ [https://perma.cc/3XYV-NDNQ] (finding that card issuers would "[r]educ[e] credit availability except to the most credit-worthy customers . . . .").

16. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) (codified in sections of titles 7, 12, 15, and 22 of the U.S. Code).

17. *See* Karen Gordon Mills & Brayden McCathy, *The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game* 4–5 (Harv. Bus. Sch., Working Paper No. 15-004, 2014) (suggesting that "regulatory overhang" may be contributing to a "small business credit gap"); *see also* Janet L. Yellen, Chair, Bd. Of Governors of the Fed. Reserve Sys., *Transcript of Chair Yellen's FOMC Press Conference* 22 (Dec. 17, 2014) https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20141217.pdf [https://perma.cc/DVF7-2RCG] (attributing anemic housing growth to "very tight credit—continuing tight credit conditions for any borrower that doesn't have pristine credit").

18. *See* Manuel Adelino et al., *Housing Prices, Collateral and Self-Employment*, 117 J. FIN. ECON. 288, 289 (2015) (finding that "during the housing price boom of 2002-2007, areas with rising house prices (and increased leverage) experienced a significantly bigger increase in small business starts and a rise in the number of people who were employed").

percent.[19] When you restrict mortgages, you restrict the ability of people to acquire capital in their homes.[20] If people cannot acquire capital, a very important source of collateral for getting a loan to start a new business has disappeared.[21]

Why did Congress enact the Dodd-Frank Act? Because people looked around after the fact and saw that a large number of people defaulted on their mortgages at the end of the early twenty-first century housing boom.[22] But the major increase in mortgage delinquencies was not among lower income borrowers, but among higher income borrowers who were speculating on rising housing prices.[23] Was there fraud in the subprime mortgage market? Yes, there was fraud in the

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19. *See* Stefano Corradin & Alexander Popov, *Home Prices, Home Equity, and Entrepreneurships* 5 (European Cent. Bank, Working Paper No. 1544, 2013) https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1544.pdf?fa04c22695 e5cb3ff81e7195452402d5 [https://perma.cc/F4PJ-HXTT] ("A 10% increase in home equity increases the probability that a non-business owning household will switch to entrepreneurship in the future by up to 14%.").

20. *See* Alan Kronovet, Note, *An Overview of Commercial Mortgage Backed Securitization: The Devil Is in the Details*, 1 N.C. BANKING INST. 288, 288 (1997) (explaining how securitization structures like home mortgage allow individuals "to gain access to the capital markets"). One way the Dodd-Frank Act restricts mortgage availability is by consolidating the banking system. *See* HESTER PEIRCE & STEPHEN MATTEO MILLER, MERCATUS CTR., SMALL BANKS BY THE NUMBERS, 2000-2014 (2015), http://mercatus.org/publication/small-banks-numbers-2000-2014 [https://perma.cc/J9H5-BAWU] ("Since 2Q 2010—immediately before the July passage of Dodd-Frank—to 3Q 2014 . . . , the United States lost 14 percent of its small banks.").

21. *See* Corradin & Popov, *supra* note 19, at 33 (finding an a strong positive correlation between "the increase in (particularly mortgage) debt" and new business formation, suggesting "that once agents switch from a fixed-income job to entrepreneurship, they draw down their home equity to finance their business investment, confirming that real estate is indeed efficient collateral").

22. Charles W. Murdock, *The Dodd-Frank Wall-Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Succeed in Preventing Future Crises?*, 64 S.M.U.L. REV. 1243, 1244 (2011) (observing that Dodd-Frank was passed in response to the "cascade of mortgage defaults" that occurred in the Great Recession).

23. *See* Jason Scott Johnston, *Do Product Bans Help Consumers? Questioning the Economic Foundations of Dodd-Frank Mortgage Regulation*, 23 GEO. MASON L. REV. 617, 692 (2016) (citing Manuel Adelino et al., *Loan Originations and Defaults in the Mortgage Crisis: The Role of the Middle Class* 13 (Nat'l Bureau of Econ. Research, Working Paper No. 20848, Jan. 2015), http://nber.org/papers/w21320.pdf [http://perma.cc/XVA2-LCHC].

subprime mortgage market.[24] But, under the common law, fraud is a defense to contract enforcement,[25] and fraud is a tort.[26] We didn't need the Dodd-Frank Act to deal with fraud; we've always known that active fraud is going to hurt people. Dodd-Frank was premised on a much different model of human behavior: a view that people are not smart enough to make the right choices; therefore, they should not be allowed to choose at all.[27] Just like with credit cards, Dodd Frank is based

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24. *See* FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 161 (2011) https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [https://perma.cc/BT5A-7KXB] ("Ed Parker, the head of mortgage fraud investigation at Ameriquest, the largest subprime lender in 2003, 2004, and 2005, told the FCIC that fraudulent loans were very common at the company. 'No one was watching. The volume was up and now you see the fallout behind the loan origination process.'"); *see also* JOHN MAULDIN & JONATHAN TEPPER, ENDGAME: THE END OF THE DEBT SUPERCYCLE AND HOW IT CHANGES EVERYTHING 23 (2011) (attributing part of the subprime mortgage crisis to "ratings agencies, who should have been the cops but were handing out fake IDs to issuers").

25. *See* RESTATEMENT (SECOND) OF CONTRACTS § 166 (1981) ("If a party's manifestation of assent is induced by the other party's fraudulent misrepresentation as to the contents or effect of a writing evidencing or embodying in whole or in part an agreement, the court at the request of the recipient may reform the writing to express the terms of the agreement as asserted . . . .").

26. *See* RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM § 9 (Tentative Draft No. 2, 2014) ("One who fraudulently makes a material misrepresentation of fact, opinion, intention, or law, for the purpose of inducing another to act or refrain from acting, is subject to liability for economic loss caused by the other's justifiable reliance on the misrepresentation.").

27. Senator Dodd illustrated his view that the 2008 financial crisis was the result of predatory lending, not just informational asymmetries, with the story of an elderly librarian named Delores King:

> Delores King was given a mortgage [that the bank] kn[ew] she could not pay, she was on a fixed income, they knew it would balloon to the point that it would consume 70 percent of her income—don't tell me they did not know what that was. And expecting that 80-year-old woman to read and understand all she was going to be subjected to in the fine print of the mortgage contract is ridiculous. Yet that is how this daisy chain worked and why we ended up in the mess we did.

156 CONG. REC. S3002 (Apr. 30, 2010) (statement of Sen. Dodd); *see also* Johnston, *supra* note 23, at 637 (characterizing the Dodd-Frank mortgage regime as one of complex, "de-facto restriction[s] on the types of mortgage products offered to consumers"); *id.* at 652 (stating that Dodd-Frank "aims at restricting consumer choice by ridding the market of certain types of loans").

on the view that consumers should not be allowed to take certain types of market risks.[28]

So, in these two areas, we have done exactly the wrong thing. Instead of harnessing market forces and making credit more available to people who are going use it to start new businesses and create jobs that benefit not just themselves but all the people they employ, we have done the opposite. We have been moving in the wrong direction at a rapid pace, though it has slowed in recent years as the political constellations have changed.[29] These laws prevent people from accessing the market in a way that can help overcome both poverty and inequality.[30]

In addition to accumulating financial wealth through the creation of new businesses, another way that people overcome poverty is through the accumulation of human capital: education. Here too we have restricted choice in a way that perpetuates poverty. Centralized policies have denied to poor parents a market choice of which schools their children may attend. We know such a choice has not been made widely available; we also know that it is what parents want and that it should happen.[31] Eighty percent of the African-American families in Philadelphia want their kids to have to have a

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28. *See, e.g.*, 15 U.S.C. § 1639c (2012) (banning certain loans to consumers that lack "a reasonable ability to repay"); *see also* 12 U.S.C. § 5481 (2012) (establishing the Bureau of Consumer Financial Protection with rulemaking authority over credit cards); 12 C.F.R. § 1026.15 (2013) (prohibiting issuance of certain credit cards "unless the card issuer considers the consumer's ability to make the required minimum periodic payments").

29. *See, e.g.*, Elise Gould, *Even the Most Educated Workers Have Declining Wages*, ECON. POL'Y INST. (Feb. 20, 2015) http://www.epi.org/publication/even-the-most-educated-workers-have-declining-wages/ [https://perma.cc/7JCA-VKAN] (finding that "among education categories, the greatest real wage losses between 2013 and 2014 were among those with a college or advanced degree").

30. *See* *Over-regulated America*, ECONOMIST, (Feb. 18, 2012) http://www.economist.com/node/21547789 [https://perma.cc/P7TG-2NLD] (questioning why "the jobless rate isn't even higher" after enactment of "partly unintelligible and partly unknowable" legislation like Dodd-Frank).

31. John E. Chub & Terry M. More, *Politics, Markets, and the Organization of Schools*, 82 AM. POL. SCI. REV. 1065, 1085 (1988) (determining that a "voucher system, combining . . . decentralization of resources and choice, is at least a reasonable alternative to direct control—one that might transform the public schools into different, more effective organizations, while still leaving them truly public").

choice in what school to attend.[32] But they are not given that opportunity because the teacher's unions have invested enormous amounts to erect legal obstacles to such parental choice.[33] Those obstacles have to be removed. Now more than ever, investing in human capital is the surest path to intergenerational movement up the income and wealth ladder. Obstacles to market choice in education have to be removed.[34]

Instead of opening up markets and making them accessible to people so that they can be an engine for overcoming poverty and inequality, we have done exactly the opposite.[35] And why? There is a tendency of both lawyers and politicians to consider selected stories—sad stories sometimes—of people who've failed.[36] They look at stories of failed choices and jump to the conclusion that the solution is to prevent people from making choices in the first place.

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32. Kelsey Hamilton, *What are parents thinking about charter schools?* AEIDEAS (April 28, 2016, 4:55 PM), http://www.aei.org/publication/what-are-parents-thinking-about-charter-schools/ [https://perma.cc/GJ5W-U3BG]; *see also* BLACK ALL. FOR EDUC. OPTIONS, *New Survey Shows Black Voters Strongly Support Parental Choice for Educational Options in Their Communities*, (August 2015), http://www.baeo.org/?ns_ref=11&id=7335 [https://perma.cc/4TPB-L64P] (surveying "2,400 Black voters in four states" with the result being "7 out of 10 say they support . . . more educational choices" and "6 in 10" favoring school vouchers).

33. *See, e.g.*, Cain v. Horne, 202 P.3d 1178, 1185 (Ariz. 2009) (en banc); Bush v. Holmes, 919 So.2d 392, 396, 398 (Fla. 2006) (siding with the American Federation of Teachers that a Florida school voucher program violated the state constitution); *see also* Joel Klein, *The Failure of American Schools*, ATLANTIC (June 2011), http://www.theatlantic.com/magazine/archive/2011/06/the-failure-of-american-schools/308497/ [https://perma.cc/AFY4-MV72] ("As Albert Shanker, the late, iconic head of the [United Federation of Teachers], once pointedly put it, 'When schoolchildren start paying union dues, that's when I'll start representing the interests of schoolchildren.'").

34. *See* Michael Greensone et al., *Thirteen Economic Facts about Social Mobility and the Role of Education*, HAMILTON PROJECT (2013) http://www.brookings.edu/~/media/research/files/reports/2013/06/13-facts-higher-education/thp_13econfacts_final.pdf [https://perma.cc/5T37-2CN6] (discussing the importance of education in climbing out of poverty).

35. *See* Amendments to the 2013 Mortgage Rules Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 44,686, 44,711 (Jul. 24, 2013) (to be codified at 12 C.F.R. parts 1024, 1026) (agreeing that "the expense associated with obtaining [business credit] reports . . . could increase the cost of credit or restrict access to credit for self-employed consumers"); *see also supra* notes 27–28 and accompanying text.

36. *See, e.g.*, *supra* note 27 and accompanying text.

You have to look at the situation in a different way and take a different perspective. You have to look at the people who took chances and succeeded. How often do you hear those stories? Taking chances and succeeding is the engine of growth. It is the engine for overcoming inequality and poverty.[37] And it is where we have to focus.

37. *See* Martin Zwilling, *How to Balance Risk Versus Opportunity*, FORBES (Jan. 14, 2014, 10:06 P.M.), http://www.forbes.com/sites/martinzwilling/2014/01/16/how-to-balance-business-risk-versus-opportunity/#f92a4e736f75 [https://perma.cc/9UFH-7X8X] ("There is no real business opportunity without risk.").