Why and when does a social planner want debt relief?

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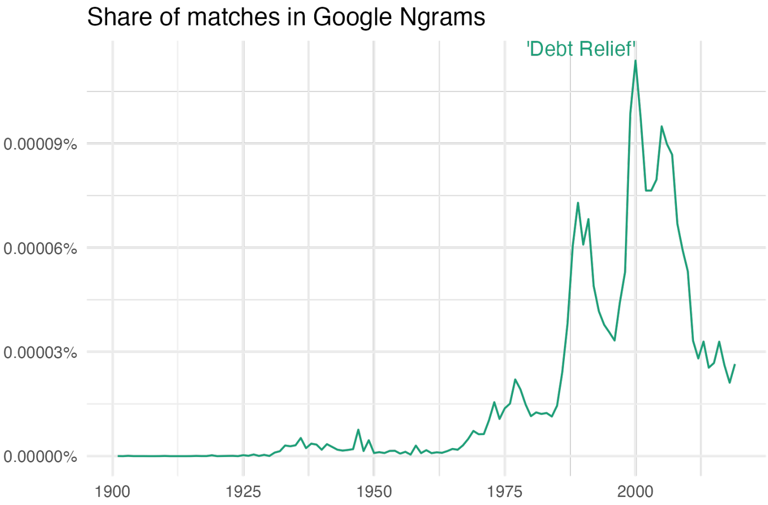
What is debt relief?

- Today’s talk: argue that debt relief can be a valuable tool for a social planner
- However, debt relief as a term is overloaded (“polysemous”)
  - Different versions of debt relief have different implications for the social planner
- The social planner needs to articulate the goal
  - Then, design features of relief will either help or hinder that goal

Where does the term “debt relief” come from?

- “Debt relief” as a term is very new in the grand scheme of things



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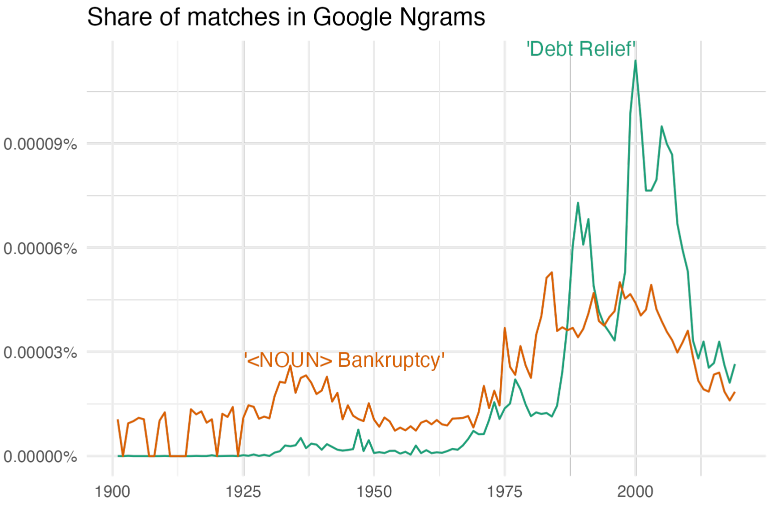
- Contrast with bankruptcy



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- Comes from the sovereign debt crises in developing nations

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Conditionality, Debt Relief, and the Developing Country Debt ...

Jeffrey Sachs · 1988 · Snippet view

This paper raises several cautionary notes regarding high-conditionality lending by the International Monetary Fund and the World Bank in the context of international debt crisis.

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Conditionality and Debt Relief - Issue 213

Stijn Claessens · 1989 · Snippet view

To restore growth in highly indebted countries, debt reduction alone is not as efficient as simultaneously providing liquidity, debt reduction, and possibly conditionality.

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Debt Relief Plays Key Role in Helping Sub-Saharan Africa

1990

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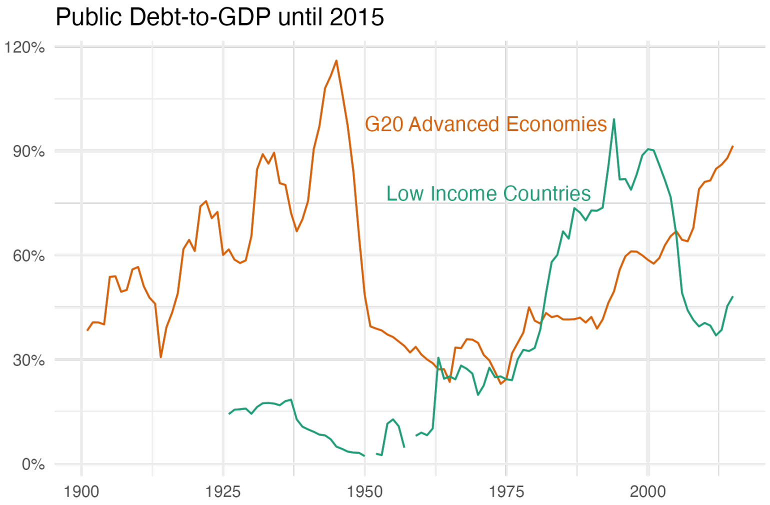


Household debt relief falls into many settings

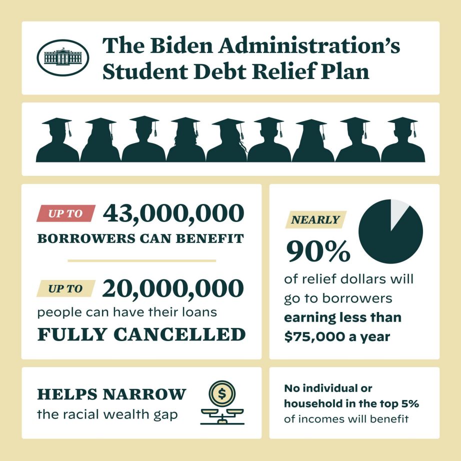
1. Medical Debt
   - Example: *RIP Medical Debt*
   - Medical debt forgiven either by hospitals or by being purchased from third-party debt collectors

Household debt relief falls into many settings

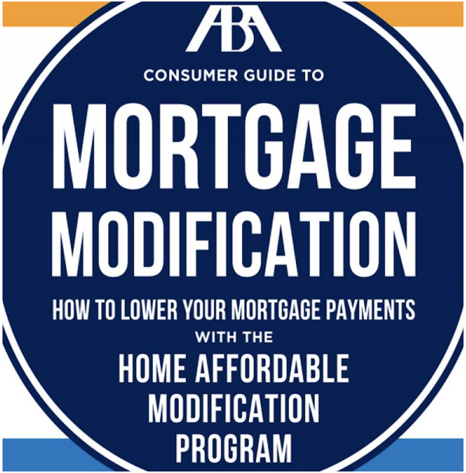
2. Consumer Bankruptcy
   - Unilateral discharge for most debt (in U.S.)
   - Legislated by government

Household debt relief falls into many settings

3. Student Debt
   - Historically in U.S.: forgiveness after 10 years of income-based repayment
   - Now in U.S.: expanded forgiveness programs



Household debt relief falls into many settings



4. Home Affordable Modification Program
    - Modification of underwater mortgages
    - Reduction of payments and mortgage balances

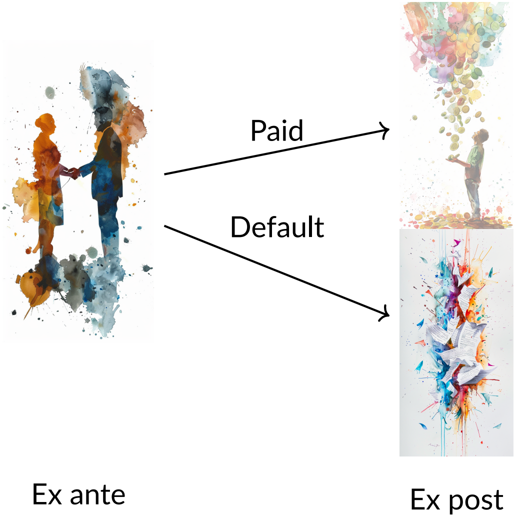
What is debt relief?

- A *debt* is an obligation to pay a creditor
  - Terms are agreed upon by the creditor and debtor
  - Contracts may be legally limited (Local Loan Co. v. Hunt)

What is debt relief?

- *Default* is a failure to repay the debt
  - A function of the debtor's ability to repay and the potential punishment for default
  - Default can be welfare-improving when markets are incomplete (e.g. Dubey, Geanakoplos and Shubik 2005)

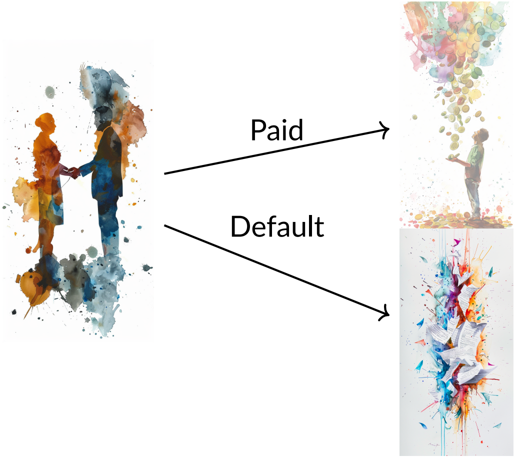
"If thou wilt lend this money, lend it not
As to thy friends, for when did friendship take
A breed for barren metal of his friend?
But lend it rather to thine enemy,
Who, if he break, thou mayst with better face
Exact the penalty."
— Antonio, The Merchant of Venice



What is debt relief?

- *Debt relief* is process in which the debtor is relieved of some or all of their obligations to the creditor
  - This forgiveness is (typically) not initially agreed upon
  - This is a *net* forgiveness – often creditors are repaid something from existing assets
  - Distinct from debt repudiation

- Distinction between default and debt relief only matters for continuation value



Ex ante

Ex post

How can we categorize debt relief?

- What are the (non-exclusive) goals of debt relief?
  1. insurance
  2. redistribution
  3. *macroeconomic* stimulus / stabilizer
- Ignoring political economy considerations (e.g. Gyöngyösi and Verner (2022))

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- How is the relief designed?
  1. Planned vs. unplanned (Systematic vs. bespoke)
  2. Unilateral vs. bilateral
  3. Direct vs. indirect financing
  4. Extinguishing vs. restructuring

Consumer bankruptcy as an example

- The U.S. consumer bankruptcy system as a backstop for debt relief
  - U.S. system is generous compared to other countries

- Ingredients of the U.S. system:
  1. Creditors bear the direct costs
  2. Current unprotected assets are used to repay creditors
  3. Bankruptcy is available to everyone, but only every 8 years
  4. Debt relief applies to (almost) all creditors

- Goal of system:

  "provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy 'a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." – Grogan v. Garner

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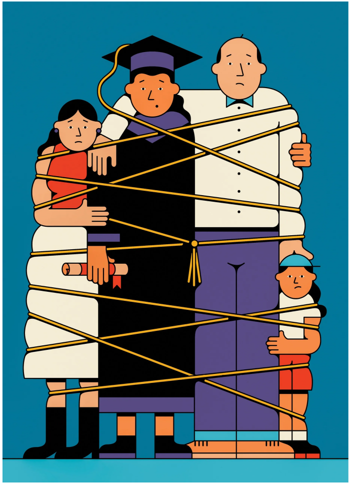
- Goal of system:
  - insurance against bad states of the world
  - remove debt overhang

Consumer bankruptcy as an example

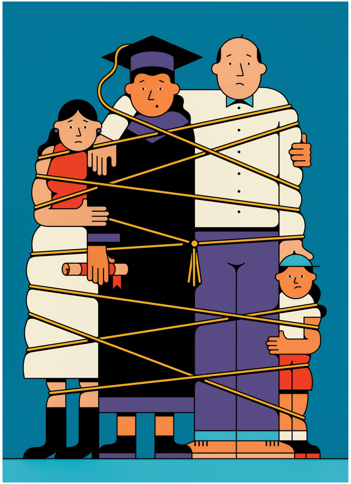
- How is bankruptcy designed?
- **Planned** vs. unplanned
  - The bankruptcy system is pre-established legal system known by creditors and debtors when debt is agreed upon
- **Unilateral** vs. bilateral
  - All debts are simultaneously dealt with
- Direct vs. **indirect** financing
  - Creditors bear the costs
- **Extinguishing** vs. *restructuring*
  - Debts are extinguished (Ch. 7) and restructured (Ch. 13)

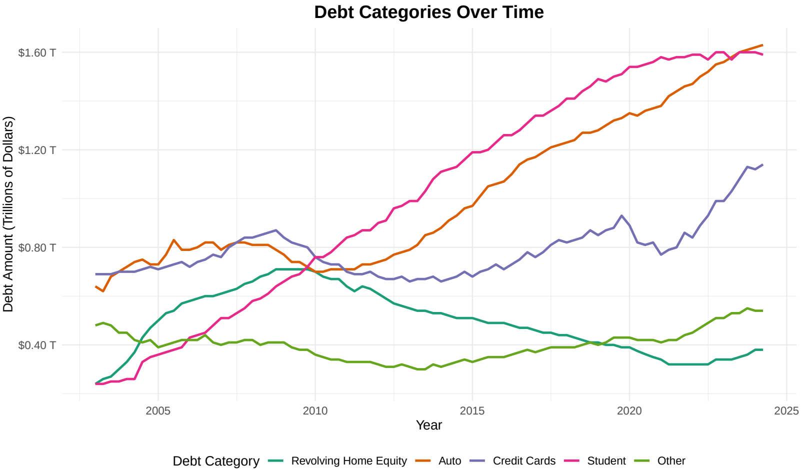
Student debt forgiveness as an example



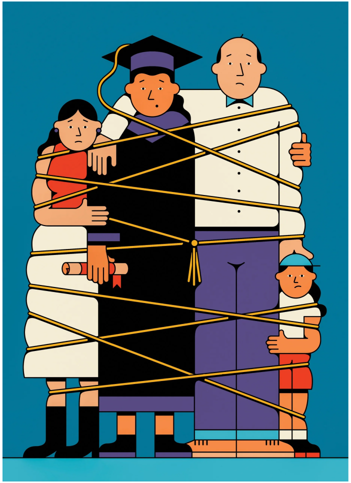
- 92% of U.S. student loans are federal
- Student debt relief has taken several forms in U.S.
  - Historically: forgiveness after 10 years of income-based repayment
  - Now: expanded forgiveness programs
  - Targets defrauded students, public service workers, teachers

Student debt forgiveness as an example





U.S. Student debt forgiveness as an example



- How is student debt relief designed?
- *Planned* vs. **unplanned**
  - Income-based repayment partially planned, but significant new one-time relief in Biden administration
- Unilateral vs. *bilateral*
  - Only addresses student debt
- **Direct** vs. indirect financing
  - Taxpayer pays
- **Extinguishing** vs. restructuring
  - Debt directly forgiven

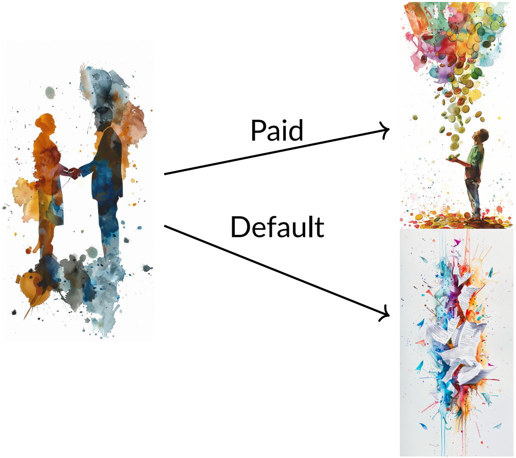
Insurance trade-offs of debt relief

- The two sides of the coin: *ex ante* and *ex post* considerations

- The value from default (and forgiveness) is a form of insurance against bad states of the world
  - Job loss triggers negative income shock which triggers default

- If they anticipate default + forgiveness, creditors charge everyone for this insurance (even those who don't default)

- This insurance can be valuable due to *incomplete* markets for other things (e.g. job loss, health shocks)



Before

After

Insurance trade-offs of debt relief

- The ability to default raises concern that borrowers will strategically default when it is in their interest
- **Empirical question:** how much does debt relief exacerbate moral hazard?
  - In housing context, Ganong and Noel (2023) argue that adverse events drive 97 percent of defaults (limited direct moral hazard)
  - In bankruptcy, Indarte (2023) estimates that 83% of filing response is from liquidity issues

Insurance trade-offs of debt relief

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  - In housing context, Ganong and Noel (2023) argue that adverse events drive 97 percent of defaults (limited direct moral hazard)
  - In bankruptcy, Indarte (2023) estimates that 83% of filing response is from liquidity issues
- How much does the chance of default/debt relief affect the cost of credit?
  - If creditor financed, distortionary
  - If gov't financed, similar to taxation
  - However, then moral hazard / adverse selection from *creditors* can be an issue

What do we know about the effects of debt relief on credit costs?

- Estimating the *ex ante* effects of debt relief on the full market is hard

- Gross, Kluender, Liu, Notowidigdo, and Wang (2021) study national law change in bankruptcy severity
  - 2005 BAPCPA reform made bankruptcy more challenging
  - How did creditors respond?

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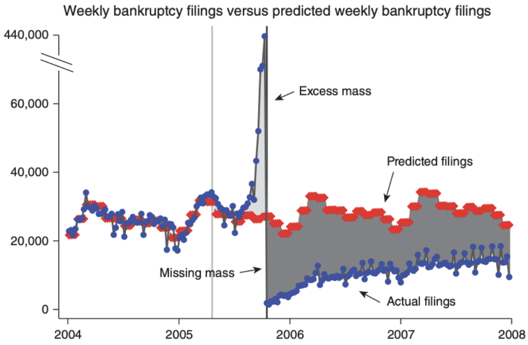

FIGURE 2. EXCESS AND MISSING MASS OF BANKRUPTCY FILINGS

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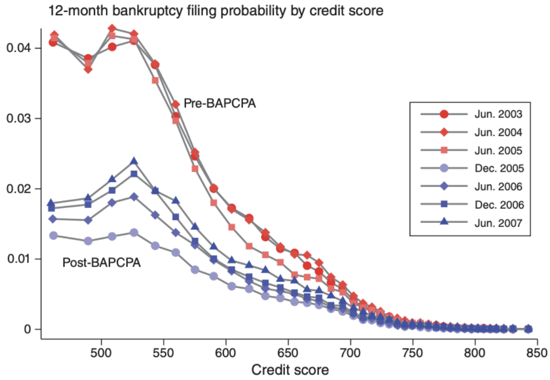

Figure 4. Probability of Bankruptcy

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- Gross, Kluender, Liu, Notowidigdo, and Wang (2021) study national law change in bankruptcy severity
  - 2005 BAPCPA reform made bankruptcy more challenging
  - How did creditors respond?
- Implication: creditor costs *are* distorted by bankruptcy debt relief

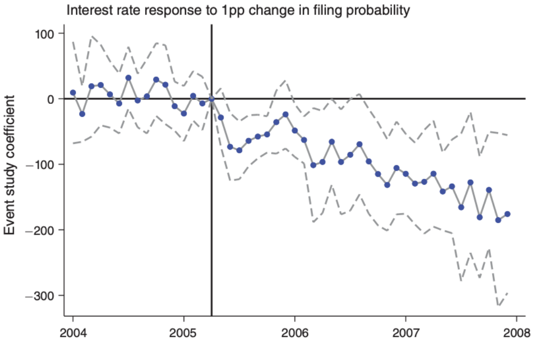
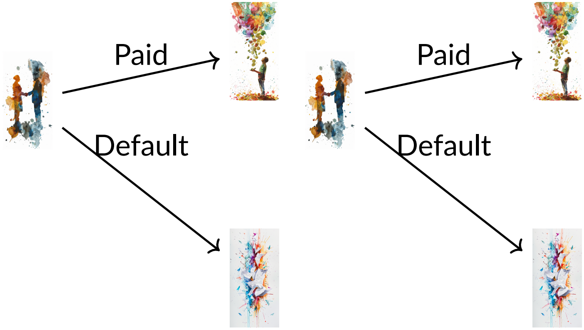


FIGURE 5. EFFECT OF DECLINE IN FILING PROBABILITY ON OFFERED INTEREST RATES

Debt relief is not a one-shot event

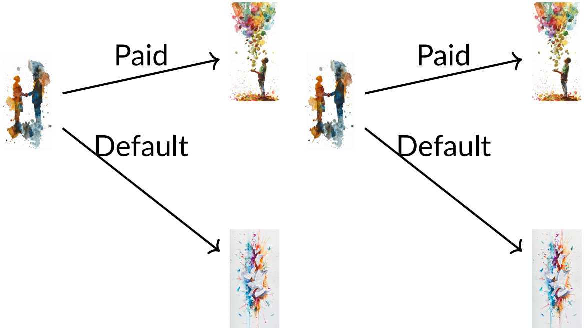
- In reality, credit is not a one-shot game
  - Many repeated interactions
  - E.g. credit reports and scores
- Debtors face potential consequences of debt relief in the future
  - Tool for creditors to prevent default – “exclude” borrowers from credit
  - E.g. negative flags on credit report
- *Social planners* also face consequences of debt relief
  - When a social planner forgives debt, they are also changing the incentives for future lending
  - What is probability it will happen again? Pre-commitment



And so on...

Debt relief is not a one-shot event

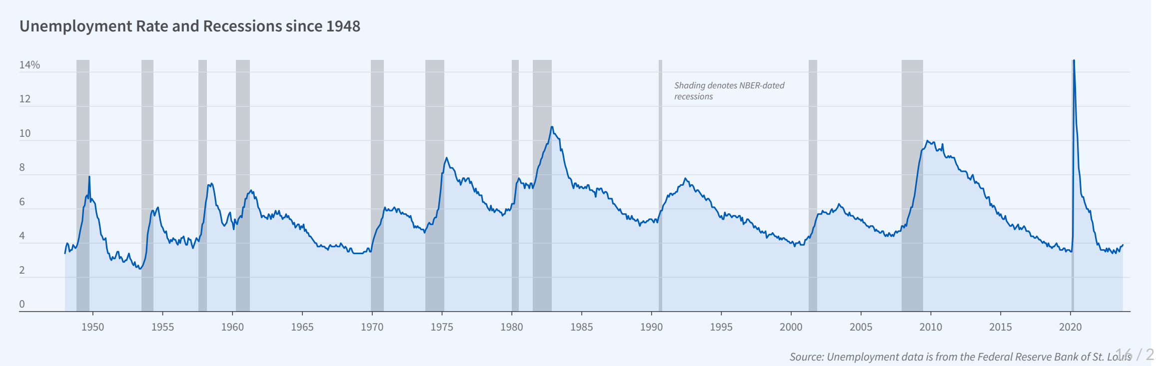
- Systematic relief (e.g. bankruptcy) creates certainty
  - This can create significant costs
  - But also certainty of protections for consumers
- Question of whether underlying economic issues are being addressed
  - “I can get no remedy against this consumption of the purse. Borrowing only lingers and lingers it out, but the disease in incurable.” Falstaff, Henry IV, Part II



And so on...

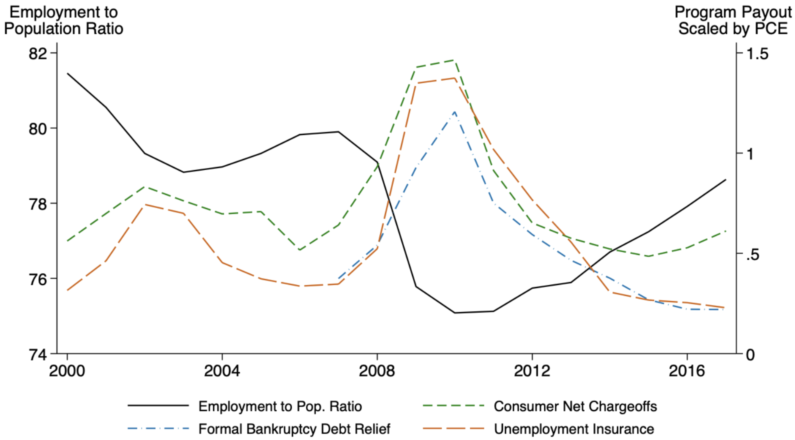
What about aggregate effects?

- Benefit of debt relief *to society* can be higher when times are bad
- If recessions coincide with debt overhang, debt relief can be a useful tool to alleviate demand collapse
- However, this is a double-edged sword
- If debt relief is anticipated, it can lead to more borrowing in good times, and more default in bad times



What about macroeconomic effects?

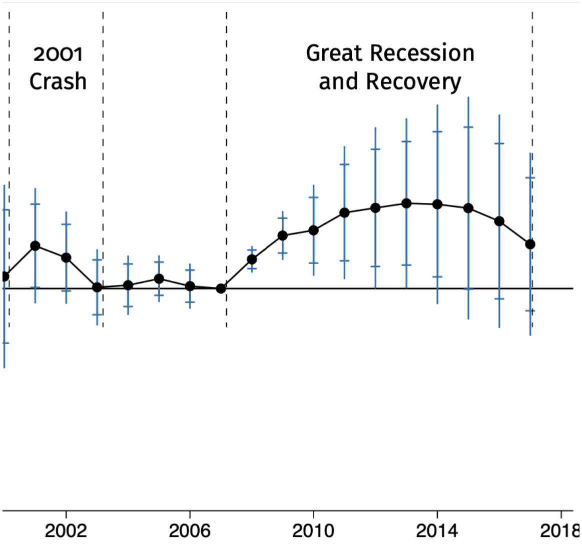
- During the Great Recession, consumer debt relief was a potential policy tool
- Not just individual, but *aggregate* benefits from discharge – aggregate demand shortfalls, and credit contraction



What about macroeconomic effects?

- Auclert, Dobbie and Goldsmith-Pinkham (2023) show that high protection states had a smaller decline in non-tradable employment and more local debt charge-offs compared to low protection states
    1. Debt forgiveness to borrowers is high value when there is an aggregate demand shortfall – borrowers have highest MPC
    2. The larger the debt relief, the less effective it is

- Bankruptcy as automatic stabilizer



non-tradable employment

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- Bankruptcy as automatic stabilizer

- Similar in Hungary from debt increase in Verner and Gyöngyösi (2020)

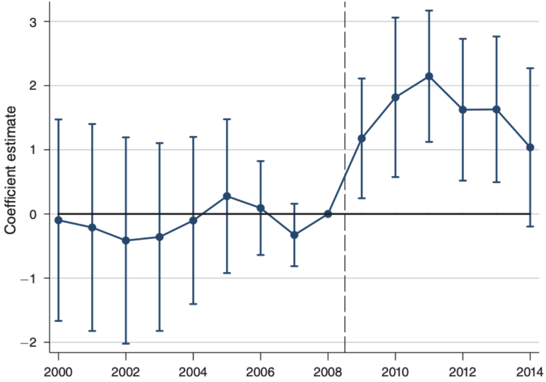
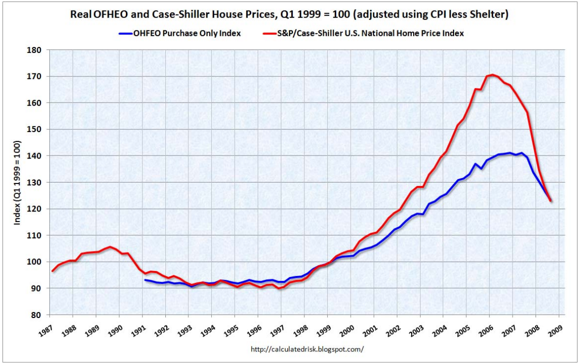


FIGURE 5. FOREIGN CURRENCY DEBT EXPOSURE AND UNEMPLOYMENT

unemployment

What about macroeconomic effects?



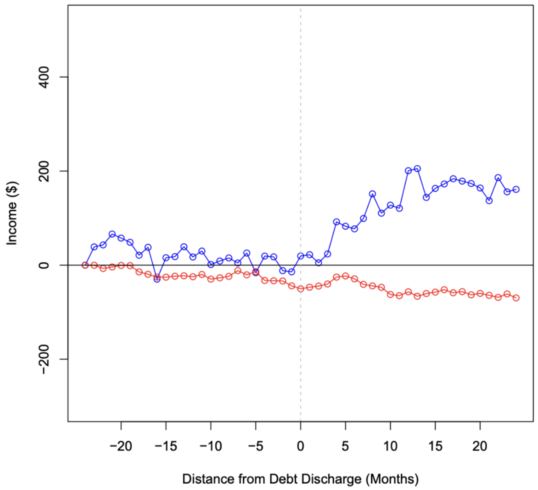
- Alternative goals for debt relief include asset price stabilization
  - Prevention of foreclosures in order to avoid additional declines in housing prices
- Ganong and Noel (2020) estimate that payment reductions from HAMP reduce default (but principal reductions do not)
- Agarwal et al. (2017) estimate reduction of 600,000 fewer foreclosures from HAMP
- Kyotama (2023) estimates a 3% reduction in foreclosures from HAMP

Redistribution as a goal

- What is goal of student debt forgiveness?
    1. Government is (usually) the creditor
    2. Effectively a transfer from taxpayers to student debtors

- **Empirical question:** does the transfer have any broader benefits?

- Di Maggio, Kalda and Yao (2020)
    - 0.003 percent increase in mobility and job changing, 0.01 percent increase in income. Not big!



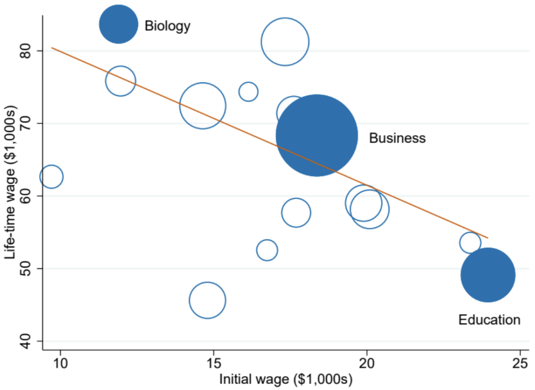
Limited efficiency benefits for student debt

- Impacts of debt relief for students are likely higher if done before investment decisions

- Hampole (2024) finds that colleges with universal no-loan policies have students who have:
    1. less student debt
    2. majors with lower initial wages
    3. majors with higher long term wages and higher variance

- Consequence of "one-shot" unanticipated debt relief – investment decision not structured in anticipation of transfer

Figure 7: The Intertemporal Trade-off in Major Choice



(A) Two-digit majors

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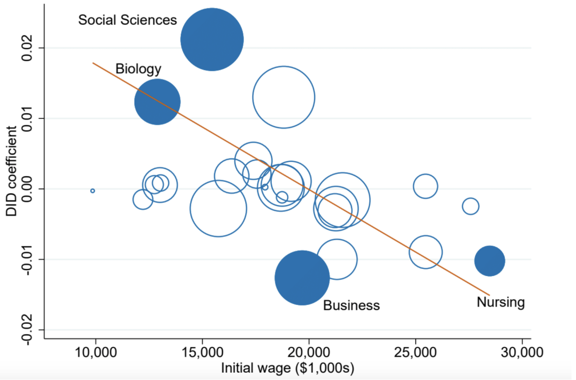
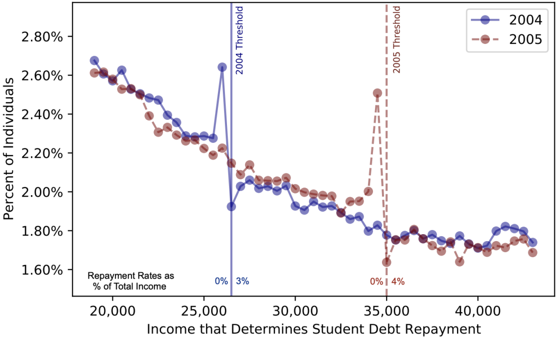
Figure 6: Majors after NLP implementation



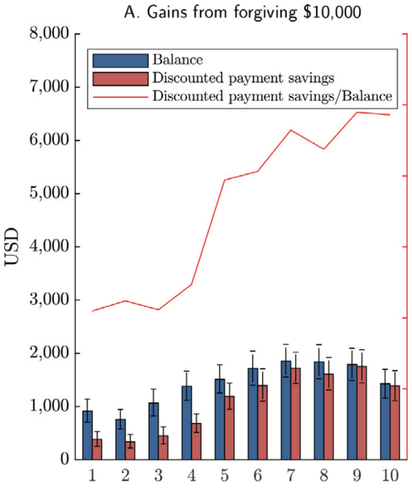
Potentially even distortionary

- Since student debt is often government financed, the transfer is from taxpayers to students
  - Particularly do not want it allocated in a way that distorts behavior
  - de Silva (2024) shows that borrowers bunch at income thresholds for income forgiveness



Redistribution also has distributional implications

- Since student debt is highly correlated with income, debt relief is regressive (Catherine and Yannelis, 2023)
- This is a challenge for policy design
  - Challenge of *targeting* relief



Redistribution also has distributional implications

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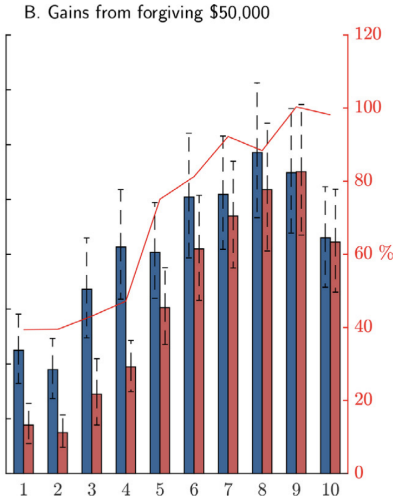
- Important to distinguish between the *nominal* value (what is owed) and the expected value (what is likely to be paid)
  - With medical debt, the nominal value is often much higher than the expected value
  - With student debt, the expected value for high income individuals is much higher (since more likely to repay)



When might a social planner want debt relief?

Given the constellation of what we know, when might a social planner want debt relief?

- *Insurance* – incomplete markets
  What kind of debt relief do we want in place for insurance?
  - Systematic vs. bespoke debt relief:
    Reduce uncertainty, but create moral hazard
  - Unilateral vs. bilateral:
    Insurance benefits are higher when all debts are dealt with
  - Direct vs. indirect financing:
    Indirect financing is more distorionary, but faster to act and cheaper
  - Extinguishing vs. restructuring:
    Unclear

- *Redistribution* - targeting or paternalism

- *Macro* benefits – demand or asset market stabilizer

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Given the constellation of what we know, when might a social planner want debt relief?

- *Insurance* – incomplete markets

- *Redistribution* - targeting or paternalism
  What kind of debt relief do we want in place for redistribution?
  - Systematic vs. bespoke debt relief:
    Occasional moments when the social contract requires redistribution to address issues (student debt?)
  - Unilateral vs. bilateral:
    Targetting particular market or issue (otherwise income)
  - Direct vs. indirect financing:
    Redistribution $\equiv$ gov't spending
  - Extinguishing vs. restructuring:
    Unclear

- *Macro* benefits – demand or asset market stabilizer

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Given the constellation of what we know, when might a social planner want debt relief?

- *Insurance* – incomplete markets
- *Redistribution* - targeting or paternalism
- *Macro* benefits – demand or asset market stabilizer
  What kind of debt relief do we want in place for macro benefits?
  - Systematic vs. bespoke debt relief:
    Automatic stabilizers should be systematic, but asset market interventions bespoke
  - Unilateral vs. bilateral:
    Automatic stabilizers should be unilateral, but asset markets bilateral
  - Direct vs. indirect financing:
    Government should be insuring against aggregate risks, but implementation challenging
  - Extinguishing vs. restructuring:
    Literature from housing in Great Recession suggest that restructuring may be much more effective; extinguishing may be better for stabilization

Conclusion: debt relief is a trade-off

- Important to separate the goals of debt relief: insurance vs. redistribution vs. macro benefits

- Insurance benefits are high when there is uncertainty about future states of the world
    - Limited protections from other social insurance programs

- Redistribution is a social choice, but should contrast with alternative use of dollar of spending

- Macro benefits are likely important policy reason for debt relief – automatic stabilizers