The Economics of Debt Relief for Consumers

Paul Goldsmith-Pinkham

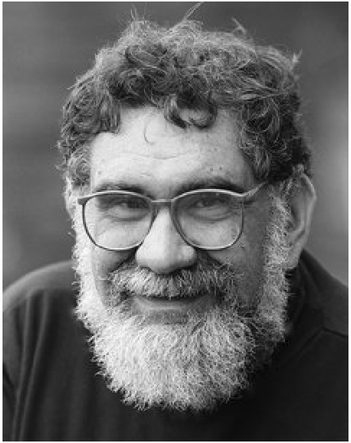
Yale SOM & NBER

Bernie Saffran Lecture, Swarthmore College

Bernie Saffran

"Bernie came to Swarthmore in 1967 from the University of California, Berkeley. He was really the start of modern economics in the department at Swarthmore. Bernie was the department. He was the intellectual center, ***the principal link to the greater economics profession,*** *and above all, the heart of the department." -Rob Hollister*

- From my class alone (2007), 10 of us went to graduate school for our PhDs in economics (out of 63 graduating majors).
- We were not directly connected to Bernie, but all heavily influenced by his presence and the culture he created



The economics of debt relief

Goal today is to talk about the debt relief and its trade-offs

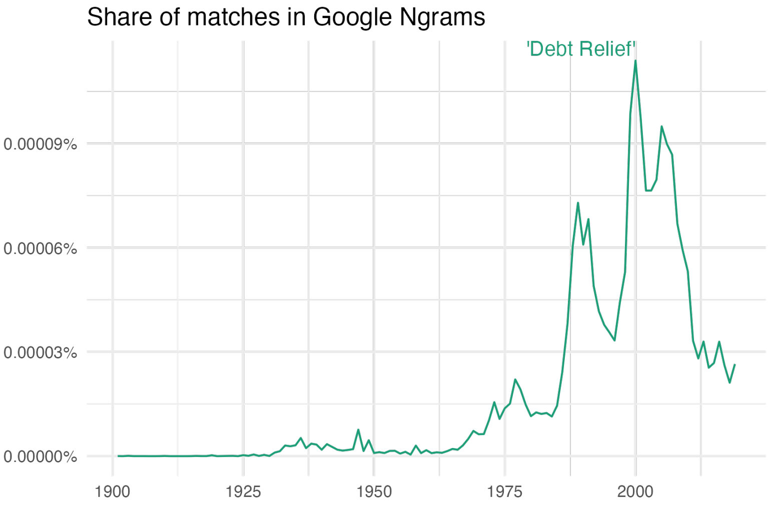
1. What is debt relief?

2. Second: what are the theoretical trade-offs and reasons for debt relief?

3. Third: what do we know so far?

Historical context of “debt relief” as term

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



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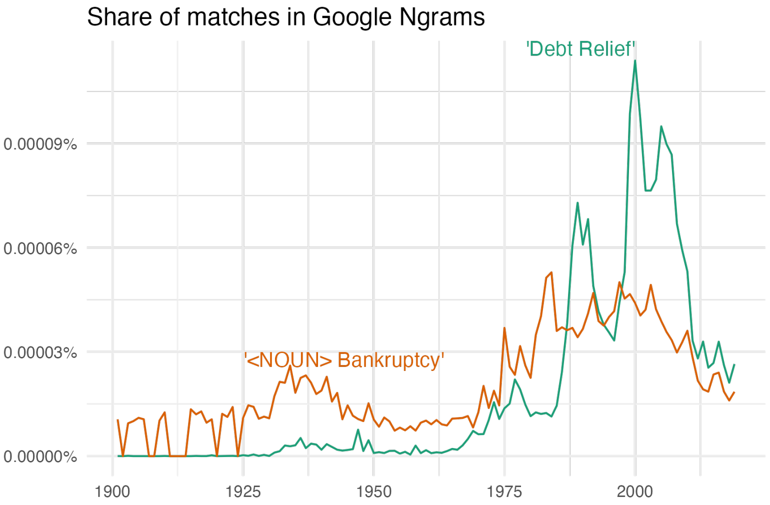
- Contrast with bankruptcy



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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

Read

More editions

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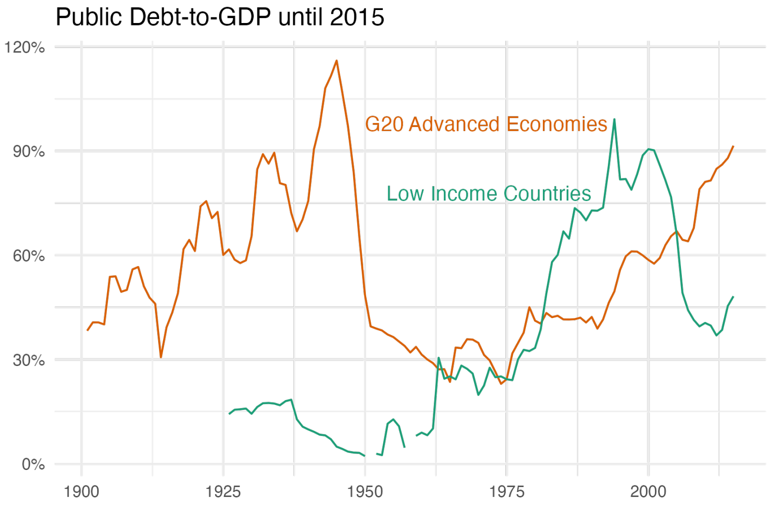


Examples of consumer debt relief

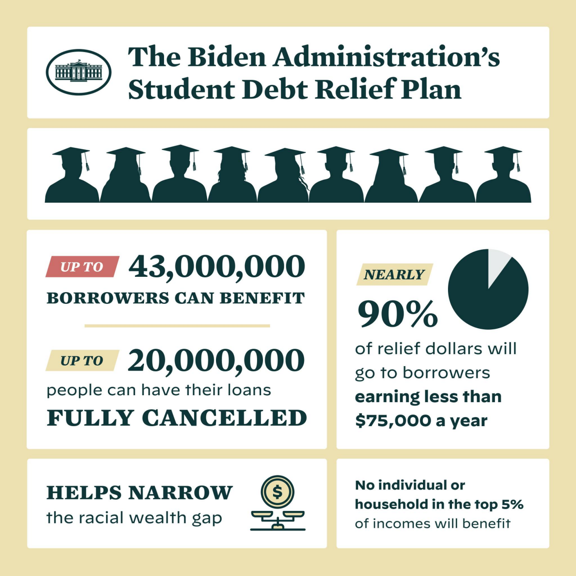
1. Medical Debt
   - Example: *RIP Medical Debt*
   - Medical debt forgiven either by hospitals or by being purchased from third-party debt collectors

Examples of consumer debt relief

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

Examples of consumer debt relief

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



What constitutes debt relief?

- A *debt* is an obligation to pay a creditor by a debtor
  - Terms are agreed upon by the creditor and debtor
- *Debt relief* (or forgiveness) 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
- Important ingredients:
  1. Who bears the (ex post) costs?
     - Creditor? Government?
  2. What is the process?
     - One off? Systemic? Anticipated or not?
  3. Who participates?
     - All creditors of a debtor or only some?

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.’

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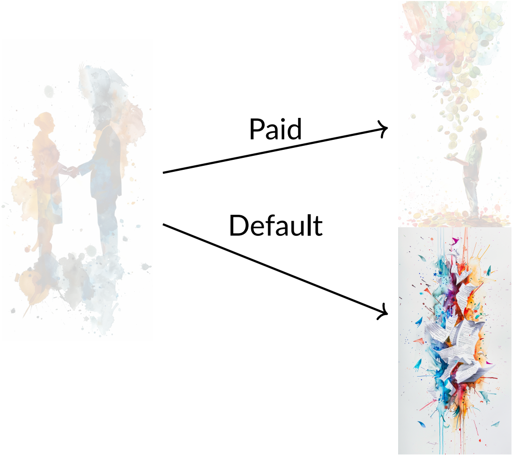
- Goal of system: insurance against bad states of the world

The static, one-shot economic trade-offs of debt relief

- In a static setting, at the time of the relief the debtor is happy to take it, and the creditor is usually not
  - **Empirical Question 1:** How much do they value it?
  - Consideration: does a creditor really expect to be repaid?

- Now: how does the creditor anticipate the debt relief?
  - **Empirical Question 2:** How much does the chance of default affect the cost of credit?

- Quite reasonable to assume that credit is more expensive because there is a chance to default (and not fully repay)



Ex ante

Ex post

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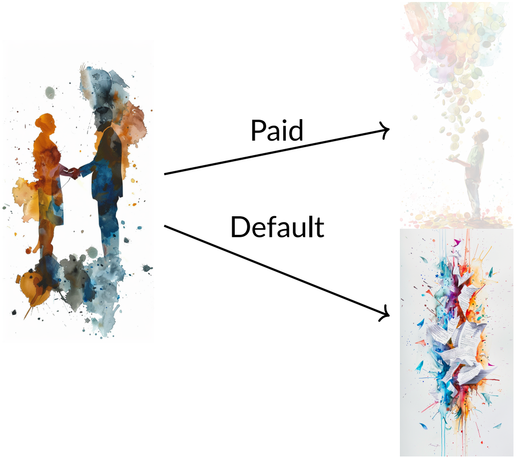
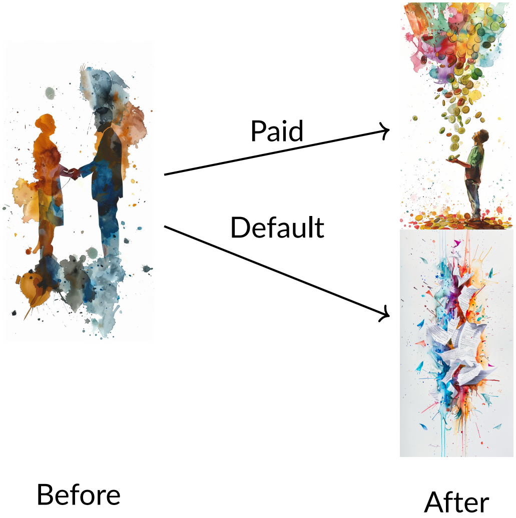


Ex ante

Ex post

The static, one-shot economic 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
- 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)



The static, one-shot economic trade-offs of debt relief

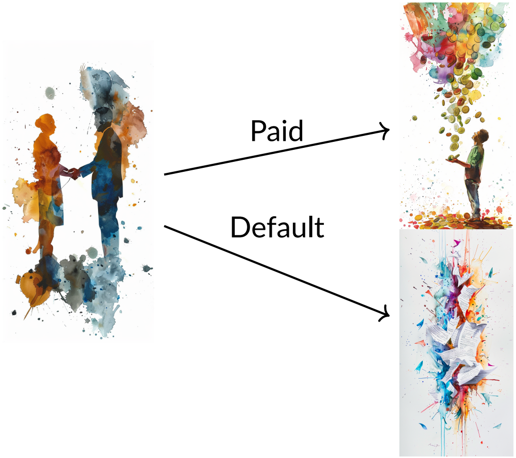
- The ability to default amplifies two types of frictions:
  1. Moral hazard
  2. Adverse selection

- **Empirical question 3:** how much does debt relief exacerbate moral hazard or adverse selection?

The static, one-shot economic trade-offs of debt relief

- **Moral hazard:** the extent to which borrowers make decisions that cause the default scenario to be more likely
- **Adverse selection:** the extent to which the pool of borrowers is worse (in an unobservable way) due to the presence of possible debt forgiveness

The static, one-shot economic trade-offs of debt relief



Before

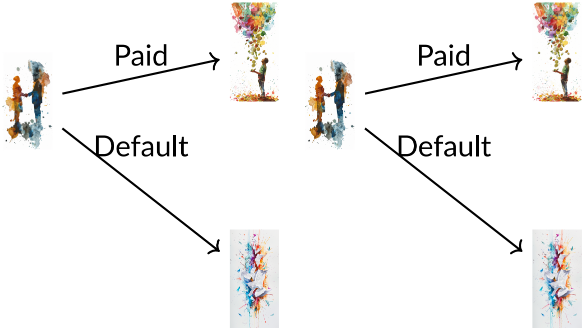
After

- **Moral hazard:** the extent to which borrowers make decisions that cause the default scenario to be more likely

- **Adverse selection:** the extent to which the pool of borrowers is worse (in an unobservable way) due to the presence of possible debt forgiveness

Debt relief is not a one-shot event

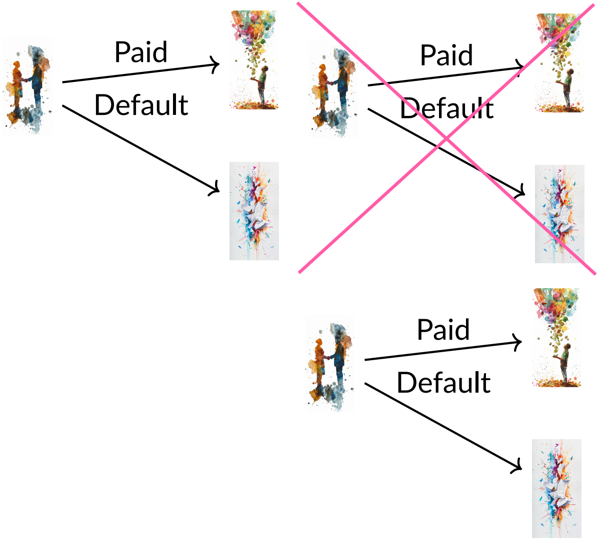
- In reality, credit is not a one-shot game
  - Many repeated interactions
  - E.g. credit reports and scores
- Thus, debtors face potential consequences of debt relief in the future
  - Tool for creditors to prevent default – “exclude” borrowers from credit
  - E.g. negative flags on credit report
- Thought experiment: imagine creditors can say: “if you declare bankruptcy, we’ll never lend to you again”



And so on...

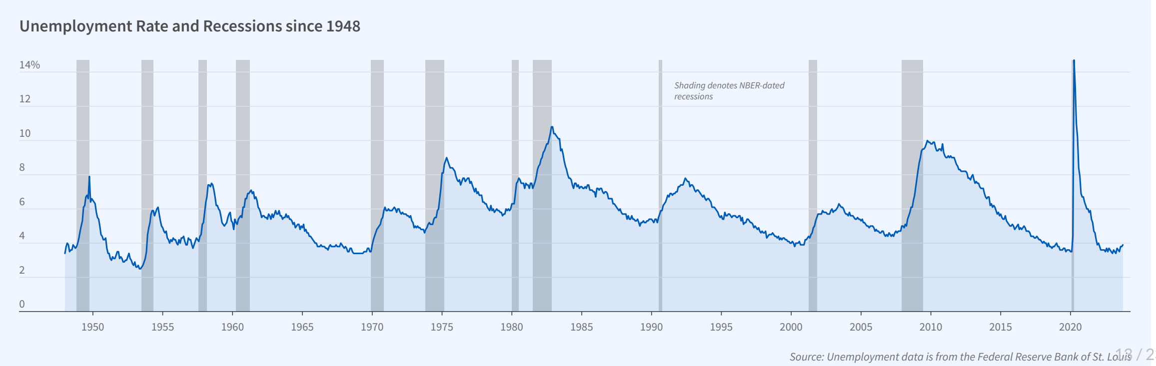
Debt relief is not a one-shot event

- This requires coordination across borrowers
- If lenders are competing and they think a borrower is creditworthy, they will lend even if credit exclusion is useful to creditors to prevent default



The impact of debt relief is not static

- 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 we know empirically about debtors' benefits of relief

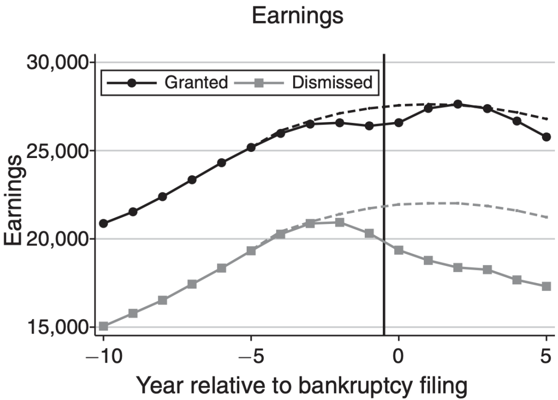
- Debt relief's social value is ambiguous: a trade-off between benefits and costs
  - Empirical question, requiring evalution of benefits and costs

- Example: Dávila (2020) shows that optimal bankruptcy protections is tradeoff between:
  1. sensitivity of interest rates to changes in protection
  2. the likelihood of default
  3. how much the borrower values money in different states of the world

- Estimation of benefits and costs is hard
  - Those who do not receive relief are a bad comparison for those who do!
  - Need an research design to estimate them
  - Will cover a few facts of what we know about debt relief

Consumer bankruptcy benefits

- In consumer bankruptcy, Dobbie and Song (2015) and Dobbie, Goldsmith-Pinkham and Yang (2017) study the impact of bankruptcy discharge on outcomes
- Compare bankruptcy filers who are granted debt discharge vs. case dismissed
- Use random assignment of judges to court cases to get variation in likelihood of bankruptcy dismissal



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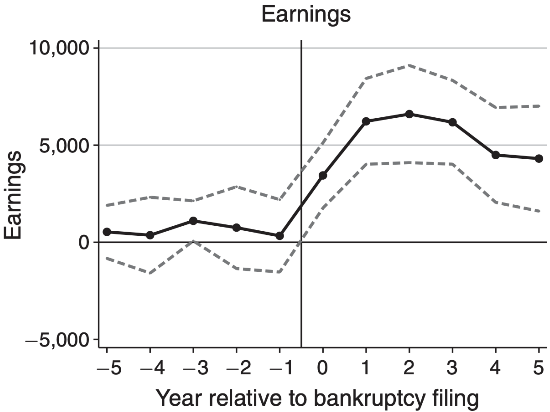

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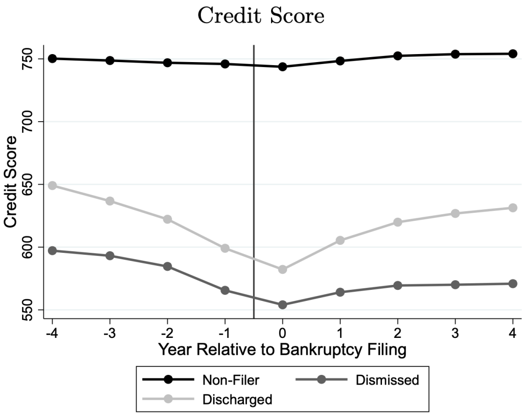

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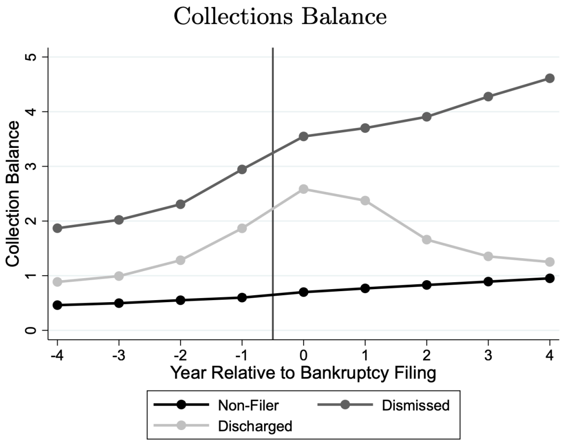
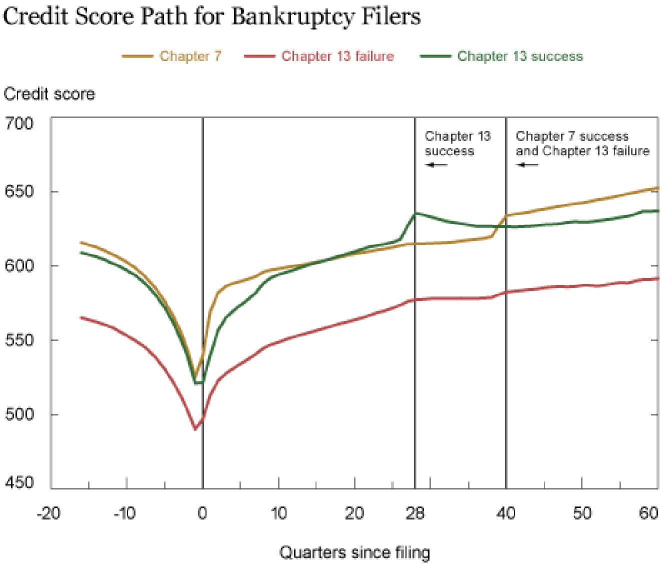


Can they borrow again?

- Bankruptcy flag is added to credit report once you file for bankruptcy
- This flag is removed after 7-10 years and *does* reduce access to credit
- But, access to credit does not disappear (Dobbie, Goldsmith-Pinkham, Mahoney and Song, 2020)



What do we know about the *ex ante* effects of relief

- Estimating the *ex ante* effects of debt relief on the full market is harder
- In bankruptcy, approaches often involve using variation across U.S. states in exemptions: amount of protection allowed in bankruptcy
  - Challenge is whether this variation captures other features about states

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  - 2005 BAPCPA reform made bankruptcy more challenging
  - How did creditors respond?

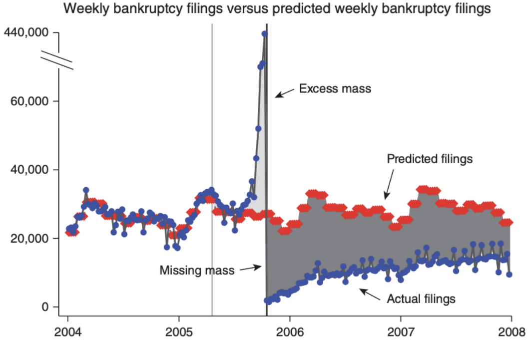

FIGURE 2. EXCESS AND MISSING MASS OF BANKRUPTCY FILINGS

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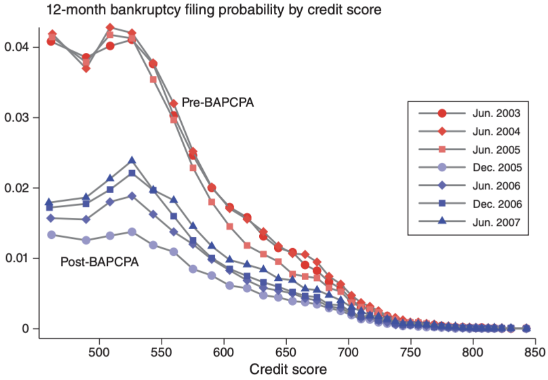

Figure 4. Probability of Bankruptcy

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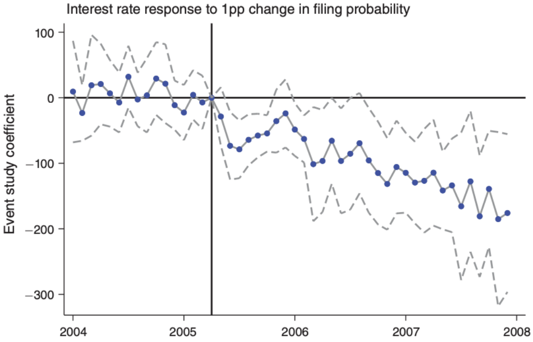
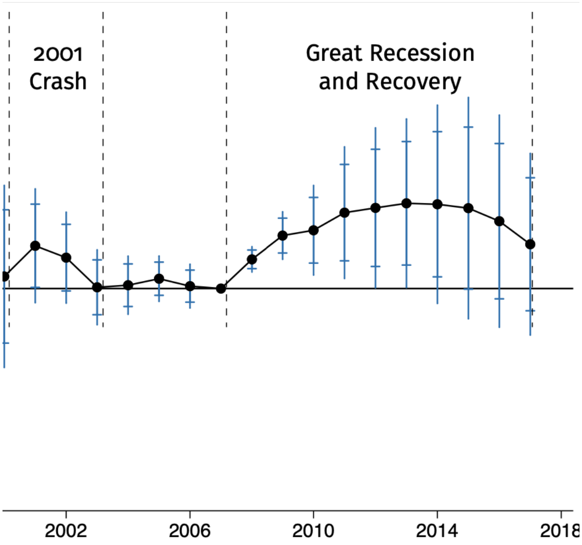


FIGURE 5. EFFECT OF DECLINE IN FILING PROBABILITY ON OFFERED INTEREST RATES

What about macroeconomic effects?

- During the Great Recession, consumer debt relief was a potential policy tool
- What is the issue? Not just indiviudual benefits from discharge, but *aggregate* – aggregate demand shortfalls, and credit contraction
- Auclert, Dobbie and Goldsmith-Pinkham (2022) show that high protection states had a smaller decline in non-tradable employment and more local debt charge-offs compared to low protection states



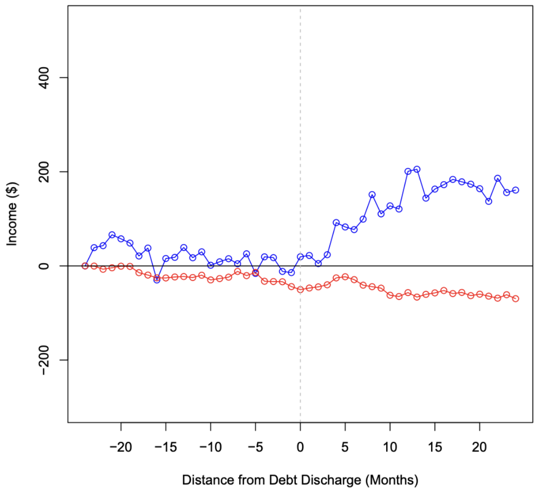
non-tradable employment

Evidence from student debt forgiveness

- Student debt much more straightforward in the U.S.
    1. Government is (usually) the creditor
    2. Tends to be one-shot
    3. Gets its own discussion because not dischargeable in bankruptcy

- Ex post question: does student debt relief help?
    - Why would it?

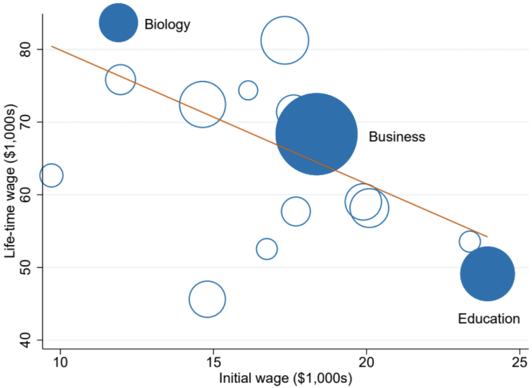
- Limited evidence of directly debt relief. Exception: Di Maggio, Kalda and Yao (2020)
    - 0.003 percent increase in mobility and job changing, 0.01 percent increase in income. Not big!



Debt relief timing matters

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

Figure 7: The Intertemporal Trade-off in Major Choice



(A) Two-digit majors

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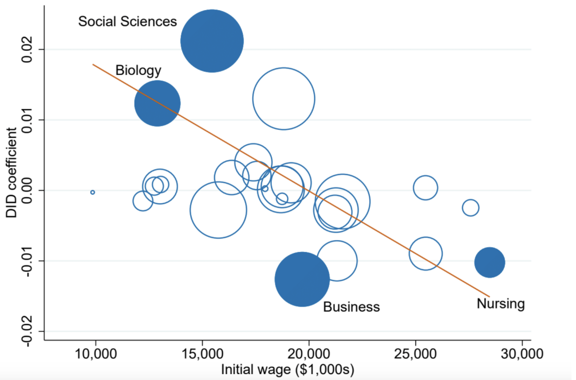
- Major economic impacts of debt relief for students are likely higher if done before investment decisions

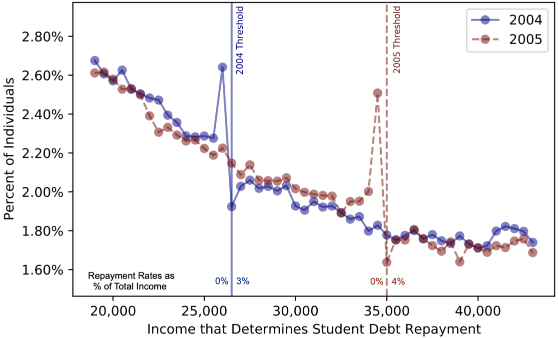
Figure 6: Majors after NLP implementation



(Poorly designed) debt relief can be distortionary

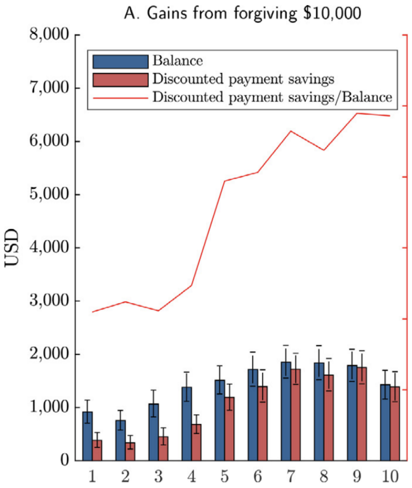
- Often, debate about debt relief implies revolves around there being a ”right” approach

- Key takeaway is that relief has trade-offs. Money is scarce, and want it to be effectively allocated.
  - 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



Debt relief also has distributional implications

- Student debt is particularly challenging because it is highly correlated with income
- An implication is that debt relief is regressive (Catherine and Yannelis, 2023)
- This is a challenge for policy design
  - Challenge of *targeting* relief



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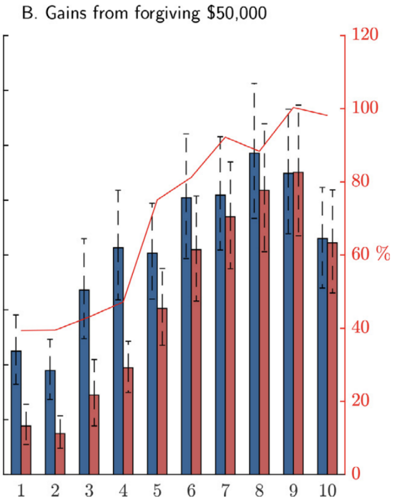
- This is a challenge for policy design
  - Challenge of *targeting* relief
- Important to distinguish between the *nominal* value (what is owed) and the expected value (what is likely to be paid)
  - With medical debt, the nominal value is often much higher than the expected value
  - With student debt, the expected value for high income individuals is much higher (since more likely to repay)



Conclusion: debt relief is a trade-off

- Debt relief is a trade-off between insurance now vs. higher costs in lending
- The magnitude in that trade-off depends on:
  - How much debtor behavior shifts in response to the relief
  - How anticipated and often the relief is
  - The value of the insurance to the debtor
- When considering the value of a dollar of debt relief, contrast with alternative use of dollar of spending