

## AFEE 2018 Paper Proposal

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The average family in the U.S. needs to take on debt to buy homes, get educations, and sometimes to even pay for normal daily expenditures. Outstanding debt generates a stream of rents to creditors and has become a significant burden on many households. A policy of household debt forgiveness could increase both economic equality and individual liberty. Under what conditions might such a policy be socially acceptable and what would be the implications of such a policy? For debt forgiveness to gain social acceptance the U.S. population would have to perceive the policy as fair and believe that such a program would treat all households equally. Further any such policy would be politically impossible if it stripped asset owners of moneys due or would not substantially lower household debt levels. This paper explores some possible parameters a politically feasible policy would contain and offers an estimate of policy costs.

## **Introduction**

Marx clarified a systemic problem of capitalism; the system requires more money at the end of the process in the form of profits than that which is put into the system as payments for resources. The continuing ad hoc solution to this paradox in the US has been the accumulation of debt by some sector(s). Since the 1990's the US has run a trade deficit and government sector borrowing has not been large enough to offset that trade deficit. To balance this identity the private sector has had to go into debt and much of that debt has been accumulated by households. The end result is the situation faced by the US today where household debt has grown to 12.96 trillion dollars. (Federal Reserve Bank NY 2017).

Such debt levels may be financially sustainable since debt servicing payments are only at historical trend levels (Federal Reserve Bank St. Louis 2017). Other conditions, such as population growth and inflation, may mean that the present record levels of debt do not bode ill for the economy (Ritholtz 2017). Current low interest rates allow households to fund their borrowing with lower payments than in the past. However these lower debt payments are based upon lower interest rates and not lower debt levels. If interest rates increase it is likely that debt payments will increase and this could lead to problems (Scott and Pressman 2015).

The financial sustainability of the debt does not mean the continuing existence of such debt is efficacious. Psychologically high levels of debt are correlated with greater mental health issues (Gathergood 2012). Financial issues are often a major factor in marital strife (Dew, Britt and Huston 2012). Payments on debt exasperate income inequity and have led to lower real standards of living for

both middle and low income households (Scott and Pressmen 2013). Further the growth non-collateralized debt obligations calls into question the moral issue of whether such debt relations are anything other than indentured servitude (Wunder 2015).

Interest in household debt is demonstrated by the many publications that look at the issue. It is easy to find papers that look at household debt over time (Weller 2007) as well as to find governmental measures that track levels of debt such NY Fed's quarterly report on household finances. Other research is beginning to emphasize the role that household debt has come to play in the maintenance of the macroeconomic system. (Godley and Wray, 2000; Guttman and Philon, 2010; Kaboub et al., 2010 Watkins 2010; Wunder, 2012)

With respect to solutions on how to deal with unsustainable household debt most research has been directed at bankruptcy as a way of discharging obligations (Waller 2001; Adkisson and McFerrin 2005; Dolfsma and McMaster 2007). This emphasis on individualized solutions seems to correspond with a belief that debt is solely the result of personal decisions that may have been strategic (Fay et al 2002) or that may have arisen from a lack of self-control (Starr 2007).

Yet the “modern consumption-driven economies require we do nothing to systematically discourage the very behavior that leads to consumer insolvency since it is the foundation of the health and stability of the system—to the degree that those two words actually describe these economies.” (Waller 2001, P 876) The US economic growth model of the last thirty years has been dependent upon household accumulation of debt. While a system of individual forbearance on debts needs to exist relying on such a system to eliminate aggregate debt accumulation seems inadequate. A program of systemic debt forgiveness would have many benefits however there are few academic publications on the topic. The rest of this paper will be dedicated to analyzing a potential program.

### **An alternative solution: the model**

This essay considers a one-time government payment to households that would be designated towards eliminating debt. A household that had any moneys left over after the elimination of debts would receive the balance as a cash payment. The size of the government payment would be a lump

sum equivalent to the size of the household multiplied by the amount of the payment. The payoff would prioritize payment of high interest debts first.

A policy such as this would most likely be implemented during a financial crisis similar to 2008 and policy design corresponds with crisis conditions in mind. The reasoning for a lump sum payment is that a policy only targeting debtors would be seen as unjust to households that had not gone into debt. Debt is viewed as a personal vice and a program that solely helped those households in debt would create political tensions. A lump sum payment would be more acceptable to those households who had limited or no debt. Beyond justice concerns the cash payments to debt free households would serve as economic stimulus. A payment policy would thus serve two ends; first it would undo some of the damage caused by household debt accumulation and second it would serve to stimulate an economy hurt by a financial crisis. In the long run both macroeconomic policy and credit creation rules need to be examined, but in the short run a policy such as the one suggested here could be both popular and affective.

Supposing such a policy was contemplated what should be the size of the lump sum payment? The US Treasury reports that the federal government debt increased by 6.1 trillion between 2008 and 2012. With a population of 300 million the total increase in government debt per person was around \$19,000 and it seems reasonable to assume much of this increase was the outcome of the recession caused by the debt crisis. Using \$19,000 as an upper bound, and using Survey of Consumer Finance (SCF) information, it becomes possible to estimate the impacts of a government debt payment.

#### *Impact on the mean household*

For simplicity sake this paper will assume a lump sum payment of \$10,000 per person. The 2016 Survey of Consumer Finances shows that the mean household contained 2.32 people therefore under this policy this household would receive a payment of \$23,200. Table 1 shows the debts of a mean household in 2016 and the amounts owed by a hypothetical mean household post payment.<sup>1</sup>

Table 1: Total Mean Household Debts Before and After Policy

2016 totals	Pre	Post
CC Balances	\$2,506.00	0
Installment Loans	\$15,681.00	0
Other Lines Credit	\$1,011.00	0
Other Residential Debt	\$15,681.00	\$4,002.00
Other Debt	\$1,393.00	\$1,393.00
Mortgage	\$63,761.00	\$63,761.00

Source: Survey of Consumer Finances and Author Calculations

This program would eliminate credit cards debts, installment loans (which includes auto, medical, and student loans) and other lines of credit (which includes non-secured personal loans) for the mean household. The mean household would still owe some other residential debts (which includes loans against pensions, life insurance, and margin loans), other debts (which includes loans on second homes...) and mortgages. The next section will breakdown the SCF debt data into income groupings for greater clarity.

*Impact by income categories.*

Each income category has differing household size and debts. Table 2 shows the size of household and payout for each income category.

Table 2: Payment to Mean Households by Income Grouping

Income Grouping	Household size	Payout to Household
1: 0-20	1.72	\$17,200.00
2: 20-39.9	2.16	\$21,600.00
3: 40-59.9	2.34	\$23,400.00
4: 60-79.9	2.61	\$26,100.00
5: 80-89.9	2.81	\$28,100.00
6: 90-100	2.82	\$28,200.00

Source: Survey of Consumer Finances and Author Calculations

The breakdown of the mean household debts pre and post payment by income grouping is shown in table 3

Table 3: Total Mean Household Debts Before and After Policy by Income Grouping

	0-20		20-40		40-60	
	Pre	Post	Pre	Post	Pre	Post
CC Balances	\$624	\$0	\$1,578	\$0	\$2,376	\$0
Installment Loans	\$6,966	\$0	\$10,253	\$0	\$15,527	\$0
Other Lines Credit	\$9	\$0	\$86	\$0	\$229	\$0
Other Residential Debt	\$650	\$0	\$1,072	\$0	\$1,989	\$0
Other Debt	\$6,966	\$0	\$10,253	\$1,642	\$15,527	\$12,248
Mortgage	\$10,361	\$8,376	\$19,499	\$19,499	\$39,573	\$39,573

	60-80		80-90		90-100	
	Pre	Post	Pre	Post	Pre	Post
CC Balances	\$3,557	\$0	\$4,501	\$0	\$4,293	\$0
Installment Loans	\$20,496	\$0	\$23,906	\$417	\$26,424	\$2,517
Other Lines Credit	\$312	\$0	\$109	\$109	\$8,729	\$8,729
Other Residential Debt	\$5,439	\$3,705	\$15,394	\$15,394	\$55,855	\$55,855
Other Debt	\$20,496	\$20,496	\$23,906	\$23,906	\$26,424	\$26,424
Mortgage	\$76,937	\$76,937	\$127,807	\$127,807	\$217,024	\$217,024

Source: Survey of Consumer Finances and Author Calculations

Table 3 shows that this policy would eliminate credit card debt for mean households in all income groups. Installment debt for the typical mean household in the bottom 90% of income groupings would also be nearly eliminated. The mean households in the bottom 60% of income groupings would have all debt but mortgage and 'other' wiped out. The total cost of this program, including the cash payments to households, would be around 3 trillion dollars.<sup>2</sup>

### Discussion of the Program

This program would eliminate much of the high interest household debt currently outstanding. The discussion in this section will concentrate on the effectiveness of this program in dealing with household debt. William Waller laid out the issues a policy dealing with individual debt insolvency must

contend with. These issues include “minimizing the damage caused by the insolvency of a debtor, maintaining the credit system, stabilizing a credit-driven economy, and social equity considerations.” (Waller 2001, p 871) Any systemic plan to reduce debt would equally have to deal with these four issues.

#### *Minimizing the damage*

A macro policy to confront outstanding debt must be implemented in a way so that the expenditures on the policy actually serve to lower household debts. The only current systemic policy that has lowered the impact of outstanding debt has been a Fed policy of low interest rates. This policy has lowered household debt payments however a return to higher interest rates will result in a return to higher payments (Scott 2015). Low interest rates have not eliminated the problem of outstanding debt, they have only relieved some of the symptoms.

Insolvency occurs when an individual cannot pay the debts owed. The policy offered here lowers debt for a large number of households and ensures just compensation to lenders. The SCF numbers show that the policy detailed here would dramatically lower unsecured debt for many US households. Further those households that would remain in debt also tend to be higher income households who can afford to sustain their debts. With fewer households in debt there would be less insolvency and less damage from insolvency.

#### *Maintaining the credit system*

A policy that pays off large chunks of outstanding debt would result in financial system disruption. The value of private sector debt to the financial system is higher than the same level of debt if it were owned in the form of government bonds. This program would essentially be replacing private sector debt with government bonds on the banking system's balance sheets. Assuming a rough private sector interest rate of 4% and a governmental bond interest rate of 2% the \$3 trillion dollars in private sector debt would have to be replaced with \$3.87 trillion in government bonds to maintain the same revenue stream. Yet the payoff, by going directly to the households, would not give banks \$3.87

trillion, it would only give it \$3 trillion. Any large systemic pay off of household debts imposes prepayment losses on the financial system.

With the decline in future revenues there would arise functional issues for the banking community. However since implementation of this policy would most likely occur during a financial crises this policy could help to mitigate that crisis as well as to help rebuild a more stable financial system going forward. One individual paying off debts early poses no issues yet a systemic payoff of debts would lead to a severe curtailment of future revenues to the financial industry. A massive prepayment does not cause a crises it only serves to make the crisis apparent. The crisis already exists because the current financial system impedes economic security and relies on the perpetual indebtedness of the population.

A debt payoff policy could be an integral part of preventing future financial crises but this payoff must be tied to greater regulation on the types of lending a just society will allow. There needs to be regulations on credit cards to eliminate the predatory behavior of banks (Scott 2007). Regulations on home mortgages to deal with how availability of mortgages puts upward pressure on home prices (Brown 2007) as well as regulations on payday lending and educational loans (Redmond 2015).

#### *Stabilizing a credit driven economy*

Growth of the US economy during the last four decades has been based upon the growing debts of US households. The policy being offered would stabilize the credit economy in two ways: firstly the policy will lower debt levels for most households freeing income that would have gone to paying debts and second the policy will give a large cash payment to many households who currently have little or no debt.

By reducing outstanding credit card, education, auto and medical debts many households will finally have income to use on greater consumption and building personal wealth. After the implementation of such a program society will need to seriously consider the types of loans that will be allowed. Permissible loans need to be designed to increase household wealth or else the policy offered here would prove only a short run solution to a long run social ailment. However if proper lending



restrictions are implemented this policy could set up the preconditions necessary to allow many more households a pathway towards actual financial prosperity.

This policy will also give cash payments to millions of household who owe little to no debt. The vast majority of debt free households are low income and for some households these cash payments could be as large as their yearly incomes. Those payments would serve as economic stimulus as some of these low income households bought needed items. It also seems likely that many of these households might use this cash as down payments on larger investments such as housing and vehicles. All of these activities would help to stimulate the economy.

#### *Social Equity Considerations*

This policy seems to offer balanced benefits to everyone. Lenders are paid the moneys they are owed and cannot reasonably argue they are being cheated. Borrowers are having large amounts of their debts forgiven and will subsequently no longer have to pay the debts nor interest on the debts. Households currently owing little to no debt would be given a cash payment that would increase financial assets allowing those households to invest or consume more. US households would find themselves in a situation where they could use the resources gained from this policy to stimulate further economic growth. Finally since low income households have significantly less debt this program would serve to radically alter the current wealth skew in the US. This plan results in low income households realizing a much larger improvement in their balance sheets and would lead to a significant improvement in wealth distribution.

#### **Conclusion**

Current household debt in the US is \$12.96 trillion dollars. This debt has many negative social consequences and the economic growth of the last 40 years was predicated on the creation of this debt. A lump sum payment granted at the household level would serve to significantly lower real debt levels. Such a payment would eliminate most credit card balances as well as eliminate many of the debts currently associated with auto lending, personal loans, education loans and medical bills. Further such a policy would give millions of households a cash payment which they could use to stimulate broader

economic activity. The cost of this payment would increase outstanding government debt by \$3 trillion or roughly a 19% increase in the current government debt levels.

#### Footnotes

<sup>1</sup> This paper calculates the mean household debts in the SCF and applies the lump sum to a hypothetical mean household. Since empirically many households will have significantly more debts than the mean the post reported number is not the new mean debt post policy. Instead what is being reported is the debt levels of a hypothetical household currently sitting at the SFC mean debt levels pre and post policy.

<sup>2</sup> 3 trillion is arrived at by multiplying the payment of \$10,000 by roughly 300 million people.

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