Debt in Just Societies

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Abstract

A post-Great Recession consensus has emerged that persons, firms, banks, and governments have too much debt. The article deals with legal and policy solutions to the dilemma that debt presents to societies: successful societies benefit from a substantial infrastructure of consumer, commercial, corporate, and sovereign debt but debt can cause substantial private and social harm. Pre- and post-crisis solutions have seesawed between subsidising and restricting debt, between leveraging and deleveraging. Unsophisticated solutions restrict debt without accounting for the risk of harm to persons least able to bear the risk, worsen pre-existing inequalities, destroy or impair the net worth of households, and impose unfavourable distributive consequences. This article offers normative tools to assist policymakers in developing institutions to take criteria other than economic stability into account, but which do not undermine the aim of economic stability. I argue for access to credit architecture that is responsive to equality concerns. I advocate a luck egalitarian approach, a responsibility-catering form of egalitarianism offering policymakers options to take the debtor's choice and desert into account while still accounting for cognitive mistakes people often make in debt decision making. More sensitivity to equality concerns in law and policy should lead to developing incentives to promote hybrid instruments to relax the rigidity of debt. It should also lead to discouraging, on moral grounds, law and policy relying primarily on private debt to finance the public goods features of mixed public-private goods.

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INTRODUCTION

When Mark Tetzlaff filed in February 2012 for personal bankruptcy in the United States, he owed about $260,000 in student loan debt.[1] Mr Tetzlaff borrowed under established US student loan programmes to undertake postgraduate studies in law and business. He borrowed to attend two law schools. He eventually graduated with a JD degree from Florida Coastal School of Law but failed the bar examination twice and never qualified as a US attorney and therefore cannot use his three-year postgraduate law degree to practice law. He also has an MBA from Marquette University. Mr Tetzlaff has worked in various positions but was unemployed at the time of his bankruptcy petition. Mr Tetzlaff has struggled with depression and alcohol abuse. He has two misdemeanour convictions. He claims that these factors made it very difficult for him to find a job. He is divorced with no children. As of the time of this writing, Mr Tetzlaff is fifty-seven years old and lives in Wisconsin with his eighty-five-year-old mother. They both subsist on his mother's government pension, known as Social Security in the United States.

In his bankruptcy proceeding, Mr Tetzlaff sought to discharge his student loan debt. In US bankruptcy proceedings for individual debtors, student loans are not dischargeable in bankruptcy unless the debtor proves that excluding the loans from discharge 'would impose an undue hardship on the debtor'.[2] The US Bankruptcy Court for the Eastern District of Wisconsin held a trial on the issue of undue hardship and decided against discharge.[3] The US Court of Appeals for the 7th Circuit denied Mr Tetzlaff's appeal. The US Supreme Court refused to hear the case.[4]

[1] These facts are summarized from *Tetzlaff v Educational Credit Management Corp*, 794 F.3d 756 (7th Cir 2015).
[2] 11 USC §523(a)(8).
[3] *Tetzlaff v Educational Credit Management Corp*, 521 BR 875 (ED Wisc 2014.
[4] The US Supreme Court denied Tetzlaff's petition for writ of certiorari on 11 January 2016.

The student debt data for the USA is startling. The latest available data on student loans in the United States puts it at about $1.25 trillion, with those over sixty years of age holding over $43 billion. Some in the United States pay on student debt well past retirement age.[5] Studies in the United States show that student debt adversely affects the life prospects and social mobility of graduates in substantial ways, impairing their net worth for a lifetime, making it difficult to borrow for homes, and generally diminishing their life prospects.[6] The student loan problem in the United States is so dire that some have predicted it will result in the next debt crisis, in the United States, and possibly beyond.[7] Debt crises are usually the result of asset price bubbles. The asset in the student loan context is education. In the relatively unregulated fee pricing environment in the United States, subsidized borrowing is leading to fee increases far outstripping general price increases in the economy.

Manolo Marban, a dog groomer in Toledo Spain, was delinquent on the mortgage on his home in Toledo and was evicted.[8] Despite that he no longer owns the house, Mr Marban is still liable for the approximate €130,000 in mortgage debt, plus penalty interest and court fees and costs. Under Spanish law, the mortgagor personally guarantees the debt and unlike in other EU member states, mortgage debt cannot be discharged in bankruptcy in Spain.[9] Says Mr Marban, tears in his eyes, 'I will be working for the bank for the rest of my life" . . . . 'I will never own anything — not even a car'.[10]

The Court of Justice of the European Union has ruled in two judgments that Spanish rules of civil procedure that stop delinquent mortgagors from

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[5] Thomas Sparrow, 'US Seniors Face Student Loan Debt', http://www.bbc.com/news/magazine-29730227, 23 October 2014.

[6] For a survey of research, *see* Mike Konczal, 'The Devastating, Lifelong Consequences of Student Debt', *New Republic,* 24 June 2014.

[7] For a survey on the student loan bubble issue, *see* Victoria J Haneman, 'A Timely Proposal to Eliminate the Student Loan Interest Deduction' (2013) 14 *Nevada Law Journal* 156, 160-166. For a discussion of why student loan debt does *not* pose a systemic risk, *see* Jonathan D Glater, 'Student Debt and the Siren Song of Systemic Risk' (2016) 53 *Harvard Journal on Legislation* 99. One economist classifies the crisis as one involving repayment. Susan Dynarski, 'An Economist's Perspective on Student Loans in the United States', Brookings Institution. ES Working Paper Series, Sept 2014.

[8] Suzanne Daley, 'In Spain, Homes are Taken but Debt Stays', *New York Times,* 27 Oct 2010.

[9] *See* Gala Cano Fuentes, Aitzibur Etxezarreta Etxam, Kees Dol, & Joris Hoekstra, 'From Housing Bubble to Repossession: Spain Compared to Other Western European Countries (2013) 28 *Housing Studies* 1197.

[10] Daley n 7. Mario Gozálvez, a truck driver, asked his 23-year-old daughter to provide a personal guarantee on a mortgage on his flat, which he used to buy a truck. At the time, she did not even have a job. Mr Gozálvez fell delinquent on the mortgage and was evicted and is fully liable for his mortgage. So is his daughter, possibly for her lifetime. He explains, 'She may not be able to inherit anything from her mother because the bank can seize it'. . . . 'No one explains this'. *Ibid.*

contesting the fairness of the terms and conditions of their mortgages breach the Unfair Contract Terms Directive 1993. Spanish law requires homeowners to bring an entirely different proceeding challenging their mortgage on consumer protection grounds, and in that proceeding cannot seek a remedy to stop repossession or regain possession of their home.[11]

Economists have characterised Spanish housing debt in the aftermath of the last economic crisis as 'the US experience on steroids'.[12] It shares some unfortunate similarities with the institutions of the encomienda and debt slavery of a former age.[13] It got so bad that human rights organisations, including Human Rights Watch, began to monitor the situation.[14] There was widespread public anger over the many repossessions in Spain.[15] Police and locksmiths refused to assist the banks in evictions. A Spanish firefighter in Catalonia refused to provide any more assistance in evictions in 2013, holding up a sign saying 'Rescatamos personas, no bancos'.[16]

Greece underwent a significant debt crisis in which it took out too much debt in the form of bonds, which the financial markets first overvalued when Greece joined the euro and then seriously discounted when the Greek government reported it had understated its debt and deficits. The Greek crisis led to a series of economic adjustment programmes and a restructuring of Greek public debt.[17] While the bondholders, mainly western European banks, took a 'haircut' in the restructuring,[18] to understand the consequences of the Greek

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[11] Case C-169/14, *Sánchez Morcillo & Abril Garcia v Banco Bilbao Vizcaya Argentaria SA* [2014] ECR xx; Case C-415/11, *Aziz v Caixa D'Estalvis de Catalunya, Tarragona I Manresa (Catalunyacaixa)* [2013] ECR xx.

[12] Atif Mian & Amir Sufi, *House of Debt* (University of Chicago Press 2014) 119.

[13] Robin Blackburn, *The Making of New World Slavery* (Verso 2nd ed 2010); Victor Bulmer-Thomas, *The Economic History of Latin America Since Independence* (Cambridge University Press 2nd ed 2003); Timothy J Yeager, (1995) 'Economienda or Slavery? The Spanish Crown's Choice of Labor Organization in Sixteenth Century Spanish America', (1995) 55 *Journal of Economic History* 842.

[14] 'Un año después, todavía queda mucho por hacer en la crisis de vivienda y de deuda', *El Diaro,* 14 Mayo 2014.

[15] Christopher Burns, ECJ Ruling Helps Spanish Mortgage Holders – Dr. Cliona Kelly, http://blogs.cardiff.ac.uk/law/ecj-ruling-helps-spanish-mortgage-holders-dr-cliona-kelly/, 30 April 2013.

[16] Mian & Sufi n xx 120. *See* Matt Wrack, 'Rescatamos Personas, No Bancos: We rescue people, not banks: Inspiration from firefighters in Spain', https://www.fbu.org.uk/blog/rescatamos-personas-no-bancos-we-rescue-people-not-banks-inspiration-firefighters-spain, 20 July 2014.

The extreme measures to protect Spanish banks failed. Spanish banks required a substantial bailout of $125 billion by Eurozone countries, at taxpayer expense. The lifetime and intergenerational debt impositions in Spain contributed to Spain's serious economic downturn as Spanish people curtailed consumption. Mian & Sufi n xx 120-123.

[17] European Commission, Financial Assistance to Greece, http://ec.europa.eu/economy˙finance/assistance˙eu˙ms/greek˙loan˙facility/index˙en.htm

[18] Jeromin Zettelmeyer, Christopher Trebesch, & Mitu Gilati, 'The Greek Debt Restructuring: An Autopsy', Peterson Institute for International Economics, Working Paper 13 Aug 2013.

debt crisis, we need to look beyond effects on those traditionally understood as asset holders.[19] The social costs of the austerity imposed on Greece in the many conditions included in the bailout packages have been significant. They have included a significant decline in GDP and domestic demand, leading to increased unemployment, dismissals, and job losses. Greek unemployment rates have hovered over 24 percent for a number of years and more than half of the population between 15-14 years of age is unemployed, at a time when social protection is under threat and simply unavailable. Substantial numbers of small and many family-run businesses, important in the Greek economy, have failed or closed. Greece has experienced a substantial increase in homelessness.[20] The suicide rate in Greece has hit new highs, with a record increase of 25 percent from 2009 to 2010 and by an additional 40 percent from 2010 to 2011. Health care services have been substantially curtailed because of a lack of funding.[21] In summer 2015, when the Venetis chain of bakeries in Greece was giving away about a third of its bread production to charity, its general manager said: 'In the third round of austerity measures, which is beginning now, it is certain that in Greece there will be no consumers — there will be only beggars.[22]

No successful society exists without a substantial infrastructure of consumer, commercial, and sovereign debt. Access to credit is a resource in a society, which means that is a primary means by which persons develop and implement plans for their lives.[23] Supported by substantial research in law and finance,[24] the World Bank and other development institutions have promoted the development of a credit architecture for low-income countries.[25] Credit creation

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[19] Most sovereign debt discussions in the legal literature focus primarily on the interests of those traditionally recognised as asset holders, mainly those how hold assets in capital markets. As we know, there are many more 'asset holders' than these.

[20] *See* Vassilis Arapoglou and Kostas Gounis, 'Poverty and Homelessness in Athens: Governance and the Rise of an Emergency Model of Social Crisis Management', Green Paper No.90 Hellenic Observatory Papers on Greece and Southeast Europe, March 2015; Olga Theodorikakou, Alexandra Alamanou and Kyriakos Katsadoros, '"Neo-homelessness" and the Greek Crisis' (2013) 7 *European Journal of Homelessness* 203.

[21] Alexander Kentikelenis, Marina Karanikolos, Irene Papanicolas, Sanjay Basu, Martin McKee, & David Stuckler, 'Health Effects of Financial Crisis: Omens of a Greek Tragedy' (2011) 378 *The Lancet* 1457.

[22] Anemona Hartcollis, 'Greece Financial Crisis Hits Poorest and Hungriest the Hardest', *New York Times*, 11 July 2015.

[23] John Rawls, *A Theory of Justice* (Harvard University Press rev ed 1999) 78.

[24] For a review of the literature *see* Nicholas L Georgakopoulos, 'Statistics of Legal Infrastructures: A Review of the Law and Finance Literature (2015) 17 *American Law and Economics Review* 62.

[25] The World Bank's Doing Business programme places great emphasis on credit institutions and access to commercial credit. *See* http://www.doingbusiness.org. For examples of World Bank research on access to credit generally, including by individuals, *see* Thorsten Beck, Asli Demirguc-Kunt, & Ross Levine, 'Finance, Inequality and Poverty: Cross-Country Evidence', World Bank Policy Research Working Paper (2004); Patrick Honohan, '*Financial Sector Policy and the Poor*', World Bank Policy Research Working Paper No 43 (2004).

has the potential to increase welfare for persons of limited means and those in the middle class in need of liquidity to achieve their life plans such as in getting an education, obtaining decent housing, buying transportation required by a job, or financing a small business. Banks could even be said to be in the business of *money* creation through lending.[26]

But debt can also cause substantial private and social harm. 'In a crisis, equity bends while debt breaks'.[27] Credit and money creation – the production of liquidity – works only on upside of cyclical markets. Products sold to consumers can be dangerous because they pose substantial risks to an individual's well-being and that of their families. Elizabeth Warren characterises dangerous credit products as 'unsafe at any rate' and laments, at least before legal reforms after the most recent economic crisis, that 'It is impossible to buy a toaster that has a one-in-five chance of bursting into flames in and burning down your house. But it is possible to refinance an existing home with a mortgage that has the same one-in-five change of putting the family out on the street. . . .'[28] For consumers, default on debt can lead to downward social mobility and even poverty for families, job loss, health problems, stress, marital problems and family instabilities.[29] Beyond these private harms, as we have seen in the most recent economic crisis, losses associated with excessive debt in a society can be enormous and lead to a systemic and cascading failures in national and global economies and bring about substantial economic downturns.[30]

The core claim of this article is that a just society would not require excessive debt to make the lives of its citizens go reasonably well and that the law on debtor-creditor relations should be tailored to account for egalitarian and other moral concerns. When developing law and policy to deal with the risk of debt, as in the form of systemic risk, governments need to focus on more than economic stability as the end of managing the effects of debt in society. They need also to focus on fair access to credit. Policy entrepreneurs need to develop

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[26] Michael McLeay, Amar Radia & Ryland Thomas, 'Money Creation in the Modern Economy, Bank of England, Quarterly Bulletin, 2014 Q1.

[27] 'Ending the Debt Addiction: A Senseless Subsidy', *The Economist,* 16 May 2016.

[28] Elizabeth Warren, 'Unsafe at Any Rate' (2007) *Democracy Journal.*

[29] Katherine Porter, 'The Damage of Debt' (2012) 69 *Washington & Lee Law Review* 979-1022.

[30] The references are legion on these points. *See, e.g.,* Financial Services Authority, 'The Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009), available at http://www.fsa.gov.uk/pubs/other/turner˙review.pdf; Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes and Consequences of the Financial and Economic Crisis in the United States, January 2011, available at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

ways around the dilemma that debt presents to societies: we need debt to make our lives go well, but we also need to avoid debt to make our lives go well. Debt can be bad for people, firms and governments (in some cases)[31] *but so can restricting it*. The aim of this article is to offer policy prescriptions that aim to get the balance right.

This article relies on insights principally from moral theory and rarely used in evaluation of law relating to debt.[32] Its arguments develop along the lines of what John Rawls called wide reflective equilibrium.[33] This methodology can be understood as meeting two main criteria.

First, the article develops policy prescriptions that take egalitarian justice and deontological or non-consequentialist moral theories into account. 'Non-consequentialist' might be the better description, if only to avoid quibbles about what gets included in deontological versions of moral theory. Non-consequentialist moral theories share what John Rawls called a 'separateness of persons' requirement[34], meaning that the burdens of policies on each person are to be taken into account. So, aggregation is impermissible in formulating public policy, or permitted only in limiting cases.[35]

The particular form of egalitarianism applied in this article is luck egalitarianism, an approach to egalitarian theory that takes both personal responsibility and justice into account. The version of luck egalitarians used in this article is based on equality of resources and not welfare. It is beyond the scope of this article to evaluate whether resource based egalitarianism is either deontological or consequentialist in approach. It should be sufficient for the applied work set forth in this article to claim that it shares broad affinities with deontological moral theories, and certainly more so than welfare based luck egalitarianism.

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[31] We will have to distinguish some cases of government debt when that debt can stimulate the economy and when the government has the ability to raise the funds in the capital markets through bonds that are not poorly rated or steeply discounted. This connects to the substantial debate among economists on austerity versus stimulus. *Compare* Robert J Barro, 'How to Really Save the Economy', *New York Times,* 10 Sept 2011; Paul Krugman, 'The Austerity Delusion', *Guardian,* 25 April 2015.

[32] With respect to the law itself, I avoid referring to a particular doctrinal category because any single category on its own does not capture the areas of law covered in this article. Areas of law dealt with in this article fall with commercial law, banking and finance law, the law on mortgages, international law on sovereign debt, as well as public law relating to assistance of persons who financially disadvantaged for a variety of reasons, including discrimination.

[33] For an explanation of reflective equilibrium, *see* Norman Daniels, *Justice and Justification: Reflective Equilibrium in Theory and Practice* (Cambridge University Press 1996).

[34] John Rawls, *A Theory of Justice* (Harvard University Press rev ed 1999) 3, 164.

[35] For a debate on contractualism and aggregation, *see* Aaron James, 'Contractualism's (No So) Slippery Slope' (2012) 18 *Legal Theory* 263; Barbara Fried, 'Can Contractualism Save Us from Aggregation?' (2012) 16 *The Journal of Ethics* 39.

Second, I avoid policy prescriptions based only in economics and finance, though I do not ignore economics and finance. These fields hold greatest relevance for corporate and commercial debt. For consumer and possibly sovereign debt, economic policy prescriptions tend to focus on one thing: restricting debt or deleveraging. Deleveraging is a necessary but incomplete focus. A focus on economic stability leads regulators to ignore or downplay concerns about justice and fairness.[36] If we rely only on economics, the analysis breaks down into a particular form of welfare utilitarianism, which can produce poor policy. A look at distribution from an economic point of view can offer significant data-driven insights about cause and effect. But economics offers inadequate normative criteria for assessing whether a particular distribution is morally acceptable. A focus on stability is laudable, given the instability that excessive debt has caused in the global economy, but if we do not also focus on how that stability is achieved and at who suffers the burdens of it, the net result could actually be to needlessly make vulnerable or exploited persons worse off. Beyond stability, fundamental questions about policy goals for the law on debtor-creditor relations have not been well-considered, and the overriding focus on economic stability has meant that governments have ignored other worthy goals. If economic stability could be achieved by means that impose fewer harms on less well-off groups, or which contribute less to income inequality, then these means need to be identified and prioritized.

Debt in whatever form shares common problems and effects. The problems associated with debt, as well as its advantages, are structural, relating to institutions governing access to credit and to our socially constructed understanding of debt itself. Debt, moreover is an entirely human created thing, dependent on law for its existence. Its effects are therefore in our control. The broad coverage to follow is necessary to develop a thorough understanding of just how serious the problems associated with debt can be in societies, but perhaps more importantly, it is necessary to elucidate the common features of debt as found in the legal architecture necessary for debt to exist, which

[36] These insights are captured in discussions of debt by economists and officials in the Bank for International Settlements. For example, the General Management of the Bank for International Settlements has argued that from a 'financial stability and macroeconomic point of view' that 'there is simply too much debt in the world today' but 'it may be the case that it is better distributed now, if it is shifted to those who can more ably manage the risks'. He also goes on to address the welfare issues associated with debt. Jaime Caruana, 'Debt; The View from Basel' in BIS Papers No 80, *Debt,* January 2015.

produces the bads to be avoided, regardless of whether the debtor is a sovereign or a student.[37]

Part I offers a 'methodological prelude', sketching the disciplinary approach of the article in moral theory and luck egalitarianism. Part I includes an outline of a version of luck egalitarianism influenced by Ronald Dworkin's approach to the subject. Part II explains the moral relevance of credit architecture, showing why debt it not only about individual choice. Part III elucidates conditions that should be met for the credit architecture of a society to be just. It provides examples from the standard varieties of debt, including student loans, home mortgages and household debt, corporate and commercial debt, and sovereign debt, to illustrate how these conditions can operate in a society, to assist governments in reforming the law on debtor-creditor relationships to achieve compliance with our well-considered moral convictions in a way that does not put economic stability at any greater risk. Part III argues for a continuum of considerations of justice to apply to the various forms of debt, with some forms of debt requiring more sensitivity to considerations of justice and moral principle than others. For example, we will find reasonably acceptable to subject corporate debt to the full force of the market but will not find this to be reasonably acceptable for home mortgages or student debt. This article makes a case for a more rigorous understanding of how that continuum can operate in a society, going beyond our folk intuitions about fairness.

I. Methodological Prelude

Most of the studies of debt and access to credit and their effects on society are in economics or what might more broadly be known as a particular version of welfare utilitarianism. Welfarist approaches hold a powerful influence in policy circles in the United Kingdom, the United States, development institutions, and elsewhere. Sociological research has been conducted as well.[38] Almost no serious philosophical work exists on the subject.[39] Given the newness

[37] The functional as opposed to doctrinal approach of this article may be more common to economists. *See* BIS Papers No 80, *Debt,* January 2015.

[38] *See, e.g.,* Basak Kus, 'Sociology of Debt: States, Credit Markets, and Indebted Citizens' (2015) 9 *Sociology Compass* 212; Donncha Marron, *Consumer Credit in the United States: A Sociological Perspective from the 19th Century to the Present* (Palgrave Macmillan 2009). Teresa Sullivan is an influential sociologist in the field. See in particular Sullivan's work with legal scholars: Teresa A Sullivan, Elizabeth Warren, & Jay Lawrence Westbrook, *The Fragile Middle Class: Americans in Debt* (Yale University Press 2000); Teresa A Sullivan, Elizabeth Warren, & Jay Lawrence Westbrook, *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America* (Oxford University Press 1989). For anthropological work, *see* David Graeber, *Debt: The First 5,000 Years* (Melville House reprint ed 2013).

[39] The lack of philosophical work is likely the result of disciplinary socialisation in philosophy away from applied or non-ideal work, with the possible exceptions of work in criminal law, tort

of the approach taken in this article, some effort will be spent outlining the methods used in this article. This is, however, not an article in philosophy and I will not engage in the sort of philosophical justification typical of philosophical work. Moreover, some of the concepts to be laid out in this part might be basic to the philosopher, who might well want to skip to section II.

A. *Right Based Moral Theory*

We could perhaps too crudely classify approaches to moral argument influential in inquiry about law into two distinct approaches: *preference* or *welfare* based approaches and *right* based approaches. There are obviously other ways of classifying moral theory[40] but the focus here is broadly on a key difference, well accepted in moral philosophy, that will become important in this article. Legal scholars have employed right based approaches far less than preference based approaches despite that right based approaches hold significant promise for helping policy entrepreneurs in making morally justifiable law. In other words, right based approaches have *ex ante* value in institutional design.[41]

Preference based approaches are consequentialist and welfare based. Because they are consequentialist, they focus on a single normative criterion of which law or policy produces the most 'good'. They are preference-based because they rely on the preferences of persons to determine goodness of a particular rule or action. For a social welfarist, the most good is achieved by maximising social welfare, and social welfare is determined by the aggregation of preferences of individuals.[42] In a welfarist approach, concepts like rights, justice, liberty, fairness and other moral concepts are unnecessary. The animating idea is that welfare maximisation captures all of the morality appropriate for a legal system.

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law, and constitutional law. *See* George Yancy & Charles Mills, 'Lost in Rawlsland', *New York Times,* 16 Nov 2014. Add to these professional obstacles that doing applied philosophical work in complex areas in which institutions affect human behaviour is very demanding. Add further to the obstacles that philosophy is not empirical by design; empirical work is supposed to be for social scientists, not philosophers. Joshua Cohen's delimitations of the fields are worth reading on these points. Joshua Cohen, 'Philosophy, Social Science, Global Poverty' in Alison M Jaggar, *Thomas Pogge and His Critics* (Polity 2010). The new movement in experimental philosophy, which is empirical, is a minority branch of philosophy and has had almost no influence in political philosophy.

[40] It is unclear where moral realist and aretaic accounts fall. *See* Heidi M Hurd & Ralph Brubaker, *Debt and the Demands of Conscience* (Oxford University Press 2016(virtue oriented justification for personal bankruptcy law).

[41] Fried n xx and James xx discuss the *ex post* versus *ex ante* issue.

[42] Matthew Adler offers a recent and influential account of a preference based approach. Matthew D Adler, *Well-Being and Fair Distribution: Beyond Cost-Benefit Analysis* (Oxford University Press 2012). Adler's core notion is that governments should design public policy to maximize the expectation of a continuous prioritarian social welfare function (SWF). For Adler, the only relevant criteria for determining welfare is individual well-being, which is captured in the notion of extended preferences over the lives of persons. Adler's SWF gives greater weight to increases in utilities for the worse off.

Right based approaches of the sort relevant here – Kantian inspired ones - are not consequentialist because they focus on the rightness or wrongness of rules or actions to each person and not on the consequences of those rules of actions across persons. In right based accounts, moral principles area irreducible and cannot be justified by reference to non-moral interests such as welfare, prudence, or rational choice.[43] In a suitably Kantian inspired right based account, right has priority over the good. The priority of right reflects what Rawls calls the 'separateness of persons' requirement: 'each person possesses an inviolability founded on justice that even the welfare of society as a whole cannot override'.[44] As Carl Cranor explains: 'substantial restrictions on how individual members of the moral community may be treated. Moreover, these constraints would obtain, even if some alternative principle or action would produce greater community good'.[45] Preferences are of limited relevance because the preference of no single person or group of persons can override what is owed to any single person under suitably constructed principles of right, constructed in conformity with moral reasons everyone must accept if they are part of the moral community, not conformity to aggregated preferences.

So, how would these differences play out in the evaluation of legal institutions? The structure of right based moral theories is often understood to be contractualist. Contractualism has gained some ground in the evaluation of law but it still has far less influence than welfare utilitarianism. Contractualist theories locate around a form of mutual justification or 'justification to others' modelled on hypothetical agreement. Using TM Scanlon's argument about the contractualist form that moral argument takes: for law to meet the demands of morality, it has to cohere with moral principles for the regulation of human behaviour that no one could reasonably reject.[46] It offers a standard of impartiality for the law to be formed around what reasonable persons should expect from the law. Think of these notions in terms of demands a person might make on another person, or an obligation a person might have to another person. We give content to demands, obligations, and judgments about right and wrong.

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[43] Samuel Freeman, 'Moral Contractarianism as a Foundation for Interpersonal Morality' in James Drier ed, *Contemporary Debates in Moral Theory* 57-76. Of course, this article extends these notions into the realm of institutional morality relevant to law and public policy. Why that extension is not automatic and has to be justified, and produces differences between interpersonal (or interactional) and institutional morality, is well accepted. This is a distinction going well back to Kant's Doctrine of Right in his *Metaphysics of Morals.*

[44] Rawls n xx.

[45] Carl F Cranor, 'Toward a Non-Consequentialist Approach to Acceptable Risks', in Tim Lewens, *Risk: Philosophical Perspectives* (Routledge 2007) 36.

[46] TM Scanlon, *What We Owe to Each Other* (Harvard University Press 1998).

That content comes from putting ourselves in the place of others, and those others doing the same for us. Reasonableness relates to the idea of justification to others. My demands have to be reasonable to you and yours to me.

Tom Hill offers a Kantian inspired approach in which he argues for a deliberative procedure for persons to use to assess how they might interact with fellow members of their society, including through laws they ought to support. Hill proposes that persons should accept principles that would be adopted by rational legislators who autonomously will universal laws treating each person as an end in herself, 'with dignity above price'.[47] Here we see a very different notion of autonomy at work than we find in the welfarist literature. For a welfarist, autonomy means ability to choose. For neo-Kantians like Hill, autonomy is the capacity and disposition to identify, accept, and follow the moral law's rational authority and understanding its commands as indispensable to our own practical reasons for action.[48] Hill argues that people ought to take this legislative attitude with them when they deliberate about positive law. Hill is not stuck in the exegetical Kant. [49] Rather, in his own words, he has 'seriously questioned the relation between Kant's ethical principles of virtue for individuals and his theory of justice for political institutions' and argues that some have argued 'perhaps with some exaggeration, that Kant tried to draw a bright line – if not an impenetrable barrier – between ethics (the doctrine of virtue) and law (the doctrine of right).'[50]

Carl Cranor argues for an approach to moral acceptability of risk associated with exposure to environmental hazards and toxic substances based on Hill's kingdom of ends approach.[51] For Cranor, '[p]ersons in the kingdom of ends should adopt moral principles that they could justify even to those who would be adversely affected if a principle of were adopted'.[52] Cranor continues: 'one would consider a principle from the kingdom of ends, asking whether everyone

[47] Cranor n xx 43; Thomas E Hill Jr & Arnulf Zweig eds, Immanuel Kant, *Groundwork for the Metaphysics of Morals* (Oxford University Press 2003) 433-36; Thomas E Hill Jr, ed, *Dignity and Practical Reason* (Cornell University Press 1992) 46-47.
[48] Thomas E Hill Jr, *Virtue, Rules and Justice: Kantian Aspirations* (Oxford University Press 2012)5.
[49] *Ibid.,* 1: Hill goes 'beyond historical scholarship with a view to developing a broadly Kantian theory drawn from some of his ideas'. Hill 'describes Kant's view, proposes an interpretation, or draws critically form Kant to develop a modified but broadly Kantian position'.
[50] *Ibid.,* 6.
[51] Cranor n xx.
[52] *Ibid.,* 45-46.

affected by it would subscribe to it, even when some would be less favourably treated than others'.[53]

These approaches are at work in the sections to follow, along with a suitable egalitarian theory. As explained below, I defend a luck egalitarian for evaluating legal institutions relating to debt and access to credit.

B. *Luck Egalitarianism*

This article relies on a prominent version of resource-based luck egalitarianism, the main proponent of which is Ronald Dworkin.[54] Luck egalitarianism is relevant to evaluating the law debt on access to credit because it offers a hybrid theory that is sensitive to individual responsibility and the effects of institutions on what is just. It mitigates the harshness of wholly individualised conceptions of risk while still holding people responsible for transactions in which they can realistically choose. It provides a way to account for both the individual responsibility of persons and justice owed to those persons by society. Because debt is structured in the form of a transaction in which people at least ostensibly make choices, taking some level of responsibility into account seems essential in making normative judgments about the fairness of debt and whether debt should be regulated to meet the demands of egalitarian justice, though as we shall see, choice may not be as responsibility sensitive as we might at first blush think it might be in some debt contexts. We also want to know how circumstances and bad brute luck affect debtors and creditors. One person's debt is another person's investment, though the relationship may be one that is intermediated through financial institutions like banks.[55]

Dworkin develops what Rawls would call a 'decision procedure' for deciding about which inequalities are morally acceptable in a society. Suppose we are at the very beginning of our society. Everyone has an equal amount of specie and it is only valuable to an auctioneer, who will accept it in exchange for a set of available resources in our society. We do not yet know our endowments of natural talents and handicaps or our station in society but we have preferences

[53] *Ibid.*

[54] Ronald Dworkin, 'Equality of Resources' in *Sovereign Virtue: The Theory and Practice of Equality* (Harvard University Press, 2000) 65-119; Ronald Dworkin, 'Equality, Luck & Hierarchy' (2003) 31 *Philosophy and Public Affairs* 190-198; Eric Rakowski, *Equal Justice* (Oxford University Press, 1991). Dworkin did not consider himself a luck egalitarian. Of course, there are a number of resource-based accounts of egalitarianism, including Rawls's theory of justice as fairness. The emphasis here is on responsibility-sensitive accounts characterized as luck egalitarian.

[55] Mian & Sufi n xx 20 ('A poor man's debt is a rich man's asset.).

for different goods and these preferences make us prone to envy.[56] The auctioneer holds all of the resources to be divided among us through an auction. We buy the resources we value the most in the auction and with some caveats,[57] we are all envy free at this stage.

People have to live in our society after the auction. How do we keep resources equal while still accounting for differences resulting from choices by our citizens? We do not care about inequality resulting from matters within our citizens' control, such as how ambitious they are or how they value work or leisure. But we do not want events outside their control, such as their natural talents or handicaps, to contribute to inequality. So, some forms of inequality are morally objectionable and some are not. Dworkin examined these issues from the standpoint of luck and choice. He divided luck into two forms: brute luck, which is luck over which a person has no control, and option luck, which is luck the result of a person's choices.

So we want to neutralise bad brute luck to make our society fair. We can do so through a hypothetical insurance market in our equal auction. In the auction, a person does not know her talents and handicaps or which catastrophes she might suffer. We also assume that everyone has equal risks. Ask the question: what insurance would the average person want against bad brute luck? Once we establish what the average person would insure against, we can then determine how to construct tax and budget institutions to compensate individuals who happen to have the bad brute luck in the actual (as opposed to hypothetical) world.

For example, it is reasonable to assume that most people would want to avoid health catastrophes and would want basic health care protections. Government should therefore put in place a basic health insurance scheme for all. We can apply the same sort of reasoning to any government policy, such as unemployment insurance, minimum wages, and so on. As explained below, we can use the hypothetical insurance insight to specify other protections, such as

[56] Preferences count in the version of egalitarian theory relied upon here, but only as part of a decision procedure to construct moral reasons for or against particular levels of inequality. These are the hypothetical or average preferences of a hypothetical or average person relied upon in some 'pretend' initial stage of a society when persons do not know their traits, talents, or status in society, and therefore can be relied up to make reasonable moral judgments. These are not actual revealed preferences but rationally constructed preferences, meant to ensure impartiality, a necessary condition for moral theorising. This kind of egalitarian theory does not take actual preferences of actual persons into account in determining the morally acceptable distribution of whatever is being distributed. Hypothetical preferences are, in short, a way to access human moral psychology to develop the right sort of moral principles that may in fact *be contrary to* actual preferences.

[57] See Dworkin, 'Equality of Resources' n xx, 69. For example, we may prefer resources that do not exist in our society.

hybrid debt instruments, sovereign debt linked to GDP, and negative home equity insurance.

A resource-based approach to luck egalitarianism allows us to avoid the propensity of welfare egalitarianism to compensate those who deliberately cultivate expensive tastes and even those not responsible for their expensive tastes and have so-called bad price luck.[58] In a resource-based account, we can avoid catering to people with expensive tastes in homes or other assets, or more generally, to people who seek substantial increases in their well-being from risky uses of credit.

Finally, Dworkin's decision procedure specifies the use of hypothetical insurance to determine levels of taxation and transfer for redistribution purposes. But this article proposes getting the substantive legal rules and policies right in the first place, to minimise the need for costly redistribution. We will apply the hypothetical insurance market test to any disadvantage sufficiently unrelated to freely made choices and promote resource equality through rules designed for the task. The aim is to have institutions structure the distribution of burdens and benefits associated with debt and credit in a way that meets egalitarian concerns. This approach has come to be known as pre-distribution.[59]

II. The Moral Relevance of Access to Credit Architecture

At first blush it would seem that morality of the institutional kind we are concerned with here has nothing to do with debt. Do we not choose to go into debt? Humans think of debt as essentially a transaction between a debtor and a creditor, which requires a choice by both the debtor to borrow and the creditor to lend. Surely our choice to take on debt means that we have taken what

[58] As set forth in Dworkin, 'Equality of Resources' n xx; GA Cohen, 'Expensive Tastes Rides Again', in Justine Burley ed, *Dworkin and His Critics* (Blackwell, 2004) 3; Richard J Arneson, 'Equality and Equal Opportunity for Welfare' (1989) 56 *Philosophical Studies* 77; John Roemer, *Theories of Distributive Justice* (Harvard University Press 1996).

[59] The concept of pre-distribution originates in Rawls' notion of a property owning democracy, which traces its origins to James E Meade's *Efficiency, Equality and the Ownership of Property* (Routledge 1964). *See* Martin O'Neill, 'Free (and Fair) Markets Without Capitalism', in Martin O'Neill & Thad Williamson, *Property Owning Democracy: Rawls and Beyond* (Wiley Blackwell 2014) 75; Gavin Kerr, '"Pre-Distributon", Property-Owning Democracy and Land Value Taxation' (2015) 14 *Politics, Philosophy & Economics* 1. The pre-distribution notion became popular in political circles, in particular in the Labour Party, based on Jacob Hacker's essay, 'The Institutional Foundations of Middle Class Democracy, http://www.policy-network.net/pno˙detail.aspx?ID=3998&title=The+institutional+foundations+of+middle-class+democracy, 2011. A recent prominent advocate of pre-distribution is former Clinton Labour Secretary Robert Reich. Robert Reich, *Saving Capitalism: For the Many, Not the Few* (Icon 2016).

Dworkin calls a 'calculated gamble' in the form of option luck. Our choice would therefore take debt outside the area of concern for luck egalitarianism or other principles of institutional morality. Egalitarian justice would have no role in relation to debt creating and enforcing institutions. Rather, should we not look to virtue ethics and leave the discussion of the law behind us and focus only on individual action? And why not adopt an approach that views regulation of debt as a simple blocking of mutually desired transactions?[60]

In this choice-oriented conception of debt, the ordinary market risk associated with debt is classic option luck. Ordinary market risk is risk that a person (or entity) assumes for itself when transacting in a market. If for example I buy a house with a mortgage, I assume the risk that the value of the house will decline and that my mortgage may go underwater if I have insufficient equity in the house. I also assume the benefit of a rise in the price of the house. A firm that borrows makes the same choice, as do the lenders to the firm. Sovereigns borrow along these lines as well, from either banks or the bond markets. In the choice story set forth here, all of these transactions carry the same normative implications.

The law also frames the concept of debt as choice sensitive. Debt becomes legally binding through the branch of private law that creates legal obligations through voluntary exchange – the law of contract. Of course, some law has developed to protect the vulnerable. In contract law, Lord Denning stated in his famous dictum in *Lloyd's Bank v Bundy* that all contract law doctrines dealing with inequality of bargaining power should be developed into a single legal principle, but no such principle has ever developed in contract law.[61] Contract law specifies some very limited doctrines dealing with unconscionability, undue influence, and duress, for example, to deal with the worst forms of abuse. In Anglo-American law, the lender-borrower relationship generally does not establish a fiduciary relationship.[62] In the language of contract, fiduciary rules are not part of the terms of the debt contract. On the regulatory side, there is the domestic and European legal apparatus to deal with

[60] For the framing of these issues, see Christine Jolls, Cass R Sunstein, & Richard Thaler, 'A Behavioural Approach to Law and Economics' (1998) 50 *Stanford Law Review* 1471.
[61] [19750 QB 326, [1974] All ER 757.
[62] John Pottow, 'Ability to Pay' (2011) 8 *Berkeley Business Law Journal* 175, 177-178. In Part III, we will cover legislative and regulatory changes in UK and US law on mortgage credit imposing requirements on lenders to take responsibility for affordability and suitability of borrowers.

bad practices in consumer transactions, but these rules offer sporadic protection in limited cases.[63]

The rational choice version of law and economics frames debt around choice and contract. Contract theory, at least its American variant, frames the core of commercial law around contract, in the form of Coasian bargaining.[64] In this transactional context, regulation – law that parties cannot choose to include or exclude in their contract - interferes with choice and usually makes contracting parties worse off.[65] Of course, a debt contract can be and is regulated but that regulation is understood in the rational choice version of law and economics as exceptional, as choice-interfering mandatory rules imposiing transaction costs in the debt contract.

According to the choice story, debt offers no facts upon which moral principles can apply because people who make decisions in a market take Dworkin's gamble and put themselves at the mercy of their own choices.[66] Debtors ought not to be able to take out any hypothetical insurance in the equal auction to insure against debt. They do not deserve protection at either the pre-distribution or re-distribution stage. Inequalities created by debt are morally unexceptional. Back to the homeowner example, if my society fails to provide me with adequate basic social services, or if government restricts my access to mortgage credit essential to secure decent housing and education for my children because educational resources are territorially allocated to particular neighbourhoods, so what. I can choose to live on subsistence credit by maxing out my credit cards to pay essential bills.

As explained in the sections to follow, the simple choice story fails to capture the moral relevance of debt and its legal architecture.

A. *Humans Choose Poorly*

The choice story is loaded with unexamined presuppositions, including fanciful economic and libertarian conceptions of human freedom. A decision by a person to borrow is subject to shortcomings of cognition that affect everyone

[63] *See, e.g.,* Iain Ramsey, *Consumer Law and Policy* (Hart 3rd ed 2012).
[64] A good example of this sort of contract theory can be found in Jody S Kraus & Steven D Walt, *The Jurisprudential Foundations of Corporate and Commercial Law* (Cambridge University Press 2007).
[65] *See* Jolls *et al*, n 62.
[66] Dworkin explains that 'option luck is a matter of how deliberate and calculated gambles turn out – whether someone gains or loses through accepting an isolated risk her or she should have anticipated and might have declined'. Dworkin, 'Equality of Resources' n xx, 73.

to the predictably many instances of departures from rationality.[67] These defects in rational capacities apply to persons acting for themselves, such as the individual homeowner or the student. They also apply to persons acting as agents for others, such as the bank manager and the government official. Agents are also subject to well-understood incentives associated with the principal-agent relationship.

B. *Choices About Debt Depend on Circumstances and Institutional Architecture*

To fully investigate how debt operates in society, we need to know how debtors get to the point of making a choice in the first place. What choices do they have and why? Our account needs to focus on both aspects of Dworkin's luck egalitarianism – on justice *and* choice. Choices about debt depend on a person's circumstances. It is sometimes difficult to distinguish brute from option luck and that the distinction is often a matter of degree rather than kind.[68] If our society makes important resource distributing decisions mainly through markets, then the chances are high that the less well off a citizen is, the more debt she will have relative to her income, and she may also suffer from restrictions on access to credit, leaving her with poor choices.[69] Particular features of debt other than choice affect how and why persons make decisions about debt.

In Dworkin's decision procedure set forth above, we assumed a fixed set of resources in our society, to distribute initially in an equal auction. In the equal auction, we all had what was in effect cash – an initial allocation of specie, whatever it may be (it was clamshells for Dworkin).[70] Our society initially decided how we would exchange in a market. It set the terms for that market in the form of an equal auction in which each member of society had equal endowments of both specie, traits, and characteristics. So, what came before our choices in the auction was structure, institutional and social. Structure was prior to choice.

Structure *is* prior to choice in actual societies. We choose within that structure. The structure substantially determines what we choose, because it determines what we can choose, our set of available choices, why we are

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[67] For an application to choices about debt, *see* Oren Bar-Gill & Elizabeth Warren, 'Making Credit Safer' (2008) 157 *University of Pennsylvania Law Review* 1.
[68] Dworkin, 'Equality of Resources' n xx, 73.
[69] Adair Turner, *Between Debt and the Devil: Money, Credit, and Fixing Global Finance* (Princeton University Press 2016) 122-124.
[70] Dworkin, 'Equality of Resources n xx, 68.

choosing, and how our choices affect equality of resources. It is what Rawls called the basic structure of society.[71] We need to focus our attention on this basic structure when it comes to access to credit. It is pre-distributional in character.

We can see structure in operation in actual societies. Consider 'let them eat credit' policies in the United States and elsewhere.[72] These policies illustrate how institutions affect choice. To combat rising inequality, starting in the 1980s, American politicians sought the easy out of federal legislation to loosen the credit policies of banks for home mortgages.[73] They effectively subsidized mortgage credit. Let them eat credit policies put choices about mortgage debt in a particular context of financing resources through housing wealth and individual decision making in a subsidized market for credit. If we want to make a collective choice to subsidize mortgage debt, we have to get the institutional design right, which did not happen in the years preceding the last economic crisis. Subsidizing mortgage financing is an appropriate policy choice if that financing changes to more hybrid structures with risk sharing or insurance features, all to be explored in Part III.

Finally, the choice story rests on an incomplete notion of liberty. It rests on a restrictive version of negative liberty requiring the protection of persons only from state action imposed directly on a person's freedom. It fails to recognise as a restriction on freedom the very real constraints on a person's capacities brought about by institutions in the state's control. I am just as unfree if the state restricts my access to credit through an explicit regulation or if the state provides me with access to credit but puts in place a set of institutions that effectively restricts me from accessing that credit. The two situations are not formally equivalent from a legal point of view but they are substantively equivalent from a moral and choice point of view. Both equally merit attention by government to comply with the demands of egalitarian justice.

C. *Access to Credit is a Resource for Distribution in Society*

Access to credit itself is a resource and it is a means by which to create and distribute other resources. It therefore clearly comes within any discussion about

[71] 'The primary subject of justice is the basic structure of society, or more exactly the way in which the major social institutions distribute fundamental rights and duties and determine the division of advantages from social cooperation'. Rawls n xx, 6.

[72] The phrase 'let them eat credit' is from Raghuram G Rajan, *Fault Lines* (Princeton University Press 2010) ch 1; *see also* Kevin T Leicht, 'Borrowing to the Brink' in Katherine Porter, *Broke: How Debt Bankrupts the Middle Class* (Stanford University Press 2012) 195-217.

[73] Rajan n xx.

equality of resources. Access to credit is a resource to achieve something important to the life projects of a person, usually to acquire important resources essential to those life projects, such as in the purchase of a home with mortgage credit, or to borrow to pay for a university degree, or to use a credit card to avoid spending savings budgeted for other purposes,[74] or to use personal credit to finance the start a small business, or to use credit to pay health care bills if government fails to provide basic health care. A home mortgage finances more than a place to live. It is finances a mix of consumption and investment. Priced into the housing market is access to good schools, locations with low levels of environmental pollution and health hazards, and access to good transportation and other public infrastructure.[75] As Oren Bar-Gill and Elizabeth Warren explain in an important paper on consumer credit:

> Credit has provided substantial value for millions of households, permitting the purchase of homes that help families accumulate wealth and cars that can expand job opportunities. Credit can also provide a critical safety net, permitting families to borrow against a better tomorrow if they suffer job layoffs, medical problems, or family breakups today.[76]

People make choices about debt that relate to access to resources affecting their life prospects in serious ways. We may not think of forms of corporate or commercial credit as relevant to equality of resource concerns but that may not be true in all cases. There will be cases in which access to credit relates to access to the opportunity to innovate, such as in the promotion of entrepreneurship. In these cases, credit serves the role of transformation – of taking an innovation of an entrepreneur and transforming it into a tradeable financial asset. Without the financial asset, a person may not be able to achieve life goals. Finance can be understood to have an ethical component.[77]

Sovereign debt has a substantial resource distributing function. Governments borrow for many of the same reasons that individuals do, to: to consume more goods today, often in the form public goods, goods undersupplied by markets, or goods that people cannot afford on their own. Governments could finance these goods by raising taxes, but in some cases is better to borrow and slowly repay the debt over time through taxation into the future. This is

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[74] Richard H Thaler & Cass R Sunstein, *Nudge* (Penguin 2009) 48-52.
[75] Anthony B Atkinson, *Inequality* (Harvard University Press 2015)162, citing Regeneris Consulting & Oxford Economics, *The Role of Housing in the Economy: A Final Report by Regeneris Consulting and Oxford Economics* (Regeneris Consulting Ltd. 2010) 8, 71.
[76] Oren Bar-Gill & Elizabeth Warren, 'Making Credit Safer' (2008) 157 *University of Pennsylvania Law Review* 5.
[77] *See generally* Robert J Shiller, *Finance and the Good Society* (Princeton University Press 2012).

known as 'tax smoothing'.[78] Tax smoothing works very similar to consumption smoothing through a home mortgage, an education loan, or an auto loan, or debt on commercial real estate such as a hotel or a university residence hall. These debtors require a large chunk of money now to capitalise an asset, which they pay off with funds from a future income stream. Governments have used borrowing to finance civil works, education, pensions, and health care. In some cases, governments might project these investments as increasing GDP in the future, from which taxes can be drawn to pay off the debt. Of course, governments sometimes get the financing model wrong, particularly when exogenous events change macroeconomics of their economy.

D. *Borrower and Lender Choices Affect Others*

Credit distributes resources not only to direct beneficiaries such as borrowers but also to others, in the form of positive externalities. For example, education has public good characteristics. Society benefits when people earn university degrees.[79] People with higher education earn more than those without it. The global economy provides increasing rewards for jobs requiring university degrees. Gone are the days, at least in some high-income countries, when people could make a decent living to support a family with a secondary qualification in a manufacturing job. People with university degrees innovate to far greater degrees than those without the degree.[80] University graduates are more civically engaged.[81]

We can tell a similar story of private home ownership. Owners take better care of their properties than tenants.[82] Crime is lower in neighbourhoods with substantial levels of private home ownership.[83] Home owners are more civically engaged than tenants.[84] Private home owners tend to have higher net worth

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[78] Robert J Barro, 'On the Determination of the Public Debt' (1979) 87 *Journal of Political Economy* 940.
[79] *See* pp xx.
[80] Rajan n xx.
[81] Mallory Angeli Newell, 'What's a Degree Got to Do With It? The Civic Engagement of Associate's and Bachelor's Degree Holders' (2014) 18 *Journal of Higher Education Outreach and Management* 67-90; C Flanagan & P Levine, 'Civic Engagement and the Transition to Adulthood' (2010) 20 *The Future of Children* 159–179.
[82] Robert D Dietz & Donald R Haurin, The Social and Private Micro-Level Consequences of Homeownership' (2003) 54 *Journal of Urban Economics* 401.
[83] *Ibid.*
[84] *See, e.g.,* Edward Glaeser & Denise DiPasquale, 'Incentives & Social Capital: Are Homeowners Better Citizens?', (1999) 45 *Journal of Urban Economics* 354; Sidney Verba, Kay Lehman Schlozman, & Henry Brady, *Voice and Equality: Civic Volunteerism in American Politics* (Harvard University Press, 1995).

than renters, which they can put to use as resources in support of their families and children, such as in the funding of higher education.[85]

The potential negative externalities from debt defaults are also significant.[86] Systemic risk differs from market risk because the risk is explicitly on persons who are not parties to the debt contract. My transaction does not impose a risk on me, or at least not only on me, but also on others. The distinction between ordinary market risk and systemic risk aligns closely with Dworkin's distinction between option luck and brute luck.[87] Everyone in society risks suffering bad brute luck because of systemic risk. Systemic financial risk has the potential to harm someone even if they had nothing to do with the transactions causing the harm. Exposure to systemic financial risk is an unfortunate circumstance having little to do with choosing but with being a participant in a market economy. Rational persons in our equal auction will want to insure against systemic risk.[88] In actual societies, governments have put in place a substantial post-crisis regulatory architecture at the pre-distribution level to mitigate systemic financial risk.

E. *Debt Disproportionately Burdens the Less Well Off*

Debt is a more important institution for the distribution of resources for the poor than the rich. Rich people have better access to credit but they need it less. The *Economist* explains:

> Income and wealth inequalities within economies . . . amplify the impulse towards debt. Rich people have a lower propensity to spend than most, so the more they earn the more they save. That money has to be recycled into the financial system, creating more financial instruments. Those in need of capital are often poor people with stagnant incomes. In practice debt is the only way to funnel money to them. You cannot, after all, buy shares in a household. Subprime debt secured against houses seemed safe.[89]

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[85] Karl E Case, John M Quigley, & Robert J Shiller Jr, 'Comparing Wealth Effects: The Stock Market versus the Housing Market', (2005) *Advances in Macroeconomics* 5, 1. Compare Charles Calomiris, Stanley D Longhofer & William Miles, 'The (Mythical?) Housing Wealth Effect', NBER Working Paper No. 15075, June 2009. The relationship of housing and wealth to inequality is substantial. Research in the UK tends to focus on geographical and intergenerational inequality between regions. Mortgage Market Review, Feedback on CP11/31 and final rules (Oct 2012). US research shows a link between housing and wealth inequality and race and ethnicity. *See e.g.,* Lauren J. Krivo & Robert L Kaufman, 'The Relationship of Housing and Wealth Inequality to Race and Ethnicity, *Demography* 41, 3 (2004), pp. 585-608.

[86] For a recent survey, *see* Dimitri Vayanos & Tim Frost, *Systemic Risk: What Research Tells Us and What We Need to Find Out* (LSE Systemic Risk Centre July 2015).

[87] John Linarelli, 'Luck, Justice, and Systemic Financial Risk' *Journal of Applied Philosophy,* Online Early View, 5 August 2015.

[88] *Ibid.*

[89] 'A Senseless Subsidy', *The Economist,* 16 May 2015.

Credit often distributes resources to the less fortunate in morally perverse ways. In addition to behavioural market failure, debt markets are also prone to moral failure. Mortgage lending offers a good example.[90] Mortgage lenders, usually in the form of banks, obtain liquidity for lending from their creditor and investors: depositors, who are actually a class of creditors in the bank, other creditors, and shareholders. Mian and Sufi refer to these providers of liquidity as 'savers'.[91] When we say a bank has a mortgage in a home, we are really saying that savers have some kind of property right, understood from a functional or economic point of view, in the borrower's home. Now consider how debtor-creditor law affects equality. Savers usually have high net worth and borrowers low net worth, or at least the net worth of borrowers is low enough cause them to borrow to buy a home. Because debt is rigid, if house prices decline, the losses concentrate on the borrowing homeowners. If they are poor enough, their family net worth disappears. The ruination of the finances of low net worth households can have dire consequences for entire families, the educational and life opportunities of children in those families, and possibly even the health of entire families.[92] But savers in a down market fare relatively better. They bear no loss on individual mortgages because debt is rigid and represents a fixed claim for payment regardless of the value of the assets that secures it. Savers may lose in some repossession contexts if they are in a jurisdiction that makes it difficult to collect on the borrower beyond the value of the home or when the borrower is judgment proof, but given that they are affluent, they are likely diversified and have relatively little debt themselves, so they suffer far less. The result is that the distribution of losses in the down market falls disproportionately on low net worth borrowers, those least able to bear the losses. Of course, borrowers benefit when house prices appreciate, though their gains are relatively illiquid unless they can access the gains through even more debt in the form of a second mortgage, but so do savers, as their diversified portfolios rise in value and they continue to collect fixed payments on mortgage debt.

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[90] As does student debt. *See* Jonathan D Glater, 'Student Debt and Higher Education Risk' (2015) 103 *California Law Review* 1561-1614.

[91] Mian & Sufi n xx, 18-19.

[92] There have been a number of studies, particularly in the United States, on so-called medical bankruptcies. *See* David U Himmelstein, Deborah Thorne, Elizabeth Warren, & Steffie Woolhandler, 'Medical Bankruptcy in the United States, 2007: Results of a National Study' (2009) 20 *The American Journal of Medicine* 1. The data in this particular study is astonishing. Just looking at the single year of 2007, 62.1% of all bankruptcies were medical. 92% of these medical debtors had medical debts over $5000. The rest lost significant income because of illness or mortgaged a home to pay medical bills. From 2001 to 2007, the share of 'medical bankruptcies' increased by 49.6%. For the effects of US personal bankruptcy on children, *see* Elizabeth Warren, 'Bankrupt Children' (2002) 86 *Minnesota Law Review* 1003.

Mian and Sufi describe mortgage debt as 'anti-insurance'.[93] Because of its rigidity, debt works contrary to Dworkinian insurance at the pre-distribution level. Mian and Sufi explain:

> Tornados and fires are examples of a number of . . . risks that we face every day. It makes no sense for individuals to bear these risks. [A] sound financial system should allow us to collectively insure one another against such risks that are beyond the control of any one person. It is a relatively small cost for us to protect each other on a regular basis, and the gains benefit everyone in the long run. When a family is able to move forward after a disaster, they can properly take care of their kids and can continue working. Our overall productivity and happiness are higher.
> Debt is the anti-insurance. Instead of helping to share the risks associated with home ownership, it concentrates the risks on those least able to bear it.[94]

Access to credit is a resource playing an important role in distributing resources essential to egalitarian justice, but given debt's rigidity, it often aggravates inequality rather than promote equality. Debt that is not regulated with the aims of egalitarian justice at hand works the opposite of Dworkin's insurance. It operates as *anti-insurance*, as taking resources away from people most in need of those resources.

These arguments relate to the structure of debt generally and extend beyond mortgages. We can apply a similar line of argument to non-consumer forms of debt, for example, to government or corporate debt. In some cases, the anti-insurance aspect of debt is often unobjectionable, as in the case of some corporate bond contexts or in the case of mezzanine finance. We should not worry too much about diversified and sophisticated investors in capital markets. Contract and choice can play more prominent roles in regulating these relationships. When debt is coupled with a social good like housing or education, moral concerns become more salient because of the risk that the debtor will be deprived of a social good essential to a decent life.

III. Developing a Just Credit Architecture

How can the above methods be put to work in the development of a legal architecture for debt and access to credit meeting the above standards for moral justification? The aim is to develop a set of principles that policy entrepreneurs can use to evaluate whether no one can reasonably reject the relevant law and whether the law meets luck egalitarian demands. A set of principles can be distilled from the above discussion. These are not moral principles, but a set of

[93] Mian & Sufi n xx, 29-30.
[94] *Ibid.,* 30.

intermediate principles developed in a reflective equilibrium and grounded in the moral assessment developed in the preceding sections. They are rules of thumb for the development of a legal architecture for debt and access to credit. In the discussion of these principles, paradigmatic forms of debt, as they are created by the law, are evaluated to determine whether they comply with relevant moral demands.

A. *Avoid Financing Public Goods Primarily Through Private Debt*

The state should not require persons to take out significant debt to further a policy aim, unless that policy aim has no role other than to benefit the debtor, the debtor can make an informed choice about the debt, and the debt does not substantially impair the life projects of the debtor. This principle should reflect a sliding scale. Some goods are important and valuable both for individuals and for society to flourish. These goods have both private and public benefits. Economists characterise these goods with mixed characteristics as imperfect public goods. The private features of such goods might mean that they are amenable to acquisition by persons individually, possibly through debt, but cases will exist in which even the private benefit aspects of these goods mandate government assistance where the debtor's circumstances are such that self-financing is morally objectionable because, for example, such self-financing does not meet standards of egalitarian justice. More generally, government ought not generally impose debt on persons to pay for goods that others benefit from, unless it can justify the debt as effectively a tax on those able to pay.

Student loans are an example of the kind of debt that can violate this first principle if not properly structured to meet egalitarian and other moral concerns. It is well accepted that higher education has both public and private goods characteristics.[95] As we shall see, student debt is a mixed case but even the private benefits aspects of university education require financing beyond the standard debt contract in order to comply with egalitarian demands. An undergraduate degree has substantial private benefits but the wealthier a student's family the greater the chances that she will attend university. Degrees and inequality very positively correlate, throwing into doubt merit based arguments about university admissions.[96] The public goods characteristics of higher education make the need for government subsidy even greater.

[95] Robert K Toutkouschian & Michael B Paulsen, *Economics of Higher Education* (Springer 2016) 93-148; Simon Marginson, 'Higher Education and Public Good', in Paul Gibbs & Ronald Barnett eds, *Thinking About Higher Education* (Springer 2014) 53-70.
[96] *See* pp xx below.

The United States and United Kingdom have substantial fee paying systems of higher education.[97] We will use these two countries as case studies for examining how student fees and loans work in those countries and whether they comply with egalitarian standards of justice.

The United Kingdom has engaged in substantial privatization of its universities. British universities are now effectively partially subsidised charities subject to regulation by higher education funding councils.[98] Teaching grants in the United Kingdom have dwindled and are now only for students in clinical years of study and for some laboratory based subjects.[99] Government budget allocations for university infrastructure are unknown of in the United Kingdom. Unlike in both Europe and in some states in the United States, governments do not own the assets of British universities and their staff are not government employees.

The United States has followed a dual structure of a substantial number of private institutions of higher education along with substantial public university systems maintained by states. This structure has transitioned into a much more privatised one, with public universities increasingly relying on private funding and tuition fees.[100] The United States has more than 8,000 institutions awarding undergraduate degrees with considerable variability in tuition structures between public and private colleges and universities.[101] An example of privatisation can be found in California, one of the largest university systems in the country. In 2004, then California Governor Arnold Schwarzenegger and the leadership of the University of California (UC) and California State University (CSU) systems agreed to a Higher Education Compact to decrease reliance by these massive university systems on direct government funding and to increase their reliance on student fees and other 'private' revenue sources. American public universities have had to deal with substantial declines in government funding and now many receive most of their funding from private

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[97] OECD, *Education at a Glance 2015* (Indicator B5); Paul Bolton, 'Changes to Higher Education Funding and Student Support in England Froom 2012/13, House of Commons Library Standard Note SN/SG/5753, 6 Feb. 2012. Bolton states of the lower fee of the time of the report: 'An average fee of just over Θ8,000 could mean that England has the second highest (average) fees in the developed world and the highest in any "public" system'.); Sean Coughlan, 'Tuition Fees: Is England More Expensive than US?', BBC News, 9 March 2016.

[98] The Dearing Report seems clear on these points. The Dearing Report (1997) 'Higher Education in the Learning Society' (23 July 1997), available at https://www.leeds.ac.uk/educol/ncihe/.

[99] Claire Crawford, Rowena Crawford, & Wenchao Jin, *Estimating the Public Cost of Student Loans,* Institute for Fiscal Studies, April 2014.

[100] *See* Jonathan R Cole, 'The Pillaging of America's State Universities', *The Atlantic,* 10 April 2016.

[101] Ben Taylor, 'Why Law School Rankings Matter More Than Any Other Education Rankings', *Forbes,* 14 Aug. 2014.

sources. The University of Virginia, for example, the flagship public university in the state of Virginia, receives a little over 10 percent of its budget from state appropriations.[102]

Student fees are now one of the main funding sources for American and British universities. In the United Kingdom, tuition fees are significant in England and Wales and more so in England. In the United Kingdom, the Education Act 1962 required local education authorities to pay full-time university students a maintenance grant for living expenses.[103] There no fees for tuition in the United Kingdom until the 1998-90 academic year.[104] Under the auspices of the National Committee of Inquiry into Higher Education, commissioned in 1997 by then Prime Minister John Major, Sir Ron Dearing issued a set of reports recommending tuition fees for British university students.[105] Tony Blair's Labour government introduced the changes leading to the first tuition fees and student loans in the United Kingdom. Parliament enacted the Teaching and Higher Education Act 1998, applicable the entire United Kingdom, introducing an annual tuition fee of £1,000 to begin in the 1998-99 academic year and for the 1999-2000 year it replaced maintenance grants with loans. Since the 2012-13 academic year, fees for full-time students at English and Welsh universities are capped at £9,000 annually, though starting in the 2016-17 year, the fee cap will be adjusted based on the rate of inflation and provided the university introducing them meets requirements of a Teaching Excellence Framework introduced in the United Kingdom in 2016. In England and Wales, the highest fees are expected to be £9,250 starting in the 2017-18 academic year.

At one time in the United States, many public university systems were essentially tuition-free for state residents. Private colleges and universities have always charged tuition fees, though their published tariffs are usually inaccurate representations of actual cost to the student because American private institutions and increasingly American public institutions engage in a practice known as 'discounting', a ratio of how much institutions provide to students from their own budgets and endowments to how much they receive from

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[102] The University of Virginia, 'Financing the University 101, available at http://www.virginia.edu/finance101/answers.html.
[103] 10 & 11 Eliz. 2.
[104] *See* Higher Education Act 2004 c. 8; Paul Bolton, HE in England from 2012: Funding and Finance, House of Commons Library Briefing Paper No. 6206, 29 Jan 2016; Crawford, Crawford, & Jin n xx, 9-11; Bolton n xx; Alison Johnston & Nicholas Barr, 'Student Loan Reform, Interest Subsidies and Costly Technicalities: Lessons from the UK Experience' (2013) *Journal of Higher Education Policy and Management* 167.
[105] The Dearing Report (1997) n xx.

external sources.[106] Every provost in the United States can probably tell you her institution's discount rate. It is also difficult to generalise about the costs of American higher education because of the decentralised way in which American public universities receive a substantial amount of their funding. In addition, American public universities maintain a differentiated fee structure for state versus out-of-state residents, a policy that British universities now follow. California provides perhaps a conservative public university example from the standpoint of cost.

California institutions of higher education were essentially tuition free until about they began to charge very low amounts of fees in the 1970s.[107] Students always had to pay maintenance (known as room and board in North America) but an extensive system of state grants covered these costs in California. The real move towards fees in California came in 2004, when Governor Arnold Schwarzenegger and the UC and CSU leadership agreed the Higher Education Compact to increase reliance on tuition fees and decrease reliance on direct government funding of UC and CSU instructional budgets. The Public Policy Institute of California has found that 'recent tuition increases have been driven

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[106] Sandy Baum & Lucie Lapovsky, *Tuition Discounting: Not Just a Private College Practice* (College Board 2006); Coughlan n xx.

[107] In California, the Master Plan for Higher Education of 1960, implemented by the Donahoe Higher Education Act of 1960, mandating tuition free higher education for California residents. The Plan's architects were Clark Kerr, then President of the University of California and Pat Brown, then Governor of California. Kerr is often credited with creating the California system of higher education, in which 'anyone from anywhere in California could, if they worked hard enough, get a bachelor's degree from one of the best universities in the country (and, therefore, in the world), almost free of charge'. Ronald Reagan fired Kerr when Reagan was Governor of California. The Plan set up a tripartite system of higher education. At the pinnacle of the system is the University of California, a federated university system of nine campuses. The 'UC's are very high quality PhD granting research intensive universities. The next group of universities are the California State Universities or CSUs, comprised of twenty-three campuses. Both of these university systems are selective, with the UCs more so than the CSUs. The third set of institutions in the tripartite system are the community colleges, two year colleges with open admissions, from which a student with qualifying grades can transfer to either a UC or a CSU, or to a private institution. The state guarantees every applicant admission to higher education, though not necessarily to a preferred institution. For example, students who graduate in the top 12.5% of their high school class are guaranteed admission to the UC system but not to the UC of their choice. *See* 'The History of UC Tuition Since 1868', The Daily Clog, A Cal Blog by the Daily Californian, 22 Dec. 2014, http://www.dailycal.org/2014/12/22/history-uc-tuition-since-1868/. The Master Plan was

> at its heart, it was actually quite simple and intuitive: the Master Plan was nothing more than a blanket commitment from the state to educate all the California students who wanted an education and, in doing so, to facilitate the kind of class mobility that has placed public education at the center of American civic life.

Aaron Bady & Mike Konczal, 'From Master Plan to No Plan: The Slow Death of Public Higher Education', *Dissent*, Fall 2012. The Master Plan fostered the ability of California universities to become an integral part of the innovation architecture in both southern California (Pasadena, West Los Angeles, north county San Diego, Orange County) and northern California (Berkeley, San Jose, San Francisco).

by dramatic reductions in state subsidies to UC and CSU'.[108] What previously came from California's General Fund now comes from student payments of tuition and other related fees. There were more substantial increases in fees at California institutions of higher education after 2004. In 2009, there was a 32% increase in tuition fees at the UCs, to over $10,000 for California residents, prompting student protests. 2011 was the first year in which tuition fees exceeded direct funding from the General Fund of state budget for California universities, though this is funding for current operations and not capital projects.[109] The UC Board of Regents capped tuition fees for California residents at $12,192 for the 2015-16 academic year, roughly the same as the tuition cap in England.[110] Average tuition fees across public colleges and universities in the United States is $9,410 for in-state residents, $32,405 at private colleges and universities and $23,893 for out-of-state residents at public colleges and universities.[111] but this excludes room and board. Public university tuition in California rose by 56 percent from 2008 to 2014, one of the largest increases in the United States public university systems.[112] Still, in-state students pay less in California for tuition than in a number of other states.

Data from the United States shows a substantial increase in tuition fees in that country over several decades, far exceeding the rise of average prices as measured by the US Consumer Price Index. The data for public universities reveal increases ranging between 52 percent for the periods 1995-96 and 2005-06 and 12 percent for the period 2010-11 and 2015-15. For private institutions, these numbers are 34 percent and 11 percent respectively. During these periods, the average prices rises as reflects in the US Consumer Price Index ranged between a negative number and 5.4 percent.[113]

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[108] Public Policy Institute of California, 'Higher Education Costs in California: Institutional Costs', Nov. 2014.

[109] The History of UC Tuition Since 1868', n xx.

[110] There are many sources for the tuition fee cap. *See, e.g.,* University of California, Office of the President, Budget Analysis and Planning, http://ucop.edu/operating-budget/fees-and-enrollments/index.html.

The UCs are the flagship research universities of the state of California and enrolled 257,438 total students as of autumn 2015. UC System, Infocenter, Fall Enrollement at a Glance, http://universityofcalifornia.edu/infocenter/fall-enrollment-glance. The California State Universities enrolled 474,571 students as of autumn 2015. The California State University Statistical Reports. http://www.calstate.edu/as/stats.shtml.

[111] College Board, Trends in Higher Education, Average Undergraduate Charges by Sector, 2015-16, https://trends.collegeboard.org/college-pricing/figures-tables/average-published-undergraduate-charges-sector-2015-16.

[112] The highest rate of increase for 2008-14 was Arizona at 72 percent. Amy X. Wang, Tuition is Increasing at Alarming rates at US Public Universities, http://qz.com/588920/tuition-is-increasing-at-alarming-rates-at-us-public-universities/.

[113] Sandy Baum, *Student Debt; Rhetoric and Realities of Higher Education Financing* (Palgrave Pivot 2016); Jonathan D. Glater, 'Student Debt and Higher Education Risk' (2015) 103 *California Law Review* 1561, 1571-1578. For consumer price index data, *see*

The above numbers reflect single-year costs in multiple year degree programmes. When tuition fees are accumulated across a three or four-year degree programme and maintenance costs are included, the costs of an undergraduate education can be considerable. Over three-fourth of all higher education institutions in England charge tuition fees at the maximum £9,000 allowable.[114] This makes the total fee for a three-year degree programme at £27,000 and this figure does not include maintenance. We have not dealt with postgraduate education, the cost of which can be considerable as well, particularly American postgraduate professional education in law and medicine, the only gateways into these professions in the United States. Particularly in the United States, the master's degree is the fastest growing university degree programme. As of 2014, eight percent of Americans held master's degrees, the same percentage that held bachelor's degrees in the 1960s, a forty-three percent jump since 2002.[115] The data on master's degrees may reflect a trend, prompted by increasing competitiveness in the economy and the desire of graduates to engage in signalling in the job market, the increasing complexity of jobs in a technology economy, the need for further credentials for promotion, or a combination of reasons. Master's degrees are expensive and unlike PhD programmes are rarely financed through fellowships or scholarships.

In a world without student debt, only the rich could attend college or university. As we will discover, this may be true even with government subsidized grants and loans and university discounting. We need to take a brief look at government funding schemes for students, continuing with the United Kingdom and United States examples.

Starting with the United Kingdom, English students have access primarily to loans to finance their education from official sources. Welsh students can cover most of their fees to British universities with a grant, though they will

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http://www.usinflationcalculator.com/inflation/consumer-price-index-and-annual-percent-changes-from-1913-to-2008/.

[114] There are many sources for this data. *See, e.g.,* 'Almost all English universities to charge maximum £9,000 tuition fee – exclusive survey by TheCompleteUniversityGuide.co.uk', 13 Aug 2015, http://www.thecompleteuniversityguide.co.uk/news/almost-all-english-universities-to-charge-maximum-%C2%A39,000-tuition-fee-%E2%80%93-exclusive-survey-by-thecompleteuniversityguidecouk/; Tom Brooks-Pollock, 'More Universities to Charge Maximum Tuition Fees of £9,000', *The Telegraph,* 23 July 2014.

[115] Libby Nelson, 'Master's degrees are as Common Now as Bachelor's Degrees were in the '60s', 7 Feb. 2015, http://www.vox.com/2014/5/20/5734816/masters-degrees-are-as-common-now-as-bachelors-degrees-were-in-the-60s.

need to cover some by loan, as well as cover maintenance by loans.[116] Scottish students do not pay tuition generally to Scottish universities if they are single and under 25 years of age. Northern Ireland caps tuition fees at £3,805, with loans available to cover the fees. The terms and conditions of these loans are dealt with below as they relate to the rigidity of student loan debt and its effects on inequality. The United Kingdom does not means test student loans; every student is entitled to borrow for their entire tuition and maintenance fees regardless of financial need.

In the United Kingdom, the government provides student loans through the Student Loans Company (SLC), a not-for-profit company founded in 1990 and funded entirely by the UK government and devolved governments of Scotland, Wales, and Northern Ireland. The UK Department for Business, Innovation and Skills owns a majority stake in the Company, at 85 percent. The Scottish and Welsh governments and the Northern Ireland Executive each own five percent of the Company. The SLC provides loans to students in higher education and also collection services, which it performs along with HM Revenues and Customs.

Data on the growth of student debt when fees became significant in the United Kingdom show steady growth from £7.8 billion in lending for tuition and maintenance in 2012-13 to £12.2 billion in 2015-16. Student debt in the UK accumulates to £86.2 billion. The data shows a remarkable participation rate of 90 percent from 2013-2016 and 89 percent for 2012-13.[117]

The United States maintains a complex system of grants and loans, primarily at the federal level. We look only at federal programs here. Pell grants are the largest grant program in the United States, with eligibility based generally on financial need.[118] Each year the US Department of Education sets thresholds for eligibility based on a household's estimated financial contribution to a student's higher education. Most Pell grants are awarded to students whose families earn less than $30,000 annually, some are awarded to students whose families earn between $30,000 and $60,000 annually and in rare cases they are

[116] Welsh resident students are currently eligible for fee grants of up to £5,190, in addition to a £3,810 loan to cover fees. These fees and grants for Welsh resident students are portable; they can be used at any British university.
[117] Bolton, 'Student Loan Statistics' n xx; Crawford, Crawford, & Jin, n xx.
[118] Students with battered immigrant status or who had a parent killed in military service in Afghanistan or Iraq are entitled to Pell grants regardless of financial need.

awarded to students whose families earn over $60,000 annually. Maximum award is $5,550. Also add work study and other grants.

There are five educational loans in the US federal system. Eligible undergraduate students can borrow up to $5,500 per year under the Federal Perkins loan program.[119] Eligibility for Perkins loans depends on student's financial need and availability of funds at the student's institution, which serves as the lender. The interest rate for the Perkins loan is currently five percent. The total amount of Perkins loans for any single student cannot exceed $27,500 for undergraduates. Direct subsidized loans are for undergraduates who can demonstrate financial need. The loan is subsidized, which means that the Department of Education, the lender, does not charge interest on the loan during periods of enrolment. Unsubsidized loans are similar to subsidized loans except that there is no financial need requirement and interest accrues during enrolment. The current interest rate for both subsidized and unsubsidized loans is 4.29%. Finally, parents can take out a Direct PLUS loan with the US Department of Education. Financial need is not required but credit history matters. The current interest rate for the Plus loan is 6.84%. Interest accrues during enrolment.

The growth of student debt in the United States has been significant in the past three decades. Student debt in the United States quintupled in the past three decades and reached the $1 trillion mark somewhere between 2012 and 2013.[120] As of the second quarter of 2016, the total amount of principal and interest outstanding was about $1.25 trillion with 41.7 million borrowers.[121] It is somewhat difficult to compare data between the United States and the United Kingdom because American student loans include substantial numbers of postgraduate students as well as students not at four-year institutions.

It definitely pays to earn a degree. The College Board in the United States estimates that the lifetime earnings for bachelor's degree graduates are 66 percent higher than those with a high school diploma. The data is robust that

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[119] A source for the information to follow is US Department of Education, Office of Federal Student Aid, https://studentaid.ed.gov/sa/types/loans, https://studentaid.ed.gov/sa/about/data-center/student/portfolio, and https://studentaid.ed.gov/sa/types/grants-scholarships?src=banner. All of these grants and loans are open to postgraduate students and to students in postsecondary education who are not seeking four-year bachelor degrees. Our focus is on undergraduates but it should be understood that the US market for education includes a substantial non-traditional age population as well as students using two-year community colleges as entry points to a bachelor's level programme at an institution that can grant four-year bachelor's degrees.

[120] *See* Beth Akers & Matthew M. Chingos, *Game of Loans: The Rhetoric and Reality of Student Debt* (Princeton University Press 2016) xx. Data can be found on the US Department of Education website. https://studentaid.ed.gov/sa/about/data-center/student/portfolio.

[121] *Ibid.*

in addition to the so-called wage or income premium that higher education creates it leads to better health outcomes, people who earn an undergraduate degree are less likely to commit a crime, more likely to be civically engaged.[122] As summed up in the Milburn Report, 'In short, graduates are wealthier, healthier and happier.'[123]

With these explanations of the state of student debt in two substantial tuition fee charging countries laid out, let's move on to evaluating on egalitarian grounds the institutions that make it possible. To comply with standards of egalitarian justice as laid out in Part II, the state will have to neutralise this bad brute luck if its aims are morally principled. In our Dworkinian early stages of society, a rational person with standard tastes in risk would want to insure against bad brute luck creating obstacles to higher education. Given the private benefits from higher education in the form of a wage premium and other benefits related to quality of life, it would be reasonable to predict that there will be a demand for higher education and that people would want to (hypothetically) insure against brute luck in being unable to attend. This insurance would include insurance against the financial inability to attend college or university.

I organise the discussion of student debt and egalitarian justice around three issues: (1) do fees by themselves breach standards for egalitarian justice?; (2) how could debt for higher education be made to meet standards of egalitarian

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[122] *See, e.g.,* Baum, n xx, 53; Pew Research Center, *The Rising Cost of* Not *Going to College* (Feb. 2014), http://www.pewsocialtrends.org/2014/02/11/the-rising-cost-of-not-going-to-college/; Kelly D Edmiston, Lara Brooks & Steven Shepelwich, *Student Loans: Overview and Issues (Update),* Federal Reserve Bank of Kansas City Working Paper No. 12-05 (last revised Feb. 21, 2015), http://ssrn.com/abstract=2137243; The Browne Report, *Securing A Sustainable Future for Higher Education,* http://www.independent.gov.uk/browne-report; Glater, 'Student Debt and the Siren Song of Systemic Risk' n xx, 128-131. The UK Institute for Fiscal Studies recently reported that wage premiums remain high despite increasing numbers of A-level graduates enrolling in UK universities. Richard Blundell, David A Green, & Wenchao Jin, Big Historical Increase in Numbers did not Reduce Graduates' Relative Wages, 18 August 2016, https://www.ifs.org.uk/publications/8426.

[123] The Milburn Report in the United Kingdom, published in October 2012, explains the data:

> Higher education enables individuals from low-income backgrounds to enter higher status jobs and increase their earnings. Graduates also enjoy substantial health benefits – a reduced likelihood of smoking, and lower incidence of obesity and depression. They are less likely to be involved in crime, more likely to be engaged with their children's education and more likely to be active in their communities. In short, graduates are wealthier, healthier and happier.
>
> Prior to recent funding reforms, the lifetime benefits of a degree to the average graduate – even after taking into account earnings foregone while studying, the costs of a degree and additional tax payments – were over Θ100,000 in net present value terms. There has recently been some debate as to exactly what this graduate premium is, but the evidence clearly suggests that graduates continue to earn more and are less likely to be out of work. (footnotes omitted).

The Milburn Report, *University Challenge: How Higher Education Can Advance Social Mobility* (Oct 2012).

justice?[124]; and (3) what does egalitarian justice have to do with the fact that higher education has both public and private benefits?

As for the first issue: It seems clear that charging fees to gain access to higher education, with no government assistance, breaches egalitarian standards of justice. With substantial fees, it seems clear that only students from families with substantial wealth would be in a position to take advantage of the benefits of higher education. Having students pay for their own higher education without any financial assistance from the state would violate basic principles of moral equality because students lack equal starting points resulting from circumstances entirely beyond their control and not from their own choices. This is classic brute luck. Persons in our Dworkinian society would want to insure against this bad luck.

Access to higher education very directly relates to household wealth. This is true even when government grants and subsidised lending are available. Several studies show that the wealthier the family, the more likely the student is to attend and graduate from college or university. US Department of Education data show that high-income students scoring relatively low on standardized tests are more likely to earn degrees than low-income students with higher test scores.[125] These studies are all done in the context of a substantial debt infrastructure to assist students in need of funds to pay fees for college or university. They reveal that merit works in the *opposite* direction: ability to pay is overriding when it comes to access to higher education. While we cannot test for a situation in which fees are charged in the absence of government assistance, we can reasonably infer that the situation would likely be worse in such a case.

Add to the household wealth lottery the geography lottery: students may through no choice of their own reside in regions in a particular country charging

[124] We could pose another issue likely worth exploring: why not rely on grants or at least on some ratio of grants to loans? We will leave this issue aside because we want to focus on debt and matters of practical politics inform us that grants have become disfavoured. Grants, however, could be seen as a way of ameliorating the effects of debt, as effectively a form of social 'equity' or social down-payment on education, a way to reduce the leverage on the investment in education. The British and American governments have, however, have moved away from grants, for whatever political considerations motivating such a move, which are beyond the scope of this article. Glater sets forth a brief history of the gradual move from less grants to more debt from the 1960s onwards. He also shows the rise of debt relates to stagnating incomes in the United States. Glater, 'Student Debt and Higher Education Risk', n xx, 1575-1579.

[125] *Ibid.,* 1572-1578; Emily Yount, 'The College Trap that Keeps People Poor', *Washington Post,* 15 Dec. 2014 (summarising the evidence); Elise Gould, 'High-Scoring, Low-Income Students No More Likely to Complete College than Low-Scoring, Rich Students', Economic Policy Institute, 9 March 2012; Martha J. Bailey & Susan M. Dynarski, 'Gains and Gaps: Changing Inequality in U.S. College Entry and Completion', NBER Working Paper No. 17633, Dec. 2011.

higher fees for access to their public university system than students in other regions. Students residing in Scotland, for example, pay no fees, while students residing in England pay substantial fees. Students residing in California pay lower fees in their public university system than students residing in Pennsylvania.[126] Add to the geography lottery that some US states maintain generous grant systems while others have none at all.

Finally, the intergenerational effects of student fees have to be considered. Fees for college or university have the real potential to undermine social mobility and entrench bad brute luck across generations. There are various kinds of bad brute luck and one such kind is the luck one has in the initial opportunity phase of one's life.[127]

Given these bad brute luck lotteries, we now face the second issue: how could debt for higher education be made to meet standards of egalitarian justice? Do student loans as they currently exist in the United Kingdom and the United States provide brute luck neutralising insurance?

For many years in the United States, student loans did the opposite of neutralising bad brute luck. Rather, they aggravated the effects of bad brute luck because of their extreme rigidity. They were a standard case of anti-insurance. There was no option for loan forgiveness or income contingent repayment for many years and there still is not for loans entered before 1 October 2007. Some loans were and continued to be subsidized based on financial need, but these subsidies have nothing to do with loan terms on repayment but only with interest rates and deferral of interest accumulations until after graduation for subsidized loans. These loans were rigid in terms of their repayment obligations and operated like a standard debt contract but only with lower costs to the borrower if subsidised.

For loans issued after 1 October 2007, President Obama has put in place through Executive Order a pay-as-you-earn (PAYE) or income-contingent system that caps monthly loan payments at ten percent of a graduate's monthly income.[128] These new rules somewhat relax the rigidity of student loans in the United States. Under this system, remaining balances are forgiven after twenty

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[126] *See* Jordan Friedman, '10 Colleges with the Highest Tuition for In-State Students', *US News and World Report,* 3 May 2016.

[127] Peter Vallentyne, 'Option Luck, and Equality of Initial Opportunities' (2002) 112 *Ethics* 529.

[128] The White House, 'Factsheet: Making Student Loans Affordable', 9 June 2014; https://www.whitehouse.gov/the-press-office/2014/06/09/factsheet-making-student-loans-more-affordable; The White House, Presidential Memorandum -- Federal Student Loan Repayments, 9 June 2014, Memorandum for the Secretary of the Treasury and the Secretary of Education.

years of payment or ten years in public service. In the United States, private lenders no longer make government-guaranteed loans; the government is now lender. The Obama program is similar to the program the Browne Report in the United Kingdom recommended, an income contingent repayment scheme. The British government has adopted the principal aspects of these recommendations.[129] Starting in financial year 2012/13, UK graduates pay their loans back only when their income reaches or exceeds £21,000. An automatic repayment of nine percent above the income threshold will be netted from the borrower's pay. A real interest rate will start to be charged when income reaches the income threshold, at a maximum of three percent above inflation when income reaches a second threshold of £41,000. Both earnings thresholds are increased annually. UK student loan debt will be written off after thirty years.

Income-based repayment programs implement a limited form of distributive justice. The distributive justice comes in at the back end, not as the front end, as it does with allocations of loans based on financial need. A more progressive form of distribution comes in at the contingent repayment level. Payment based on how much a borrower earns should result in a more progressive distribution of repayments, in which higher earning graduates repay more than lower earning graduates.[130]

Income-based repayment policies are a limited form of Dworkinian insurance.[131] They still maintain substantial costs for unlucky borrowers because of their limited loan forgiveness provisions. Loan rigidity is relaxed but costs over the life of the loan can be high. As explained in the context of the UK program: 'The impact of these changes on graduates is expected to be larger average loans, lower *monthly* repayments, an large increase in the average duration of a long, increased average repayments across the lifetime of the loan (with the largest increases coming from the highest earners) and an increase in the proportion of graduates who have some of their loan written off from around 15% for pre-2012 borrowers to around 60%.'[132] Loan still remain riskier for those of lesser means.

The UK income-based repayment program suffers from moral hazard. The moral hazard comes in because of the income thresholds. If graduates are

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[129] Bolton, 'HE in England from 2012: Funding and Finance, n xx, 3.
[130] *Ibid.,* xx.
[131] Glater recommends a direct form of insurance, which is not the approach used here. Glater, 'Student Debt and Higher Education Risk' n xx, 1597-1603. As explained in Part II, Dworkinian insurance is a thought experiment, similar to Rawls's original position.
[132] Bolton, 'HE in England from 2012: Funding and Finance, n xx, 6-7.

rational, a very big assumption, then they will weigh the costs and benefits of exceeding the income threshold. The result could be that those on the margins will forego jobs pushing them by modest amounts over the threshold, but those with the prospects of earning substantially over the threshold will not care, as the repayment obligation is fixed at nine percent and the benefits of a substantially higher income will far outweigh the costs of repayment in the appropriate cases. The US programme avoids moral hazard by not specifying an income threshold. Robert Shiller offers a solution by recommending linkage to income indexes.[133] Shiller's proposal is more radical because it recommends principal reduction and not simply loan forgiveness after a specified number of years if the principal remains outstanding. He also does not tie his loans exclusively to education.

Extreme rigidity remains in the United States for a large inventory of loans issued before 1 October 2007.[134] This extreme rigidity also results from the fact that unless a debtor in personal bankruptcy proves 'undue hardship' in an adversarial proceeding in federal bankruptcy court, the US Bankruptcy Code prohibits the debtor from discharging student debt. Bankruptcy Code section 523(a)(8) provides:

> [a] discharge under . . . . this title does not discharge an individual debtor from any debt — unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents, for — . . . an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; . . . or an obligation to repay funds received as an educational benefit, scholarship, or stipend; . . . or any other educational loan that is a qualified education loan . . . . incurred by a debtor who is an individual.

The case of *Brunner v. New York State Higher Education Services Corp.* states the standard test for undue hardship. Debtors must prove that (1) if forced to pay the debt, she cannot maintain, based on current income and expenses, a 'minimal' standard of living for herself and her dependents; (2) additional circumstances inform the court that this state of affairs will likely

[133] Robert J Shiller, *The New Financial Order* (Princeton University Press 2003) 140-145. Perhaps we are seeing signs of this moral hazard in action: Gemma Tetlow, 'Two-Thirds of UK Students Will Never Pay off Debt', *Financial Times,* 4 July 2016, though repayment issues may have also or more to do with other factors, such as rising inequality, declines in well-paying jobs for graduates, and so on.

[134] It is beyond the scope of this article to compare personal bankruptcy entitlements in the United Kingdom and the United States. Though no provision similar to section 523(a)(8) exists in the United Kingdom, there may be other barriers to personal bankruptcy effectively producing a similar result.

persist for a significant portion of the repayment period; and (3) the debtor has made good faith efforts to repay the student debt.[135] This standard is very strict and results in relatively few discharges of student loan debt.[136]

Section 523(a)(8) reflects a contract model of bankruptcy. It is a rigid mandatory term imposed on debtors in favour of creditors, ostensibly designed to prevent opportunism by graduates with no assets and supposedly little to lose by declaring bankruptcy soon after graduation.[137] These rational choice arguments are now suspect for reasons having to do with problems of choice, but there are also compelling normative arguments against the exemption.

The exemption cannot meet basic requirements for egalitarian justice. It very likely violates the fresh start policy fundamental to personal bankruptcy law in the United States. It has substantial and perverse redistributive effects on the worse off and those with bad brute luck. Student debt is unsecured debt, but the exemption gives it even better protection than secured credit, where the issue is whether secured creditors have 'adequate protection' under US bankruptcy law.[138] The private lenders protected by section 523(a)(8) enjoy government guarantees for their loans and so the federal government has already provided insurance against risk of discharge by opportunistic graduates. Why is a mandatory term necessary to protect sophisticated institutional creditors from insolvent individual debtors? It is a perverse form of paternalism that cannot be morally justified.

On to the third issue: what does egalitarian justice have to do with the fact that higher education has both private and public benefits? It advises governments on the need for balance and risk sharing in the financing of higher education. College and university degrees produce public benefits. Graduates produce positive externalities to societies. To the extent that poor and less affluent students must rely on loans and these loans subsidize universities and societies, the state of affairs is reasonably rejectable by these students. Adequate assistance must be provided. The relaxing of loan rigidity of loans is an important step. It provides for risk sharing between society and students. But an expanded grants system to reduce the ratio of loans to outright assistance

[135] 831 F.2d 395, 396 (2d Cir. 1987)(per curiam).
[136] Jason Iuliano, 'An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard' (2012) 86 *American Bankruptcy Law Journal* 495 ('Incredibly, only 0.1 percent of student loan debtors who have filed for bankruptcy attempt to discharge their student loans'.).
[137] Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986) 250-252.
[138] 11 USC §361.

might be more morally acceptable. It is morally permissible to expect students to make some contributions but not to ask them to shoulder disproportionate burdens.

It is reasonable to impose costs on student debtors for future private benefits they will acquire as graduates. The economics of student lending informs us that student loans are a financial means by which a person transfers wealth from a future life period of relative prosperity to the present when times are lean.[139] Student debt generates the opportunity for future prosperity. It is well understood in economics that student lending finances an investment in human capital. This investment pays private as well as public benefits. Some personal investment is morally acceptable so long as its terms comply with the standards of egalitarian justice discussed above. To comply with the first principle, that of avoiding the financing of public goods primarily through private debt, we want our moral convictions to be respected while still maintaining some level personal investment when goods are a mix of the public and private.

B. *Do Not Unreasonably Restrict Egalitarian-Sensitive Access to Credit*

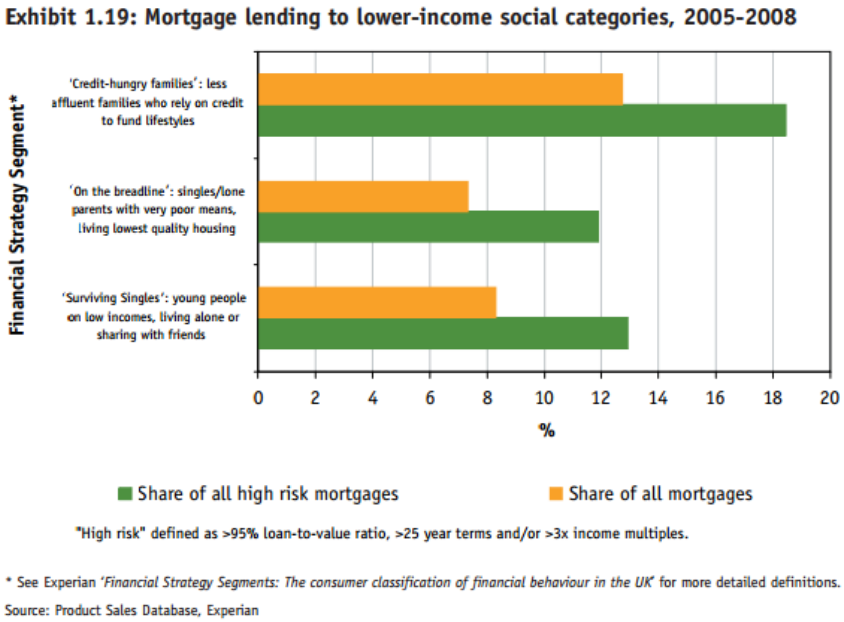
As we have seen above, access to credit and wealth are positively correlated. The lower a person's net worth, the more they rely on debt. Access to credit is a more important institution for distributing resources for the poor than for the rich. We can say with some certainty that a good number (but not all) of low-net worth persons in a society are in their disadvantaged position as a result of bad brute luck. For these persons, we would want the balancing of responsibility and justice in our luck egalitarian framework to put more weight on justice, to remediate the effects of bad brute luck. The question then becomes how to pick out which forms of credit are more or less sensitive to these egalitarian concerns. Under our luck egalitarian framework, some forms of credit will be more egalitarian sensitive than others. If the kind of credit in issue is likely to neutralise bad brute luck inequalities and relates to distributing important resources in a society, then it is more egalitarian sensitive and apt for institutional design along egalitarian lines.

As explained in Part II, the home mortgage in societies in which substantial private home ownership is prevalent is an example of an egalitarian-sensitive form of credit. Although this is a very basic and unchanging social fact in many societies, the regulation of mortgages took a turn after the financial crisis of 2007-09 towards substantial reductions of mortgage availability for low net

[139] *See* Akers & Chingos n xx, xx-xx.

worth households. These regulatory changes were designed around a single principle: macroeconomic stability.[140] Reliance on the single variable of economic stability in designing mortgage credit allocation systems will result in substantial restrictions on access to home mortgage credit for the less well off. Changes in the regulation of home mortgages have effectively made persons with marginal net worth even worse off.

The UK's Turner Report, issued in March 2009, recommended a regulatory response to the crisis that included substantial reform of the regulation of mortgages towards actual product regulation and not simply disclosure – to what is known as regulation of the conduct of business of mortgage providers.[141] The Report found: 'Though not to the same extent as in the US subprime market, [UK] mortgage credit was extended to social categories which would not previously have enjoyed access (Exhibit 1.19)'.[142] Exhibit 1.19 is reproduced in full below:



From an egalitarian perspective, the fallacy in the Turner Report's conclusions about mortgage credit is its evaluation of 'credit-hungry families',

[140] *See* pp. xx-xx.
[141] Turner Report, n xx. *See* The World Bank, *Responsible Lending: Overview of Regulatory Tools* (Oct. 2013) 36 (discussion of available regulatory options with a focus on conduct of business).
[142] Turner Report, n xx, xx.

'on the breadline' and 'surviving singles'. The Report characterises 'credit hungry families' as 'less affluent families who rely on credit to fund lifestyles' and 'on the breadline' as including only 'singles' and 'lone parents'. These categories are flawed because they omit an important category of families who are 'credit hungry' but because they actually need the funds to live ethically in the societies in which they happen to be a member. These persons have no control over the fact that home ownership is one of the few means by which their society enables them to stay out of poverty, live in safe communities, save for their families, and have good schools for their children. Buying a house is not only about consumption of shelter.[143] Society cannot both make particular resources essential for people to live a decent life and make them available only through private debt markets while depriving people with reasonable means by which to acquire these resources in those markets. These oversights result from focusing only on a single and incomplete policy aim of economic stability, a goal that just might be best achieved by making the unluckiest the worst off in the distribution of home mortgage credit.

Post-crisis, the United Kingdom and the United States have put in place a set of hard paternalistic laws governing the conduct of business by mortgage providers. These new rules regulate well beyond disclosure requirements.[144] Regulation of the conduct of business of mortgage providers and actual mortgage terms and conditions is designed to deal with the fact that people choose poorly when it comes to financial products. These laws deal with problems of poor choice by mortgage borrowers but they fail to deal with other factors of moral relevance in the design of credit architecture. They will worsen inequality.

The Turner Report led to a Mortgage Market Review and to the Financial Services Act 2012, all of which fed into the Mortgage Conduct of Business Regulations now found in the UK's Financial Conduct Authority Handbook.[145] The Mortgage Conduct of Business (MCOB) chapter in the Handbook deals with the 'regulated mortgage contract'.[146] It requires mortgage providers to assess mortgage affordability. It requires stress testing of borrowers by mortgage providers for some additional risks such as interest rate risk. It substantially

[143] *See* pp. xx above.
[144] This is Jason Scott Johnston's characterisation of US law in Jason Scott Johnston, 'Do Product Bans Help Consumers? Questioning the Economic Foundations of Dodd-Frank Mortgage Regulation' (2016) 23 *George Mason Law Review* 618 and it seems to apply with equal force to UK law.
[145] The Financial Conduct Authority Handbook, https://www.handbook.fca.org.uk/handbook.
[146] *Ibid.,* Rule xx.

restricts interest-only mortgages to borrowers with a repayment strategy independent of selling the property. It requires advice only mortgages and offers fewer protections for high net worth borrowers.[147]

US housing stock is valued at $26 trillion, which makes it the largest asset class in the world, worth a modest amount more than capital in the American stock exchanges.[148] US law is similar to UK law. The Dodd Frank Wall Street Reform and Consumer Protection Act of 2012 Section 1411 (b) amends the Truth in Lending Act[149] by inserting a new section 129C. Title XIV of Dodd-Frank is subtitled the 'Mortgage Reform and Antipredatory Lending Act. Section 1411, entitled 'Minimum Standards for Residential Mortgage Loans', obligates both mortgage originators and brokers to refrain from making a residential mortgage loan unless they make 'a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments.'[150] Dodd Frank further provides that such a determination 'shall include consideration of the consumer's credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations, employment status, and other financial resources other than the consumer's equity in the dwelling'.[151] Dodd Frank further requires that a mortgage lender 'determine the ability of the consumer to repay using a payment schedule that fully amortizes the loan over the term of the loan'.[152] The US Consumer Financial Protection Bureau specifies safe harbour or rebuttable presumption requirements in its very lengthy Regulation Z for a 'qualified mortgage' meeting these requirements. Regulation Z also prohibits

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[147] *Ibid.* Ch. 11. *See* Sarah Nield, 'Mortgage Market Review: "Hard Wired Common Sense"? (2015) 38 *Journal of Consumer Policy* 139; Vanessa Mak, 'What is Responsible Lending? The EU Consumer Mortgage Credit Directive in the UK and the Netherlands' (2015) 38 *Journal of Consumer Policy* 411; Sarah Nield, 'Responsible Lending and Borrowing: Whereto Low-Cost Home Ownership' (2010) 30 *Legal Studies* 610.

[148] 'Comradely Capitalism', *The Economist,* 20-26 Aug. 2016, 16.

[149] Truth in Lending Act Chapter 2, 15 USC §1631 *et seq.* (2006). For a discussion of these statutory provisions, *see* John Pottow, 'Ability to Pay', (2011) 8 *Berkeley Business Law Journal* 175.

[150] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 §1411, 124 Stat. 1376, 2142 (2010).

[151] *Ibid.*

[152] *Ibid.*

interest-only periods in mortgages, negative amortization, balloon payments, loans for more than thirty years, and excess points of fees. It specifies permissible debt-to-income ratios for borrowing.[153]

Economic stability is indisputably an important policy goal for any financial system. 'America's mortgage-finance system, with $11 trillion in debt, is probably the biggest concentration of financial risk to be found anywhere.'[154] But how do we deal with the fact that if governments increase the cost of credit, then credit becomes more scarce and out of the reach of more borrowers who are the people most in need of credit? Substantive regulation of mortgages in the form of affordability requirements do not only shift costs to the lenders. A rational lender will in turn shift them back to borrowers. The borrowers who suffer the most are those least able to bear the loss, low net worth homeowners, who have the most to lose. In some cases, mortgage debt is a feasible way to distribute resources. It may actually be a way to distribute wealth to non-saving households.

The solution might be in soft paternalist approaches to nudge mortgage lenders to offer more innovative and less rigid loans, such as the shared responsibility mortgage, and to nudge borrowers to accepting these new products. Some less onerous affordability rules can be maintained, such as rules on income verification, but make the market less exclusionary through product innovation, a subject to which we turn in section C below. Government homebuyer assistance for selected categories of low net worth borrowers also may be coupled with innovative mortgage products. Governments could tailor homebuyer assistance around concepts of luck. Additional solutions would be in policy innovations to mitigate foreclosure externalities.[155]

The basic insights about egalitarian sensitivity in the design of debt regulation and contracts apply beyond the example of home mortgages. Sovereign debt is an example of egalitarian-sensitive form of debt. It can be salubrious and effective as a way to support economic and social policy or it

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[153] Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 12 CFR Part 1026.

[154] The Economist, 'Comradely Capitalism', n xx.

[155] Beyond our scope is an evaluation of social or public housing. As this article is on debt contracting, the focus is on mortgages and private home ownership. The social housing solution is only a stop gap unless the collective choice is to move the economy away from private home ownership. There are also concerns about what might be considered to be involuntary of forced renting in a society in which home ownership produces sharp class distinctions. Thad Williamson, 'Realizing Property-Owing Democracy: A 20-Year Strategy to Create an Egalitarian Distribution of Assets in the United States', in Martin O'Neill & Thad Williamson, *Property-Owning Democracy: Rawls and Beyond* (Wiley Blackwell 2014) 225, 234-235.

could be predatory or odious.[156] Sovereign debt restructuring is egalitarian sensitive to the extent that the debtor-government uses resources otherwise used to neutralise inequality to service debt to external creditors.[157]

Some debt is less egalitarian sensitive or not egalitarian sensitive at all. Some debt, particularly most forms of corporate and commercial debt, are best left to be governed solely or primarily by principles of economics and finance without taking egalitarian concerns into account. For example, corporate bonds are probably best understood using standard tools of economics and finance because a range of persons in different situations need to be able to rely on efficient capital markets to support their pensions, for insurance, for savings, and so on. Corporate debt in this sense plays an important social function. In many of these contexts, equality is very purposefully built into the hierarchical structure of the finance. Mezzanine finance is an example. Dual class capitalisations offer another example. Dual class capitalisations may suffer from other problems associated with dilution of holdings of particular classes of shareholders, but no moral issues are implicated and issues of distribution in these contexts are perhaps best left to the law on fiduciary duties or to the listing rules of stock exchanges. Convertible debt may be a feature of the capital structure of some firms in need of capital but whose business plans are risky in the initial stages. The inequality between debt and equity created in a convertible debt context is uncontroversial, perhaps a simple truth that investors are more willing to invest in debt if the firm is a risky venture.[158]

C. *Relax the Rigidity of Debt in Appropriate Cases*

As explained in Part II.E, debt is often referred to with the metaphor of rigidity. Debt is rigid because one of its central features is that it is a fixed claim for repayment regardless of the value of the underlying asset it might be financing or the debtor's circumstances. It is therefore extremely insensitive to circumstances. This circumstance-insensitivity makes it prone to produce social outcomes that violate principles of egalitarian justice. Debt disproportionately burdens those most in need of it to access resources in a society, which includes

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[156] *See* Schiller n xx, 158 on salubrious debt as debt 'designed by the lender to have a salutary effect in terms of social welfare'. This concept can be extended to the borrower's intention as well.

[157] *See, e.g.,* Matthias Goldmann, 'Human Rights and Sovereign Debt Workouts' in Juan Pablo Bohoslavsky & Jernej Letner Černič, *Making Sovereign Financing and Human Rights Work* (Hart 2014) xx.

[158] I have, of course, offered a very simple and incomplete explanation of convertible debt. This article is not the place for an expansive discussion. For a basic discussion, *see* William Klein, John Coffee Jr, & Frank Partnoy, *Business Organizations and Finance: Legal and Economic Principles* (Foundation Press 11th ed 2010) xx-xx.

those who have suffered bad brute luck. As discussed in Part II.E, a positive relationship exists between reliance on debt and net worth – the poorer a person is, the more likely she relies on debt to secure resources necessary to live a decent life. Lower net worth persons have to use costlier means to secure basic resources than higher net worth persons. Debt is both circumstance- and brute luck- insensitive. Debt then, can be an extremely potent driver of inequality.

Given debt's relative importance to the unlucky than for the lucky and for the poor rather than the rich, restricting its availability through heightened affordability measures is likely the wrong policy approach if society is concerned about egalitarian justice. It is well accepted that easy access to debt can lead to over-investment, asset bubbles, and economic crises.[159] These arguments are incomplete because they focus only on the relaxation of qualifications for debt or the debt subsidy at the point of formation of the debt contract and not on the terms and conditions of the debt contract itself. Policies focusing only or primarily on affordability or subsidy means that policies are focused on the most harmful and restrictive means from an egalitarian standpoint. Surely methods exist to both promote economic stability and which do the least amount of harm from an egalitarian point of view.

Student loans are an example of an area in which debt rigidity has been somewhat relaxed through income-based repayments and loan duration limits. There are no affordability checks or risk assessments of student loans.[160] In the United States, the financial need of the student determines the amount of the government subsidy and in the United Kingdom all student loans are subsidized, though the subsidies as between the two countries are different and what is most important is the overall cost of the loan to the borrower. While the student loan situation is far from ideal, it does show modest movement towards policies to balance subsidies, approval requirements, and rigidity relaxation.

Beyond student lending, there has been little movement towards rigidity relaxation but several proposals for innovation on home mortgages. Mian and Sufi advocate a 'shared responsibility mortgage', a hybrid concept with features of both debt and equity.[161] While the UK mortgage market is overwhelmingly in adjustable rate mortgages, which soften the blow to borrowers in economic

[159] The problems of subsidizing debt are covered in section D below. Debt subsidies are closely related to relaxation of debt affordability or qualification requirements. Creditors will relax affordability if government subsidizes debt.
[160] *See* Michael Simkovic, 'Risk-Based Student Loans' (2013) 70 *Washington & Lee Law Review* 527; Note, 'Ending Student Loan Exceptionalism; The Case for Risk Based Pricing and Dischargeability' (2012) 126 *Harvard Law Review* 587.
[161] Mian & Sufi, n xx, 171-174.

declines because interest rates decline as well in such periods, an SRM goes further. An SRM would be linked to a local house price index. If house prices rise or remain the same as when the mortgage was entered, the monthly mortgage payment stays the same as does the mortgage amortization schedule. If the house price index falls below the level it was when the borrower entered into the mortgage, the monthly mortgage payment reduces but the mortgage amortization schedule remains the same. This results in an automatic but temporary reduction of the mortgage principal. It is temporary because house prices tend to increase the longer the time period in which they are considered. So, when the local house price index increases, the mortgage payment and principal will revert to its initial state. To eliminate or reduce the possibility that the lender will increase mortgage interest rates to compensate for its risk in sharing the downside potential of the housing market, the SRM could give the lender, say, a five percent share of the capital gain when the home is sold or refinanced. Others have similar advocated alternative mortgage products.[162] A 'continuous workout mortgage' adjusts payments in response to trigger events such as recession or job loss.[163] Governments could require or incentivise home owners to buy home equity insurance to cover mortgage payments in the event of job loss or other developments that hinder ability to pay.[164]

Sovereign debt is another area in which there have been some proposals for debt flexibility but no action by governments, creditors, or international organisations.[165] One such proposal would be for contingent repayment based on the ability of the sovereign debtor to finance basic minimums for their population. Another might be to treat debt that is invested for future generations differently than debt intended for short-term consumption.[166] Other

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[162] *See, e.g.,* John Y Campbell, 'Mortgage Market Design', (2013) 17 *Review of Finance* 1; João F. Cocco, 'Evidence on the Benefits of Alternative Mortgage Products' (2013) 68, *The Journal of Finance* 1663.

[163] Robert J Shiller, Rafal M Wojakowski, M Shahid Ebrahim & Mark B Shackleton, 'A Systemic Approach to Home Loans: Continuous Workouts vs. Fixed Rate Contracts', https://www.aeaweb.org/conference/2015/retrieve.php?pdfid=161; Robert J Shiller, Rafal M Wojakowski, M Shahid Ebrahim & Mark B Shackleton 'Continuous Workout Mortgages', NBER Working Paper 17007, 2011, https://www.nber.org/papers/w17007.

[164] Shiller, n xx, 118-120.

[165] According to Kenneth Rogoff: 'If . . . governments stood back and asked themselves how to channel a much larger share of the imbalances into equity-like instruments, the global financial system that emerged might be a lot more robust than the crisis-prone system we have now'. Global Imbalances without Tears, Project Syndicate, 1 Mar. 2011, https://www.project-syndicate.org/commentary/global-imbalances-without-tears, cited in Mian & Sufi, n xx, 185.

[166] These examples are from Sanjay G Reddy, 'International Debt: The Constructive Implications of Some Moral Mathematics' in Christian Barry, Barry Herman & Lydia Tomitova, *Dealing Fairly with Developing Country Debt* (Blackwell 2007) 81, 89-93.

examples are in linking payments or interest rates to GDP growth.[167] These terms would of course be priced into the debt.

D. *Do Not Subsidise Debt Without Relaxing its Rigidity*

The corollary to the above points on relaxing affordability and rigidity is that any debt subsidies would have to be managed so as not to create unsustainable increases in asset values, high default rates, and externalities associated with defaults on debt obligations. An example of a harmful set of debt subsidies not accompanied by relaxation of debt rigidity can be found in the law and financial practices leading up to the most recent global economic crisis, with features of easy credit policies and government involvement in mortgage securitization in the United States.[168] Governments can do both together – subsidize and relax – or neither.

Banks can absorb some economic stability risk through various means – diversification, by hedging with derivatives, and by taking on more equity so that their capital structures look more like those of other firms.[169] Another solution is to get banks out of the business of lending that is not backed 100% by deposits, and letting the capital markets directly in on investment in home mortgages.[170] Banks are, however, not the only lenders in some complex economies and other lenders who engage in lending that entails systemic risk to the financial sector and the economy would have to be regulated as well. The point here is not to explore these options in detail here – they have already been explored in depth elsewhere[171] – but simply to identify the issues that will have to be dealt with in regulating debt in egalitarian sensitive ways.

E. *Do Not Shift Debt from Private to Public*

Some have advocated a shift out of debt for the less affluent and for the public provision of resources through general taxation and redistribution.[172] A shift of debt from private to public hands may not solve the problems that debt creates, but only move the problems to a different set of relationships. In such

[167] Shiller, n xx, 124-130.
[168] There are many explanations of the events leading to the most recent global economic crisis. Just a few accessible accounts are cited here: Rajan n xx; Mian & Sufi n xx; Turner n xx; Charles W Calomiris, *Fragile by Design* (Princeton University Press 2014).
[169] Anat Admati & Martin Hellwig, *The Bankers' New Clothes* (Princeton University Press 2013) xx.
[170] Turner n xx, xx; Adam Levitin, 'Safe Banking: Democracy and Finance' (2016) 83 *University of Chicago Law Review* 357.
[171] [cites]
[172] [cites]

contexts there is a real risk that debt will not be reduced but simply shift to different parties.[173] Governments can over-leverage as well, and sovereign debt crises have disproportionate effects on the less well off. Not all governments can borrow in their own currency and on favourable terms in the bond market. Public debt, moreover, is prone to pathologies known to political economy, risking wasteful expenditures making everyone worse off.

There also may be a mix of private and public benefits that debt, if properly designed to deal with egalitarian concerns, might serve. As explained in Part II.D, private home ownership, for example, can provide a mix of both private and public benefits. Student loans are another example, as explored in Part III.A above.

Conclusion

This article seeks to promote a discussion of how to develop approaches to regulating debt and access to credit from moral and egalitarian standpoints. It relies on a particular form of luck egalitarianism. Normative principles currently predominating legal and policy discussions about debt and access to credit come primarily from economics. Economics offers a substantial set of tools to measure and evaluate distribution and inequality. Political philosophy (or normative political theory) offers insights on the situations in which inequality relating to access to credit are morally objectionable. Egalitarian theory tells us when inequalities can or cannot be morally justified. Political philosophy is not empirical but can assist governments in evaluating legal and policy options. Law, economics, and political theory can be used in combination to develop a credit architecture that aims for efficacy, efficiency, and justice. This article is an initial step in bringing these disciplines together to show how governments can undertake this important work.

[173] *See* Turner n xx, 80-87.