

## Expansionary Legal Policy Options

In this chapter, I apply the lessons about law and macroeconomics developed in the previous chapters. I formulate novel legal tools that stimulate aggregate demand without requiring comprehensive legislative action or increasing government budget deficits. These tools provide options for stimulating moribund economies at the zero lower bound.

The tools I describe here—countercyclical utility-rate regulation, adjusting debtor–creditor law for the business cycle, and changing the law of remedies with the business cycle—do not exhaust the universe of expansionary legal policy options. Almost every law and regulatory policy could be modified to stimulate (or depress) aggregate demand. Instead, the tools illustrate how law and regulation can provide economically meaningful stimulus when monetary and fiscal policy are hamstrung.

One important category of expansionary legal policy that I sidestep here is interventions in the labor market. Legal interventions in the labor market, such as minimum wage laws, could have important effects on unemployment and aggregate demand. When the economy is producing below capacity, changes to labor law offer a potentially powerful tool of expansionary legal policy.

Changing labor law, however, causes two countervailing effects. Consider the effect of lowering minimum wages at the zero lower bound. Lower minimum wages cheapen low wage labor, potentially reducing unemployment and thus increasing aggregate demand. Lower minimum wages, however, also reduce the purchasing power of minimum wage workers who would be employed at any minimum wage level. Reducing the income of these

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cash-strapped workers reduces aggregate demand. These effects may cancel out. Indeed, we see exactly this with respect to unemployment insurance. The best empirical evidence suggests that the unemployment-increasing effects of work disincentives caused by more generous unemployment benefits offset the unemployment-decreasing effects of the increase in spending associated with higher benefits.<sup>1</sup> As a result, labor market interventions like unemployment insurance offer less potent stimulus tools than might be suspected. (They may be highly desirable on other grounds, however.) I therefore focus my attention on expansionary legal policy measures that stimulate the economy in a more theoretically and empirically robust manner.

To effectively stimulate the economy through changes in labor regulation, we need to know which of these countervailing effects is bigger at the zero lower bound. Thus, implementing expansionary legal policy through labor regulation demands careful empirical study that we currently lack. Rather than relying on administrative expertise to resolve these vexing empirical questions, I instead focus on proposals with direct effects on aggregate demand that are more likely to be positive.

### Countercyclical Utility Regulatory Policy

Distributing electricity, natural gas, water, and other essentials to consumers is expensive. Much of the cost is incurred in building the distribution network itself; once installation is complete, the costs of supply go down considerably. When, say, an electricity grid is established, the marginal costs are just the cost of producing the electricity consumed. But the massive fixed costs of building the production and distribution network means there is little economic sense in multiple suppliers competing for the same consumers.

These qualities place utilities in an unusual category: “natural monopolies.” Typically, laws preventing anticompetitive practices would intervene to protect consumers from monopolist utilities. After all, monopolies inefficiently reduce output and raise prices. But because it would be extraordinarily expensive to develop multiple distribution networks for the same service, governments instead allow natural monopolies to persist and regulate their prices to reduce inefficiencies. Utilities gain the security of local monopoly and steady returns on capital, and consumers gain from government oversight to prevent price gouging and efficient provision of distribution net-

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works. When utility regulators work effectively, utilities charge prices reflecting the average costs of supply and distribution, not monopoly power.

This is, in theory, an elegant solution to what could be a vexing problem. But the current U.S. utility regulation framework process has perverse macroeconomic effects. Specifically, utility prices rise when aggregate demand is low, further reducing consumer spending and exacerbating sluggish demand. Instead of exacerbating business cycles, utility regulators should mitigate them, adjusting utility rates with an eye on their aggregate demand effects.

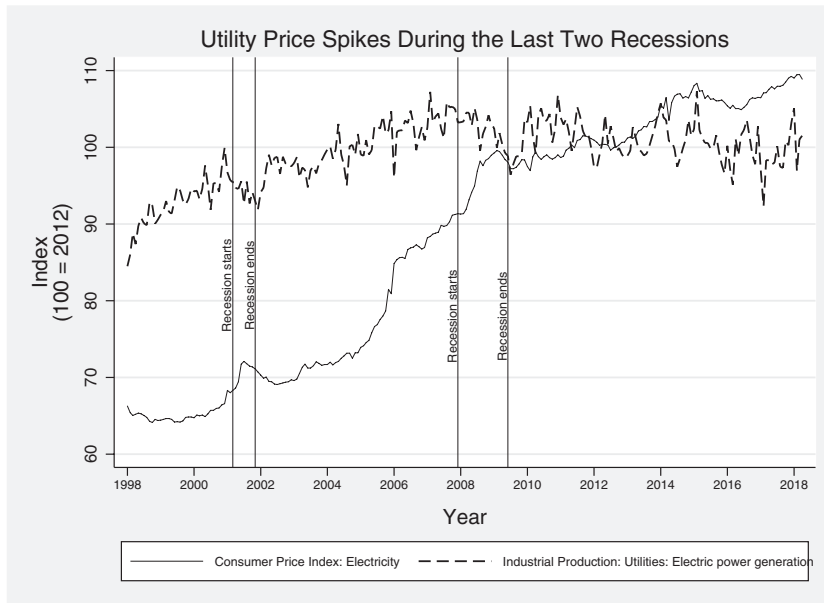
### Today's Utility-Rate Regulation

As it stands, utilities are regulated according to a “cost of service” framework. Utilities periodically propose rates to regulators, who then set the rates so that utility investors earn a competitive, but not excessive, return on their capital. By providing a competitive return, regulators enable the capital formation necessary to construct and maintain high fixed-cost distribution networks.

Regulators scour the market to decide what prices are acceptable and assess utilities' investment levels to ensure they are reasonable. Otherwise, utilities could raise profits by undertaking unnecessary investment to justify higher prices.

Many considerations underlie final utility pricing. For instance, the state of Connecticut prescribes that its Public Utilities Regulatory Authority account for “economy, efficiency and care for public safety and energy security” and “promote economic development within the state with consideration for energy and water conservation [and] energy efficiency.” Furthermore, the law stipulates that the “level and structure of rates be sufficient, but no more than sufficient, to allow public service companies to cover their operating costs including, but not limited to, appropriate staffing levels, and capital costs, to attract needed capital and to maintain their financial integrity.”<sup>2</sup> This system makes for unusual pricing. Usually, when demand for a commodity falls, prices drop over the medium- to long-term. But utilities are different. When demand goes down, as in recessions, prices don't naturally follow. In fact, the opposite happens. In order to cover their costs amid lower sales, utilities may ask to raise prices. This appears to be what happened in the United States during the Great Recession and the recession of 2001. As Figure 11.1 shows, U.S. electric power output during both downturns fell, but retail prices rose sharply before stabilizing. Unregulated wholesale electricity prices, by contrast, declined dramatically between

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**Figure 11.1** Observe the rapid increase in utility prices coinciding with the beginning of the last two recessions.

*Data Source:* U.S. Bureau of Labor Statistics, “Consumer Price Index—All Urban Consumers—Electricity,” retrieved from Federal Reserve Bank of St. Louis, <https://fred.stlouisfed.org/series/CUSR0000SEHF01>; Board of Governors of the Federal Reserve System, “Industrial Production: Utilities: Electric Power Generation,” retrieved from Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/IPG22111S>.

2008 and 2010. In March–April 2010, average wholesale electricity prices in two deregulated U.S. markets (Massachusetts and California) languished more than 50 percent below their March–April 2008 levels.<sup>3</sup>

From the perspective of stabilizing aggregate demand, this price pattern is unfortunate. Utilities tend to be necessities; most consumers can cut down only slightly when prices increase. Higher prices for utilities therefore act like a tax hike: just about everyone feels the pain. Utility spikes reduce discretionary income and, thus, aggregate demand.

### Business Cycle–Sensitive Utility-Rate Regulation

Utility regulators could work differently. They could account for aggregate demand when considering rate proposals. At the zero lower bound, regula-

tors could reject rate increases. And if their quadrennial reviews of utility prices happen to occur during a liquidity trap, they could demand lower rates. After the slump is over, regulators could then allow higher rates to enable the utility to cover its cost of capital over the business cycle.<sup>4</sup>

Reducing utility rates at the zero lower bound raises the discretionary income of utility consumers. With less spending on utilities, consumers spend more on everything else. If utilities respond to lower rates by reducing their cash holdings, then lower rates in a liquidity trap directly stimulate the economy. Instead of cash sitting on utility balance sheets, aggregate demand increases as consumers spend much of their increased discretionary income.

While business-cycle sensitivity should raise output and employment at the zero lower bound, it doesn't affect output in ordinary times. This may seem counterintuitive, because higher utility prices impede aggregate demand in ordinary economic times. But in ordinary times, aggregate demand does not determine output. Interest rates and prices adjust to aggregate demand fluctuations, leaving output and unemployment unchanged.

If utilities respond to lower rates by reducing dividend payments at the zero lower bound, however, then we can no longer be certain that business cycle-sensitive utility regulation stimulates the economy. Utility consumers spend more at the zero lower bound, but the utility's investors earn less and spend less. Here, we have to consider the propensity of individual market participants to spend. On balance, we would expect utility customers to have a higher propensity to spend an additional dollar than utility investors. This is because utility customers often do not have access to capital markets and so cannot borrow in hard times. Their spending is therefore determined by their discretionary income. Decreases in utility rates increase discretionary income and should thus increase spending by these customers.

By contrast, utility investors, even the proverbial "widows and orphans," can more easily offset decreases in discretionary income by borrowing or by selling stock rather than reducing consumption. Dividend recipients also tend to be wealthier than the average consumer, increasing their propensity to save an additional dollar rather than spend it on essentials. Indeed, a considerable body of empirical research supports the prediction that the rich spend less of an incremental dollar than the poor.<sup>5</sup> In total, the consumption of utility investors should be less sensitive than the consumption of utility customers to short-run changes in discretionary income at the zero lower bound. As a result, aggregate demand should increase in response to lower utility rates at the zero lower bound.

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Because the utility still earns its costs of capital over the course of the business cycle, its investment patterns should not change as a result of business cycle–sensitive regulation. Utility investment depends on long-range risk-adjusted returns, which will be unaffected by the change in regulation. Investment theory requires assets whose returns are more correlated with aggregate income to receive a higher average return. Therefore, the utility’s average profits over the business cycle must increase if regulators impose business cycle–sensitive utility regulation. Higher utility profits in ordinary times need to more than offset lower profits at the zero lower bound.

Ultimately, better access to capital markets and investors’ higher propensities to save suggest that the stimulus effect of lower utility prices at the zero lower bound will hold, even though utility companies and investors will, for a time, make less money.

### Magnitude of Effects

For many families, utility rates matter as much as tax rates or transfer spending. In 2010, households in the second quintile (twentieth to fortieth percentiles) of the U.S. income distribution earned an average of almost \$27,000 before taxes. These households spent an average of over \$1,600 on electricity and natural gas alone.<sup>6</sup> These households paid an average of slightly over \$1,000 in combined U.S. income taxes and social security taxes.<sup>7</sup> Their utility bills exceeded their tax bills. The discrepancy is even larger for the lowest quintile in the income distribution, who spent approximately \$1,200 on electricity and natural gas in 2010 but paid only a net \$194 in federal income and social security taxes.

Because lower-income and lower-wealth households have high marginal propensities to consume, “conventional wisdom” holds that stimulus programs targeted at these households have “particularly strong” effects.<sup>8</sup> In the United States, the Obama administration prioritized decreases in Social Security taxes as a stimulus measure over other tax reductions because low- to middle-income households pay substantial amounts of Social Security taxes. From 2008 to 2010, net income tax and Social Security payments by households in the first income quintile decreased from \$357 to \$194. For the second quintile of income, average combined Social Security and income tax payments decreased from \$1,667 to \$1,082.

These tax reductions provided an important aggregate demand stimulus because these households consumed much of the increase in discretionary

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income. But business cycle–sensitive utility regulation alone could provide a comparable stimulus. If retail electricity prices decreased by 7 percent between March 2008 to March 2010 instead of increasing by over 7 percent (as they did, in fact), then business cycle–sensitive electricity regulation provides roughly the same stimulus effect as tax reductions for the lowest quintile of the income distribution and almost half as much stimulus as the tax decreases for the second quintile. This one expansionary legal policy tool alone thus offers quantitatively meaningful stimulus at the zero lower bound.

### Implementability

Business cycle–sensitive rate regulation complies with the utility regulators’ statutory responsibilities, which broadly mirror those assessed in Connecticut: economy, efficiency, and economic development. At the zero lower bound, lower utility rates stimulate the economy, resulting in higher output and lower unemployment. This increases “efficiency” and “development.” Raising utility prices outside the zero lower bound enables utility investors to cover their operating and capital costs. Indeed, the higher returns of ordinary times could more than make up for lost profits at the zero lower bound. Under this scheme, utilities can maintain fidelity to statutory guidelines without falling afoul of the imperative for investor returns. Because the statutory mandate to regulators is already extremely broad, including another consideration—macroeconomics—cannot be said to obfuscate a previously clear legal process.

Utility regulators enjoy several advantages over legislators when it comes to making business cycle–responsive policy. First, public utility boards are small. Connecticut’s authority, for example, consists of only three people. Smaller organizations, such as utility regulators and the Fed, can respond more quickly to changing macroeconomic conditions. Second, public utility regulators tend to be experts about the economics of utility companies. Regulators also can acquire macroeconomic expertise readily through board appointments. Lawmaking bodies, by contrast, gain macroeconomic expertise only if voters elect macroeconomists. Even if no one with macroeconomic expertise is appointed to the regulatory body, professionals on public utility boards can become informed on the macroeconomic implications of utility prices much more rapidly than can the legislature. We should therefore be confident that regulators will be more likely to successfully execute

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a business cycle–responsive program than a legislative body operating in an ever-changing spending environment.

In the United States, state law largely governs utility rate regulation. Because some of the stimulus effects of lower utility rates spill over into other jurisdictions, state-appointed utility regulators may not champion business cycle–sensitive regulation as much as a national regulator would. Although this is a concern, state-level stimulus programs at the zero lower bound provide important within-state stimulus effects, meaning that regulators will retain substantial incentive to stimulate the economy even if they care only about the within-state effect. Moreover, business cycle–sensitive utility regulation also provides states with a rare tool for macroeconomic policy that is tailored to state, rather than national, economic conditions.

Keeping utility rates down at the zero lower bound and allowing them otherwise to rise in order to maintain profits over the business cycle also shifts risk beneficially. Under this system, utility consumers face less risk and utility investors more. This is a positive outcome because the latter almost certainly have a higher capacity to bear risk. By shifting risk in this way, consumer spending becomes less sensitive to the business cycle, stimulating aggregate demand at the zero lower bound.

While business cycle–sensitive utility regulation offers an empirically important and institutionally realistic option for expansionary legal policy at the zero lower bound, it doesn't come without costs. Such sensitivity adds complexity to the regulatory process. Instead of aiming for a competitive annual rate of return, regulators must seek out rates over the business cycle—a more involved process. This is especially tough because utilities must be allowed a higher average rate of return to compensate for a new undesirable pattern of returns (lower when incomes are down, higher when incomes are up).

But we should not exaggerate the burdens of added complexity. Even today, regulators set utility prices in a complicated environment. As a result, utilities do not, in fact, always earn their cost of capital on an annual basis. But utilities still manage to operate. Moreover, incentive problems (we don't want utilities to expand their capital stock *ad infinitum* while earning a constant rate of return) and green-energy priorities (we want to encourage the use of environmentally friendly sources of power) mean that utility regulators already must consider many factors when deciding on rates. Asking sophisticated regulators to consider one additional factor—

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the business cycle—seems a small price to pay for a useful new macro-economic policy tool.

## The Law of Debtors and Creditors

If our goal is to use law to stimulate aggregate demand at the zero lower bound, then it is important to understand why aggregate demand falls in the first place. The sources of a demand crash point to potential remedies. And a significant source, according to some scholars, is debt. The question for our purposes is how law can be used to modify demand-killing debts.

### How Debt Affects Aggregate Demand

Atif Mian and Amir Sufi emphasize the role of mortgage and household debt in causing the Great Recession.<sup>9</sup> They show that the drop in housing values caused precipitous spending declines among borrowers, reducing aggregate demand.

Their basic insight is that debt amplifies the effects of changing home prices on spending and output, so that total consumption declines as a result of the decrease in home values. To see why, let's say we live in a world of savers, who tend to accumulate wealth rather than spend it, and borrowers, who have a high propensity to spend whatever they have. Although the real world is more complicated, this simplification adequately captures the overall economic balance sheet, with lending on one side and borrowing on the other.

Without debt, changes in asset value affect spenders and savers evenly. If housing values go down by 10 percent and nobody owes any debt, then everyone's housing assets shrink by 10 percent. Borrowers and savers reduce spending accordingly. Because borrowers have a higher marginal propensity to spend than savers, they are likely to reduce their consumption by more than savers even though the value of their asset has changed by the same amount.

With debt, however, changes in housing values affect savers and spenders asymmetrically. Suppose a saver lends \$80,000 to a borrower to buy a home worth \$100,000. The saver's wealth is the value of the loan—\$80,000. The borrower's housing wealth is the excess of the house's value over the debt obligation, or  $\$20,000 = \$100,000 - \$80,000$ . The \$80,000 debt must be paid

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off in full before the borrower can enjoy any equity. With debt, a 10 percent decline in home values, from \$100,000 to \$90,000, leaves the value of the saver's assets unchanged. Because the saver enjoys a debt claim to the first \$80,000 in house value, the reduction in housing values from \$100,000 to \$90,000 has no effect. The borrower's wealth, by contrast, falls by half as a result of the 10 percent decline in housing values, from  $\$20,000 = \$100,000 - \$80,000$  to  $\$10,000 = \$100,000 - \$90,000$ . Even though housing values have fallen by only 10 percent, the borrower's wealth has fallen by more than the saver because the borrower bears the entire risk of changes in housing values above \$80,000.

With debt, the value of the borrower's assets becomes very sensitive to changes in the value of assets overall while the value of the saver's assets becomes relatively stable. Because the borrower has a higher marginal propensity to consume out of wealth than the saver in any case, debt makes the economy more sensitive to changes in asset values. Changes in asset values primarily affect the balance sheets of the people who are most likely to increase or decrease spending in response. As a result, total spending fluctuates more in response to changes in asset values with debt than without.

In general, Mian and Sufi argue, when housing values go down in an economy where debt levels are high, spending declines precipitously because borrowers lose a great deal of wealth. This reduces their spending directly. These losses also limit borrowers' access to credit, reducing their spending further and amplifying the debt supercycle. The resulting shortage of aggregate demand may cause a recession or depression, as in the United States during the Great Recession, according to Mian and Sufi's findings. Spending on durable goods such as cars fell most in areas with the highest levels of mortgage indebtedness and in areas with the greatest decline in housing values.<sup>10</sup>

If debt throttles aggregate demand, then there is a straightforward solution to deep recessions caused by inadequate demand: debt forgiveness.

The distribution of wealth—and therefore spending capacity—between debtors and creditors is largely determined by bankruptcy law. If bankruptcy law and court rulings favor debtors, then spending will be higher than if the law favors creditors, who have lower propensity to spend. In ordinary economic conditions, pro-debtor law would shift the pattern of aggregate demand but would not increase output by much because changes in aggregate demand primarily cause changes in interest rates rather than changes

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in output. At the zero lower bound, however, pro-debtor bankruptcy laws do not just reshuffle aggregate demand; they increase it.

Mian, Sufi, and a coauthor have looked into the evidence.<sup>11</sup> U.S. states offer valuable test cases because they differ in their foreclosure laws. In some states, foreclosure sales must take place through the judicial system and are subject to extensive and costly review. Other states handle foreclosure proceedings outside the judicial system. Mian, Sufi, and Trebbi find that this variation has a large effect: in states that make foreclosure more difficult, foreclosures happen much less frequently—about half as often as in the other states.<sup>12</sup> The authors also find that, during the Great Recession, increased foreclosure sales caused substantial declines in home prices and spending as proxied by auto sales. The claim that the law of debtors and creditors affects spending is thus more than theoretical. It has sound empirical footing.

In light of this research, Mian and Sufi argue that reducing borrowers' debt obligations can mitigate demand slumps. They favor widespread debt forgiveness and recommend legislative changes in bankruptcy law to enable it during recessions.<sup>13</sup> The idea is that eliminating or reducing repayment obligations puts money in the hands of borrowers—people with high propensities to spend.

If this approach strikes the reader as novel, that is only because many governments have forgotten how to forgive. State action to reduce debt and thus induce debtors to spend is a tried-and-true response to demand crises. During the Great Depression, for example, the U.S. federal and state governments passed many laws improving borrowers' access to credit or restricting creditors' rights to repayment. Congress established the Federal Housing Administration, which guaranteed mortgage loans, enabling borrowers to access private credit markets that would otherwise have been closed to them. Congress also created the Home Owners Loan Corporation, which lent money at low interest rates to homeowners who could not meet their mortgage obligations, effectively paying off portions of the homeowners' debt by reducing their interest burden.

Some states were more assertive, restructuring loan contracts themselves to favor borrowers over creditors. Famously, Minnesota passed a law temporarily limiting banks' rights to foreclose on homes, even if their owners were in default on their mortgages. Bankers sued, arguing that the law violated the contracts clause of the U.S. Constitution, but the Supreme Court sided with Minnesota. The justices ruled, "If state power exists to

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give temporary relief from the enforcement of contracts in the presence of disasters due to physical causes such as fire, flood or earthquake, that power cannot be said to be nonexistent when the urgent public need demanding such relief is produced by other and economic causes.”<sup>14</sup>

Mian and Sufi propose that policies such as these could have substantially mitigated the effects of the Great Recession. But their proposals are politically unrealistic. The recommended policies demand action from the same legislatures that failed to deliver fiscal stimulus during the Great Recession and from the same administrators who were unable to spend the tens of billions allocated for debt forgiveness by TARP. Debt forgiveness is a good idea when unemployment is high and interest rates are at or near zero, but we cannot expect legislatures to simply take up the cause or administrators to understand it without more sustained focus on law and macroeconomics.

But all is not lost. Although comprehensive intervention into credit markets requires legislative action, legislatures have already vested considerable discretion over bankruptcy law to courts and regulators. Although courts cannot overturn settled bankruptcy law, they make many decisions on the margins of existing law. At the zero lower bound, a pro-debtor tendency among judges in marginal cases can provide significant stimulus without requiring legislative approval.

### The Role of Bankruptcy Law

Bankruptcy law provides debtors with a “fresh start” and solves a collective action problem among creditors. When a debtor is insolvent, each creditor has an incentive to seize the debtor’s assets in order to secure repayment before the other creditors. But if every creditor rushes to seize critical assets (such as the debtor’s car or factory), then the debtor’s earning capacity suffers. To maximize the debtor’s earning capacity and the return to creditors as a whole, bankruptcy law imposes a collective decision-making procedure for restructuring the debt of insolvent debtors. Instead of pursuing repayment individually, each creditor and the debtor resolve their disputes collectively through bankruptcy.

In the United States, an insolvent debtor follows one of three bankruptcy “chapters” (Chapters 7, 11, and 13). Most personal debtors file for Chapter 7 bankruptcy, which benefits debtors by discharging debts entirely. Chapter 7 seizes and sells the debtor’s assets (subject to some “exemptions”) to repay creditors. The U.S. bankruptcy code instructs judges to dismiss Chapter 7

filings in the case of “abuse” and instructs judges to presume abuse if a debtor’s income exceeds a specified percentage of debts and expenses. The code vests bankruptcy judges with the discretion to allow a Chapter 7 filing to continue in spite of income over the threshold if the debtor shows “special circumstances that justify additional expenses.”

If an insolvent personal debtor is ineligible for Chapter 7 or hopes to retain some assets, then the debtor typically files for Chapter 13 bankruptcy. Chapter 13 allows the individual debtor to keep some assets but requires the debtor to make ongoing payments to existing creditors rather than discharging obligations completely. To confirm a Chapter 13 plan, the bankruptcy judge must determine that the plan is “feasible” and has been offered “in good faith.” Needless to say, judges enjoy discretion in making these determinations.

While insolvent personal debtors choose between Chapter 7 and 13 bankruptcy, insolvent business debtors choose between liquidation under Chapter 7 and reorganization under Chapter 11 of the bankruptcy code.<sup>15</sup> Many businesses that first file for Chapter 11 reorganization subsequently convert their bankruptcy filing to a Chapter 7 liquidation. Indeed, creditors can compel a debtor to convert a Chapter 11 reorganization into a Chapter 7 liquidation if the creditors demonstrate that conversion is “in the best interests of creditors.”<sup>16</sup> Bankruptcy judges exercise considerable discretion in applying the “best interest of the creditors” test.

### Student Loan Forgiveness

In the United States, the federal government funds or guarantees most student loans—and there are a lot of student loans. In 2015–2016, federal loans or guarantees accounted for 90 percent of \$107 billion in student borrowing.<sup>17</sup> More than \$1.2 trillion in student loans were outstanding as of 2015,<sup>18</sup> the vast majority either disbursed directly by the federal government or guaranteed by it.

With this expansive government role, widespread forgiveness of student debt held or guaranteed by the government offers an excellent means of stimulating aggregate demand without intervening in private credit markets. In a sense, this is fiscal policy because when the government writes off a loan or makes good on a guarantee, its debt rises. Unlike conventional fiscal policy, however, student loan forgiveness occurs through the legal system, making that forgiveness a form of expansionary legal policy.

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Bankruptcy law treats student loans differently than other loans. Unlike most debt, student debt is not generally dischargeable in bankruptcy.<sup>19</sup> But judges still exercise considerable discretion over student loan discharge. If a judge rules that repayment of student loans causes “undue hardship,”<sup>20</sup> then the student loans become dischargeable. “Undue hardship” provides a vague standard recognized as leaving much to the judgment of the court.<sup>21</sup> Judges have no qualms exercising this discretion either. Rafael Pardo’s research shows that

Legally irrelevant factors unrelated to the merits of a debtor’s claim for relief (e.g., the level of experience of the debtor’s attorney and the identity of the judge assigned to the debtor’s case) influence the extent to which a debtor obtains a discharge of her student loans. Importantly, such factors appear to have a stronger effect than the handful of legally relevant factors associated with discharge outcomes.<sup>22</sup>

Although they haven’t so far, bankruptcy judges could, in theory, use this discretion to account for the macroeconomic environment. They should. When short-term interest rates are zero and employment rates are low, judges should be more inclined to find undue hardship and discharge student debt than they would in ordinary economic times.

A variable undue hardship standard that adjusts to the business cycle offers two advantages over a nonadjustable standard. First, in a depressed economy, well-paying jobs are scarce, making it more likely that repayment of student debt constitutes an undue hardship. Attention to the wider economy just gives the debtor her due, recognizing that, in the midst of recession, it really is harder to pay off loans. Second, student loan forgiveness promotes aggregate demand and output at the zero lower bound.

In addition to expansionary legal policy, student loan forgiveness could also become a target of expansionary fiscal policy by administrative agencies (see Chapter 7). Presently, when a bankruptcy filer seeks discharge of student debt, a private nonprofit corporation under contract with the U.S. Department of Education pursues repayment, if necessary by litigation. The company, Educational Credit Management Corporation (ECMC), has only one goal: to minimize government losses on loans. According to a *New York Times* report, it pursues that end with such singular focus that it has attempted to collect even from severely ill debtors and debtors caring for others with costly medical bills.<sup>23</sup>

The Department of Education can and should change ECMC’s behavior by allowing public policy considerations to inform recovery strategies. If a

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debtor seeks discharge of student loans during a liquidity trap with high unemployment, then the department could presumptively accept discharge in bankruptcy rather than challenge it. At the very least, contracts with ECMC should allow the department to provide policy guidance on ECMC's bankruptcy litigation strategies—guidance that should attend to the business cycle.

Because there are \$1.2 trillion in student loans outstanding, business cycle-sensitive discharge policy—implemented by either the judiciary or by the Department of Education—could have an empirically important stimulus effect. If even 5 percent of student debt were discharged at the zero lower bound, cash-strapped individuals would gain \$60 billion to spend precisely when stimulus is most needed to raise output and lower unemployment.

### Personal Bankruptcy Forgiveness

As significant as student debt forgiveness might be, much more stimulus can be achieved through changes to private credit markets. Bankruptcy judges exercise authority over the loans of all debtors who file for bankruptcy, confirming or rejecting Chapter 7 and Chapter 13 personal bankruptcy plans. (Personal debtors rarely file under Chapter 11.)

Chapter 13 plan confirmation standards such as “feasibility” and “good faith” are difficult to apply. Judges vary in their beliefs about the good faith of debtors and the merits of their bankruptcy plans, with significant effects on outcomes. Research indicates that a bankruptcy judge in the 95th percentile for confirmation likelihood (a pro-debtor judge) approves over 50 percent of Chapter 13 plans. A judge in the 5th percentile approves less than 40 percent of plans.<sup>24</sup> Applying the same rules, bankruptcy judges come to different outcomes.

There thus exists considerable discretion with respect to Chapter 13 bankruptcy. Bankruptcy judges could use this leeway to account for the business cycle. At the zero lower bound, they could all behave like pro-debtor judges, raising aggregate demand by confirming more Chapter 13 plans and forgiving more debt. This would give borrowers—again, people with high marginal propensities to consume—more resources. Because debtors filed for relief for almost \$200 billion in debt in the United States in 2010,<sup>25</sup> a 10 percentage-point increase in Chapter 13 confirmation rates would provide substantial stimulus without exceeding the range of discretion currently exercised by bankruptcy judges.

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### Liquidation versus Reorganization in Business Bankruptcy

Bankruptcy judges also exercise discretion in determining whether requests by creditors to convert a Chapter 11 business reorganization into a Chapter 7 liquidation is in “the best interests of creditors.” (Businesses rarely file under Chapter 13). Recent research indicates that Chapter 11 filing with a randomly assigned judge who is in the 95th percentile for converting a reorganization into a liquidation has a 55 percent chance of being converted into a liquidation.<sup>26</sup> An otherwise identical Chapter 11 filing with a bankruptcy judge in the 5th percentile has only a 25 percent chance of conversion into a Chapter 7 liquidation. Business bankruptcy judges apply the same standards to produce different outcomes, exercising considerable discretion.

Zach Liscow suggests that bankruptcy judges use this discretion to favor the creation or preservation of jobs during recessions.<sup>27</sup> The idea here is that reducing returns to the creditors of a bankrupt firm—that is, allowing the firm to reorganize and continue rather than liquidate—may enable that firm to keep more employees on staff. If the reorganized firm and its employees have a higher propensity to spend than the investors whose return is reduced, then rulings against creditors and in favor of reorganization raise aggregate demand. And at the zero lower bound, increases in aggregate demand translate into increases in output.

In the United States, tens of thousands of businesses file for bankruptcy every year.<sup>28</sup> Although most of these are small, in 2015 almost a hundred were publicly traded companies. If keeping jobs via reorganization has the positive effects on aggregate demand Liscow hypothesizes, then business bankruptcy rulings offer another important mechanism for the application of expansionary legal policy.

### Implementation

Unlike most of the expansionary legal policy discussed in this part, judges, and not regulators, implement changes in emphasis in the law of debtors and creditors. Judges are not macroeconomic policy experts, so we should not rely on them to fine-tune business cycles. Moreover, judge-made legal stimulus cannot be coordinated and supervised by a law and macroeconomics oversight body such as OFRA. For these reasons, expansionary legal policy implemented by judges should be subject to tighter restrictions than expansionary legal policy implemented by regulators.

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To ensure that judges implement expansionary legal policy without exceeding their legitimate discretion over bankruptcy law, appeals courts should not consider the state of the business cycle when reviewing a bankruptcy judge's attempt at expansionary legal policy. Instead, they should reverse a bankruptcy judge's pro-debtor decision when that decision violates the preexisting law. Only when an appeals court would affirm a pro-debtor ruling in ordinary circumstances should the appeals court affirm a pro-debtor ruling made for the purpose of stimulating the economy.

Even with this restriction, we should be wary of expansionary legal policy implemented by judges. For the most part, judges should avoid expansionary legal policy. But bankruptcy judges occupy a central place in resolving the debt crises that are the proximate cause of most prolonged downturns. As a result, bankruptcy judges are uniquely well placed to implement expansionary legal policy. Moreover, judges do not need great acumen to know when debt burden is unusually high and interest rates are close to or at zero. We should feel confident trusting bankruptcy judges to undertake expansionary legal policy in those conditions.

If debt is more likely to be discharged or invalidated at the zero lower bound, then should we not be wary about opportunistic debtors filing bankruptcy or challenging debts during downturns? Indeed, judges would have to be alert to such abuses. But there is good reason to suspect the risks here are more theoretical than real. Filing bankruptcy entails significant social and financial costs, even if one is successful. So great are these costs that most of those who would benefit financially from bankruptcy do not file.<sup>29</sup> As long as statutes do not change, these incentives will hold even if judges are more apt to side with debtors. Moreover, debtors cannot file for bankruptcy repeatedly, restricting the most opportunistic from exploiting time-varying bankruptcy rules.

A more pressing concern is that easy debt discharge during liquidity traps will spook creditors at precisely the moment when the economy needs more lending. Creditors will not lend money during liquidity traps if they fear that it will be quickly discharged. Lenient discharge standards therefore should be limited to debts incurred before the economy hit the zero lower bound. Judges should be less inclined to use their discretion to discharge credit agreements formed during a liquidity trap.

## Expansionary Policy through the Law of Remedies

In addition to deciding who wins and who loses a legal dispute, courts fashion remedies. Remedies vindicate the legal rights of the winning party. In fashioning remedies, courts exercise enormous discretion, as we will see below. And different remedies have disparate effects on aggregate demand. “Injunctive” remedies, which require or proscribe actions, sometimes promote aggregate demand (when spending is required) and sometimes stifle it (when spending is forbidden or delayed). In fashioning remedies, which are famously subject to considerable judicial discretion, courts should promote aggregate demand at the zero lower bound.

### Two Kinds of Remedies

When a court decides that a plaintiff’s rights have been violated, it can respond with two basic classes of remedies: liability-rule protection and property-rule protection. If the liability rule is applied, the defendant pays damages. If the court favors property-rule protection, the defendant is ordered to cease whatever behavior has caused the suit. Almost every legal right can be protected by either a property rule or a liability rule.

Say a developer intends to build a block of apartments. The neighbors worry that noise from the building will be a nuisance and that the structure will block the view from their homes, hurting the existing homes’ market value. Faced with imminent construction, the neighbors sue to halt the developer. The court first has to decide if the developer has the right to build or the neighbors have the right to be free of the nuisances associated with the development. If the court sides with the neighbors, then it must further decide how it will remedy this right. Under property-rule protection, the court issues an injunction restricting construction. The developer cannot build unless it finds a way to comply with relevant nuisance rules or else the neighbors agree to waive their right, probably in exchange for a settlement. Alternatively, the court might favor liability-rule protection for the neighbors, estimating the reduction in the neighbors’ home values and compensating them for this reduction in value. In this case, construction could continue, but the developer must pay damages to the neighbors.

The relative advantages of property and liability rules are the subject of a foundational debate in law and economics. Much has been written about

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the microeconomic efficiency of each kind of remedy in various contexts. What has rarely been considered are the macroeconomic ramifications of each kind of remedy.

### Macroeconomic Effects of the Choice of Remedies

When courts use property rules to stop economic activity, they reduce spending, or at least delay it. In ordinary economic conditions, this effect of property rules is irrelevant. The workers who would have contributed to the now-barred activity find other employment. At the zero lower bound, however, injunctive remedies can have serious direct costs because workers taken off a project won't find other jobs. If the neighbors successfully halt the proposed development in a liquidity trap, the construction workers tasked with building it won't have another job to turn to.

My argument has been that, at the zero lower bound and amid high unemployment, courts should favor the rule that promotes spending. When it comes to lawsuits, this usually means favoring the liability rule, which enables a project to move forward as long as the entities responsible for it can pay damages.

Preferring damages over injunctions in construction disputes offers the possibility of meaningful stimulus. At the start of the Great Recession, construction spending in the United States exceeded \$1 trillion annually. If 5 percent of this construction is subject to injunction, then a shift to damages at the zero lower bound could enable \$50 billion in spending. Plaintiffs' rights retain liability rule protection, limiting the scope for inefficient projects to go forward.

The same logic applies to the law of preliminary injunctions, which temporarily prohibit activities subject to ongoing litigations. In some cases, a party to a suit may plan to take action before a verdict is reached. The opposing party, usually the plaintiff, may ask for a preliminary injunction to preserve the status quo until the legal issue can be resolved. For example, it may take a while to determine whether the developer has the right to build or the neighbors have the right to be free of nuisances. The law of preliminary injunctions determines what happens while that right is being litigated: Can construction move forward, or must it wait?

Courts grant preliminary injunctions when they determine, first, the plaintiff has a substantial likelihood of success on the merits; second, the plaintiff faces a substantial risk of irreparable damage if the injunction is

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not granted; third, the balance of the harms weighs in the favor of the party seeking the preliminary injunction; and, finally, injunction serves the public interest.

Law and macroeconomics suggests that courts should be less inclined to grant preliminary injunctions during liquidity traps. Doing so halts spending, reduces aggregate demand, and raises unemployment. The forgone output is multiplied significantly. Granting the injunction during a time of robust growth, by contrast, has much smaller effects on nonparties. During a liquidity trap, the balance of the harms weighs less in favor of the party seeking the injunction, and the public interest is less well served by an injunction. Again, liability-rule protection would be more beneficial, enabling the stimulus that the property rule prevents.

There are, however, some cases in which property rule remedies promote spending. Consider the seminal 1921 contract-law case *Jacob and Youngs v. Kent*, heard by the New York Court of Appeals. The case concerned an alleged breach by a developer, Jacob and Youngs, who contracted to build a house for a wealthy landowner, George E. Kent. The contract required Jacob and Youngs to install in the house a particular brand of piping—Reading Pipe. However, the developer used other brands identical in quality. When Kent found out, he withheld payment. Jacob and Youngs sought to recoup what it thought it was owed.

Both sides agreed that the developer breached the contract. The dispute was, in part, over remedies. The developer argued that “substantial performance” had been provided, so that the remedy should be nominal monetary damages. Kent argued that performance was defective, and the remedy should provide property-rule protection, possibly including an injunction requiring the builder to knock down the newly constructed home and reconstruct it with Reading brand pipe. Justice Benjamin Cardozo, writing for the majority of New York’s high court, ruled in favor of the developer. In essence, the court favored liability-rule protection of Kent’s right to Reading brand pipe and assessed the monetary damages at zero. Traditional law and economics scholars, as well as academics writing from other perspectives, continue to dispute the appropriate remedy in *Jacob and Youngs*.<sup>30</sup>

With respect to macroeconomic outcomes, the effects of the ruling are more clear-cut. An injunction requiring the developer to spend to knock down and rebuild the house would have raised aggregate demand. Awarding Kent money damages, by contrast, left spending flat. Money damages shift

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wealth around, but not necessarily spending. At the zero lower bound, therefore, a court concerned with macroeconomics facing a *Jacob and Youngs*-like case should prefer the injunctive remedy. In such cases, courts are effectively in a position to follow Keynes's suggestion that, in depressions, we should pay people to dig holes and fill them up. Keynes was being facetious, but in the circumstances we are concerned with—high unemployment at the zero lower bound—there is merit to the idea.

### Implementation

Judges are generally ill suited for expansionary legal policy. As a result, judges should generally steer clear of attempting to stimulate the economy. In the case of some remedies, however, existing legal standards call for the consideration of macroeconomic factors. In these cases, judges need to consider remedies in order to fulfill their legal obligation.

In articulating the standard for issuing a “preliminary injunction,” the U.S. Supreme Court explained that “courts must balance the competing claims [by plaintiff and defendant] of injury and must consider the effect on each party of the granting or withholding of the requested relief. In exercising their sound discretion, courts of equity should pay particular regard for the public consequences in employing the extraordinary remedy of injunction.”<sup>31</sup>

If courts ignore the effects of an injunction on aggregate demand, then they fail to consider the “public consequences” of the injunctions that they issue. Injunctions often delay spending. And this delay has public consequences, as injunctions against spending cause third parties economic harm at the zero lower bound while injunctions that favor spending benefit third parties. Moreover, these harms are “irreparable”—another important consideration for preliminary injunctions. Spending after the merits have been resolved, when the multiplier may well be lower, does not redress the harms third parties suffered because of the original injunction. As a result, courts need to consider macroeconomic effects when issuing preliminary injunctions.

Many different actors in the legal system can help to ensure that remedial decisions are appropriate to macroeconomic conditions. Courts should promote aggregate demand during liquidity traps by favoring damage remedies instead of injunctions of economic activity. Although judges are unlikely to be macroeconomic experts, they should be able to identify

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periods of zero short-term interest rates. In addition to judges, government plaintiffs, such as zoning boards suing developers, can tailor their remedial requests to the state of the business cycle by requesting damages, rather than injunctions of economic activity, at the zero lower bound. (If a plaintiff does not request an injunction, then the court is unlikely to grant one.) By doing so, government plaintiffs can protect their interests through damages without standing in the way of much-needed spending.

As in other cases we have examined, relying on business cycle-varying remedies to stimulate the economy raises the risk of opportunism. Developers whose projects will be forestalled by property-rule injunctions in ordinary times may commence projects at the zero lower bound in hopes of profiting from the increased likelihood that the project will be allowed to move forward in the face of potential lawsuits. If the project is a harmful one, then its construction at the zero lower bound constitutes inefficient behavior prompted by legal variation over the business cycle.

Judges, exercising their “sound discretion,” should be wary of such opportunism and make efforts to thwart it. But, in practice, opportunism may not pose great risk. Importantly, varying remedies over time do not alter legal rights. If a developer’s project violates neighbors’ rights, then the developer will have to pay damages equal to the harm caused by the project. Unless the developer expects the court to underestimate the value of the harm, the developer will not have incentive to push through an inefficient project at the zero lower bound. In addition, holding back spending until liquidity traps are present may in fact be efficient behavior worth encouraging. Incentivizing spending during liquidity traps fosters private stimulus at precisely the time it is most needed.

In this chapter, I developed three examples of expansionary legal policy—utility rate regulation, bankruptcy law, and the law of remedies—to illustrate the tool’s potential. Each policy offers the potential for meaningful stimulus worth billions of dollars; and none of the interventions require legislative approval. Instead, they direct preexisting regulatory or judicial discretion toward a new policy end—macroeconomic stimulus.

Law pervades economic life. As a result, the three examples developed here only scratch the surface of expansionary legal policy. If every judge and regulator worked through the macroeconomic implications of their actions and chose the option that stimulated aggregate demand in close cases at

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the zero lower bound, then expansionary legal policy could end or mitigate prolonged periods of economic weakness, even if monetary and fiscal policy were hamstrung. There would be collateral damage—judges and regulators are flawed policymakers, with respect to macroeconomics and everything else—but the potential gains are well worth pursuing.