The Economic Logic of a Fresh Start

BY SATYAJIT CHATTERJEE

A debtor's right to have his or her debts dismissed or discharged via a bankruptcy proceeding is referred to as the law's "fresh start" provision. Fresh start has been — and continues to be — a controversial feature of the U.S. bankruptcy law. Lately, the law has come under scrutiny because of the dramatic rise in personal bankruptcy filings over the past 25 years. In this article, Satyajit Chatterjee explains the economic logic underlying the fresh start concept. He also argues that this logic can explain why opposition to a discharge policy has waxed and waned over time.

U.S. law gives debtors the right to petition a bankruptcy court and ask to be released from their financial obligations to creditors. For reasons explained in this article, a debtor's right to have his or her debts dismissed or discharged via a bankruptcy proceeding is referred to as the law's "fresh start" provision. Fresh start has been — and continues to be — a controversial feature of U.S. bankruptcy law. Of late, the law has come under scrutiny because of the dramatic rise in personal bankruptcy filings in the last 25 years. In 2005, roughly one out of every 75 U.S. households took advantage of the fresh start provision; in 1980, only one out of 375 households did.

The need to deal in some fashion with people who cannot (or will not) repay their debts was felt from the earliest days of European settlement in New England. By and large, the colonists dealt harshly with defaulters and were quite hostile to the idea of the discharge of personal debts. But this hostility appears to have waned by the late 19th century, when Congress enacted a federal bankruptcy law with a fresh start provision. Unlike earlier attempts at legalizing discharge, the 1898 law proved to be more permanent, although later laws modified many of its provisions. The latest turn in this gradual evolution is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, a law that significantly curtails a debtor's right to a fresh start.

The objective of this article is twofold. The first is to explain the economic logic underlying the fresh start concept. For there *is* an economic logic – one that gets ignored when advocates portray fresh start as a form of protection against rapacious creditors or when opponents portray it as a refuge for the morally bankrupt. The economic logic puts debtors and creditors on an equal footing but argues that, under certain circumstances, society as a whole is better off when discharge is permitted. The second objective is to argue that this logic can explain why opposition to a discharge policy has waxed and waned over time. Why did the colonists view discharge with hostility? Why did this opposition wane by the turn of the previous century? Why has opposition to a fresh start reappeared now? The economic logic of a fresh start suggests that these shifts in attitude reflect an evolving tradeoff between the economic costs and benefits of a fresh start.

Satyajit Chatterjee is a senior economic advisor and economist in the Research Department of the Philadelphia Fed. This article is available free of charge at www.philadelphiafed.org/econ/br/.

WHAT IS A FRESH START?

U.S. bankruptcy law permits an individual debtor to be released from his or her financial obligations to current creditors. The main requirement for obtaining this release, or discharge, of debt is that the debtor must surrender to creditors whatever property he or she has at the time the discharge is sought. By surrendering all existing

property to creditors, a debtor who is unable or unwilling to repay all of his or her debt can obtain permanent protection from collection efforts by current creditors.

There are some exceptions to this general provision of the law. On the liability side, not all financial obligations are eligible for discharge. Examples of nondischargeable obligations include student loans and judgments incurred in judicial court cases. On the asset side, debtors are not required to surrender certain assets to creditors. For instance, in Florida and Texas, home equity is exempt from seizure by creditors. In addition, any property essential to a person's livelihood or dignity (such as tools used by a carpenter to do his job, ordinary clothes, and so forth) is generally exempt from seizure by creditors as well.[1]

The term fresh start is used to describe this provision of bankruptcy law because it neatly encapsulates the spirit of an oft-cited justification for discharge given in a 1934 ruling by the U.S. Supreme Court. According to the court, discharge of debt "gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[2]

To understand the economic logic of the fresh start provision, we should view the need for this provision from two closely related, but distinct, perspectives. The first is the situation as it relates to a debtor and creditor *after* debt has been incurred (what economists call the *ex-post* perspective). The second perspective is the situation as it relates to potential debtors and creditors *before* any debt is incurred (what economists call the *ex-ante* perspective). The desirability of a fresh start can be argued from either perspective, but the nature of the argument is different in the two cases and therefore best discussed separately. As we will see, both perspectives are implicit in the famous Supreme Court justification for a fresh start quoted earlier.[3]

In most modern societies, contract law gives creditors the right to seize the property of a debtor who does not repay his or her debts.

FRESH START FROM THE POST-DEBT PERSPECTIVE

To understand the post-debt logic for having a fresh start provision, we need to be clear about what transpires in its absence. In most modern societies, contract law gives creditors the right to seize the property of a debtor who does not repay his or her debts. If the debtor lacks sufficient property, the law permits creditors to garnish the debtor's earnings in excess of what is needed by the debtor to meet nondiscretionary expenses. Importantly, these creditors' rights continue to be in force as long as there is some unmet financial obligation. It is against these creditors' rights that the fresh start provision extends protection.

Since this article is about the economic *logic* of a fresh start, and the logic can be somewhat subtle, it helps to talk about the issues by using an example. I will introduce the example in this section and progressively extend it in the following two sections. In this section, I use the example to make clear one reason why unrestricted creditors' rights can be bad for society.

Consider the case of a debtor, whom we shall call D, who has borrowed from a creditor, C, and her payment on the debt is now due. Assume also that D has no assets and her obligation to C amounts to $5000. Further assume that D's monthly takehome pay from her regular full-time job totals $2000 and her monthly nondiscretionary expenses are $1800. Since D does not have the funds to pay off her obligation, she is in default. According to the law, C has the right to seize $200 from D each month for the next 25 months in order to recover what is owed to him.[4]

However, matters may unfold differently. Imagine that D has the option to reduce her hours at her job so as

[1] Other exceptions exist to prevent abuse of the provision. For instance, shifting one's wealth into nonexempt assets shortly before filing for bankruptcy is viewed as an abuse and will make the debtor ineligible for a fresh start. Similarly, the right to a discharge is not available to a debtor who has used this provision in the previous six years — so "serial" discharge is viewed as an abuse and is not permitted.

[2] *Local Loan Co. vs. Hunt* U.S. 234, 244 (1934).

[3] The language of the Supreme Court ruling points to a set of core issues that any discussion of fresh start should cover. A complete and thorough discussion of all aspects of fresh start would be well beyond the scope of this article. The last two chapters of Thomas Jackson's book and the article by Michelle White provide more details about the costs and benefits of fresh start. The article by Michel Robe, Eva-Maria Steiger, and Pierre-Armand Michel provides further background on the nature of fresh start. Also, I do not discuss a second form of bankruptcy — called Chapter 13 — in this article. In a Chapter 13 bankruptcy, the debtor is allowed to keep his or her assets in return for agreeing to a new repayment schedule that involves a partial discharge of debt. Historically, only a third of bankruptcy filings in the U.S. have been Chapter 13 filings; the rest are of the fresh start variety. For a nice discussion of Chapter 13 bankruptcy, see the article by Wenli Li.

[4] Actually, the law would permit C to recover *more than* $5000 because recovery takes time and C loses interest on the part of the debt yet to be repaid. Taking compensation for lost interest into account would require D to pay $200 each month for more than 25 months.

to make her monthly take-home pay exactly $1800. If D chooses to do this, C can no longer seize any income from D because D does not have any discretionary income. D may prefer this "less work" option to the option of working full-time and having her additional $200 a month "taxed" away by C for the next two years. Of course, this less work option will keep D under the threat of garnishment indefinitely, but the benefits of working full-time and eventually becoming debt-free come too far in the future for D to make the extra effort.

This outcome is inefficient because D clearly values the extra $200 a month more than the effort required to earn it — which is why she was working full-time in the first place. But now C's right as a creditor stops D from doing so. Society's loss is the $200 D could earn, net of her efforts to earn it. One might wonder why the loss to society does not include the $5000 loss to C, but from a societal point of view, C's loss is exactly offset by D's gain.[5]

In this example C's rights as a creditor force D to obtain her discretionary income in a form that C cannot seize, that is, in the form of leisure. One can also imagine D's being induced to engage in activities that allow her to hide her earnings from C, for instance, doing informal work for friends and relatives or engaging in illegal activities. If these alternatives are inferior (from society's point of view) to D's working full-time at her regular job, the inefficiency remains and is perhaps compounded. In general, whenever a debtor has the option to substitute nonseizable forms of income for regular earnings, unbridled creditors' rights can cause a costly distortion of work effort. In such situations, an efficiency case can be made for constraining a creditor's rights. Indeed, if D is given the right of discharge, she will avail herself of it and continue working full-time at her regular job and the loss to society will be avoided.[6] This is the economic justification for discharge implicit in the Supreme Court's statement that discharge gives a debtor "new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."

But this *post-debt* justification ignores the fact that when discharge is permitted, a creditor's incentive to lend is seriously blunted. Is not the reduction in lending that is sure to result an important loss from a societal point of view? This is an important objection, and it brings us to the issue of whether discharge can be justified from a *pre-debt* perspective. As we will see, discharge can be justified from a *pre-debt* perspective, but the argument in favor of it must be amended in an important way.

RETHINKING THE (POST-DEBT) LOGIC OF A FRESH START FROM A PRE-DEBT PERSPECTIVE

We will continue with our example of creditor C and debtor D, but we will now focus on their situation as they contemplate entering into a lender-borrower relationship. To do so requires extending the example. The extended example explains that if the lender understands the circumstance under which his creditor will default, and he can act to avoid that circumstance, then fresh start serves no useful purpose. In fact, instituting a policy of fresh start in such a situation could make matters worse!

We will assume that both C and D are forward-looking: Each person fully understands how the other will act in the future if a loan is made. We will continue to assume that D's circumstances are exactly as before: She has a full-time job earning $2000 a month with the option of working fewer hours; she has no assets; and her monthly nondiscretionary expenses are $1800. To keep matters simple, we will also assume that D does not plan to save any portion of her resources for the foreseeable future. This means that she will spend any loan granted to her and she will not have any property a creditor can grab in the future. Finally, we will assume that the best alternative use of C's funds is a risk-free investment that will earn him 5 percent per year.

Consider first the case where discharge is not permitted. From our previous discussion, we know that if D borrowed a lot of money, she will not pay it back. Being forward-looking, C understands this fact and will not lend a lot of money to D. Indeed, the *most* C would be willing to lend is the present value of the longest stream of $200 monthly payments D can handle. Let's assume that the longest stream is 12 months; that is, if D is faced with the prospect of making 13 or more monthly payments of $200 each, she will stop making payments and take the less work option. But if she needs to make fewer than 13 monthly pay-

[5] This is the sense in which economic logic puts lenders and borrowers on an equal footing: Any gain or loss to the lender that comes at the expense of an equivalent loss or gain to the borrower is viewed as being neutral with regard to gains or losses to society as a whole.

[6] It could be argued that the inefficiency could be avoided without permitting discharge if C and D negotiated a better outcome. After all, C must understand that if he insists on getting all of his $5000 back, he will get nothing. Given this, he might offer to partially forgive D's debt, and D might well accept such an offer and go back to working full-time. However, it's likely that C is dealing not only with D but with many other debtors, and C must be cognizant of the fact that forgiving D's debt might embolden other debtors to demand a similar consideration. These external effects might prevent an efficiency-restoring renegotiation between C and D.

ments, she will continue making them. In this case C can lend, at most, $2238 (rounded) to D without losing money on the deal. This amount of $2238 is simply the present discounted value of 12 monthly receipts of $200 each when the annual interest rate is 5 percent. This is the key difference when matters are viewed from the *pre-debt* perspective: If C is aware of the level of debt beyond which D will default, he will rationally lend less than that amount and default will not occur. If foresight can prevent default, the *post-debt* rationale for discharge does not apply.

In fact, having a discharge policy in place can actually make matters worse. Consider the above contract that requires D to pay $200 a month to C for 12 months. Would D have the incentive to adhere to this contract if she has the option to invoke discharge? The answer depends on the pecuniary and psychological costs of invoking discharge. The pecuniary costs of discharge include the out-of-pocket expenses of going to court, the cost of not being able to borrow again for an extended period of time, and the cost of being barred from certain types of employment following default.[7] The psychological cost might stem from a feeling of shame in having failed to meet one's obligations. If these costs are high enough, D will adhere to the contract.

But it is also possible that these costs are too low to prevent D from invoking discharge. If this is the case — and C is aware that D's costs of discharge are low — the amount C would be willing to lend to D will be less than $2238. How much less? For concreteness, suppose that the costs of discharge are such that D would adhere to the contract if she had six or fewer monthly payments of $200 to make. Then, the most that C would be willing to lend would be $1183 (rounded). This amount is the present discounted value of six monthly payments of $200 each when the annual interest rate is 5 percent.

Thus, a discharge policy may have the effect of reducing D's credit limit from $2238 to $1183. However, it is entirely possible that D would actually prefer to borrow more than $1183 and pay it back but the existence of a discharge policy makes it impossible for her to do so. The bottom line is that a discharge policy can have adverse effects on borrowers by making it too easy for them to default and consequently make creditors less willing to lend.

This objection to a discharge policy is implicitly recognized and countered in the Supreme Court ruling quoted earlier. Recall that the ruling made reference to the "honest but unfortunate debtor" in making the case for discharge. Evidently, the court was drawing attention to the fact that misfortune plays a role when people don't pay back their debts. And indeed, as argued in the next section, the risk of bad outcomes can provide a justification for a discharge policy.

THE ROLE OF RISK IN RESTORING THE (PRE-DEBT) LOGIC OF A FRESH START

To explain the role of risk, we will extend our example one more time. The point of the extended example is that the risk of not being able to repay gives a fresh start a benefit that may counter its costs. The benefit is that in the event that the debtor is unable to repay, she can invoke discharge and be relieved of the burden of her debt. But the debtor may choose to invoke discharge even when she has the capacity to repay. To avoid this outcome, the creditor must reduce the amount lent, which is the cost.

The risk of not being able to repay gives a fresh start a benefit that may counter its costs.

Imagine that in the month immediately after D takes out her loan there is a small chance that her discretionary income will fall permanently to $100. We will assume that D is contemplating entering into a contract wherein she promises to pay $200 each month for some (to be determined) set of months. The question we want to answer is: How much would C be willing to lend to D, recognizing that D's discretionary income may fall to $100?

Let's answer the question first for the case where discharge is not permitted. If D's discretionary income remains $200 in the first month of the loan, she will be in a position to make 12 monthly payments of $200 (which is the maximum number of months she can promise, given that she can choose the less work option and not pay anything). But if her discretionary income falls to $100 in the first month, she will be in default. At that point, C will have the right to "tax" away all of D's discretionary income until all obligations are met. Faced with this "tax," D will choose the less work option (that is, reduce her discretionary income to

[7] Failure to meet debt obligations is recorded in a person's credit history. This history is available to potential creditors and employers. A tarnished credit history typically leads to difficulties in obtaining new loans and could lead to difficulty in obtaining certain types of employment.

zero by working fewer hours) and never repay anything.[8] Knowing this, C will be willing to lend somewhat less than $2238 against D's promise to pay $200 each month for the next 12 months. By offering to lend somewhat less than $2238, C will get more than a 5 percent rate of return on his investment in the event D actually pays back. This return above the opportunity cost of his funds (which by assumption is 5 percent) is C's compensation for taking on the risk that D will default on the loan.

Now let's answer the question assuming that discharge is permitted. In this case, D will adhere to her loan contract as long as she has six or fewer monthly payments of $200 to make (which is the maximum number of months she can promise to pay, given that she has the option to invoke discharge and walk away from her debt) and her discretionary income is $200. If her discretionary income falls to $100 in the first month of the loan, she will invoke her right to discharge and walk away from her debt. Again, anticipating this, C will be willing to lend somewhat less than $1183 against D's promise to pay $200 each month for the next six months because there is the small chance that D will not make any payments at all.

The bottom line is that without the possibility of discharge, the "honest but unfortunate" debtor runs the risk of being condemned indefinitely to life under the threat of seizure, a situation that is both unpleasant and bad for work effort. Permitting discharge eliminates this possibility but reduces the maximum amount a debtor can borrow. The amount the debtor can borrow is less because the lender must make certain that the debtor has the incentive to repay even when there is no financial hardship. If debtors' aversion to the risk of bad outcomes is sufficiently strong, or if their need to borrow is sufficiently weak, then from the debtors' perspective permitting discharge will be preferable to prohibiting it.

This risk-based logic for discharge is further strengthened if we recognize that lenders need not bear any losses from having a discharge policy in place. This is so because in the (likely) event that D does make all six of her monthly payments of $200 each, C earns more than a 5 percent rate of return (annualized).[9] Therefore, by lending on similar terms to many people, C can use the additional returns from the above-5-percent interest rate paid by nondefaulting debtors to offset the losses inflicted by defaulting debtors and still obtain an average return of 5 percent on his investments.

From the *pre-debt* perspective, then, the case for a discharge policy rests ultimately on the risk of bad outcomes and the fact that discharge provides a form of insurance against this risk. The economic logic of a fresh start then comes down to a comparison between the benefits of insurance and the costs of a reduced borrowing capacity. If enough people in the economy value the insurance benefit of a discharge policy more than the cost of a reduced borrowing capacity, a policy of discharge, or fresh start, will be socially desirable.

The economic logic of a fresh start provides insights into the history of the evolution of personal bankruptcy law in the U.S., in particular, into Americans' divergent attitudes, over time and space, toward the efficacy of a discharge policy.

FRESH START AND THE EVOLUTION OF U.S. BANKRUPTCY LAW

The economic logic of a fresh start provides insights into the history of the evolution of personal bankruptcy law in the U.S., in particular, into Americans' divergent attitudes, over time and space, toward the efficacy of a discharge policy. An obvious but nevertheless important point about the economic logic is that it states *conditions* under which having a discharge policy is socially desirable. Thus, if we observe an economy that looks upon a discharge policy with disfavor — or *vice versa* — the economic logic of a fresh start suggests reasons this might be so.

The colonial history of the United States affords a unique opportunity to observe the economic logic of a fresh

[8] D's options are to hand over all of her discretionary income for the next 24 months or reduce her work effort. Since the less work option is preferable to the prospect of handing over all her discretionary income for the next 13 (or more) months, she will surely choose the less work option when faced with the option of handing over all of her discretionary income for the next 24 months.

[9] This is so because C lent an amount less than $1183 but insisted that D pay back $200 for six months. For instance, if C lent only $1500, the implicit interest rate in the event D paid back the loan would be about 15 percent.

start at work.[10] Each of the 13 original colonies started out with debtor and creditor rights based on English laws. These laws gave creditors the right to seize the property of insolvent debtors and, if there was any suspicion that the debtor was hiding property, to imprison him or her. There are ample records of impoverished insolvent debtors spending years in jail petitioning colonial legislatures for relief. A discharge of debt was possible at the behest of the creditor only.

But as time progressed, the colonies altered these laws to suit their own needs.[11] As one would expect from the post-debt logic of a fresh start, the law that came under pressure first was the law permitting the imprisonment of debtors. It was clear to everyone that keeping insolvent debtors in jail for years served no useful purpose. It was unlikely that someone who had been imprisoned for several years had any hidden wealth, so creditors were not being served by this imprisonment and society lost the labor of the imprisoned debtors. Bowing to public pressure, Massachusetts enacted a debtor relief law in 1698, which permitted insolvent debtors who owed less than £500 to obtain their release from jail upon swearing an oath of poverty. But the law did not discharge debts: Debtors were responsible for paying back everything they owed, and creditors retained the right to attach future property accumulated by insolvent debtors toward satisfaction of any unmet obligations.

As the discussion of the post-debt logic of discharge would lead us to expect, this law had an adverse effect on the work effort and savings of insolvent debtors released from jail. Why would an insolvent debtor exert effort and accumulate wealth if his creditors could "tax" it all away? The Massachusetts legislature acknowledged this problem when, in 1725, it noted that the law had been a "…great encouragement to idleness and ill-husbandry, and too much a temptation to perjury…" and repealed it. Nevertheless, similar laws were passed periodically until 1787, when relief of debtors who owed moderate amounts of money was made a permanent part of Massachusetts law. The experience of Massachusetts in this regard is similar to that of the other colonies that enacted debtor-relief laws. But even though the post-debt logic of discharge was quite apparent to the Massachusetts legislature, neither it nor most other colonial legislatures permitted discharge of debt until much later.

This reluctance to permit discharge can be explained from the perspective of the economic logic of a fresh start. Recall that permitting discharge leads lenders to lend less. Hence, whenever the capacity to borrow is really important to people, we can expect society to be hostile to the idea of discharge. There is ample historical evidence that in the early years of colonization, ordinary people acutely felt the need to borrow. To quote historian Bruce Mann: "Debt was an inescapable fact of life in early America. One measure of how thoroughly this was so is in the pervasiveness of debts owed and owing in probate inventories….Debt cut across regional, class, and occupational lines. Whether one was an Atlantic merchant or a rural shopkeeper, a tidewater planter or a backwoods farmer, debt was an integral part of daily life." This one single fact probably goes a long way toward accounting for the general reluctance of colonists to enact a discharge policy. When a person's ability to earn a living depends on his or her capacity to borrow, it is not in the interests of a people to erect barriers to the flow of credit by making it difficult for creditors to collect on their loans.[12]

Nevertheless, a few colonies did enact discharge laws fairly early in their histories: Rhode Island, New York, Maryland, and South Carolina.[13] These exceptions may also be consistent with the logic of a fresh start. As historian Peter Coleman notes, these

[10] The discussion in this section draws from three sources. Most heavily, it draws from Peter Coleman's highly regarded history of insolvency, imprisonment, and bankruptcy in colonial America. It also draws from historian Bruce Mann's recent book on colonial America's attitude toward debt and debtors, and it draws from David Skeel's fascinating account of the century-long legislative struggle to establish a federal bankruptcy law.

[11] Thus, with regard to bankruptcy laws, the colonies acted like small, largely independent democratic countries with legislatures attuned to the needs of their respective citizenry, a fact that imperial authorities in Britain did not always care for but put up with nevertheless. Interestingly, this situation continued after independence because even though the Constitution gave the federal government the right to devise "uniform laws regarding bankruptcy," no long-lasting federal bankruptcy law was devised until 1898. Thus, the states (and territories) continued to enact local bankruptcy laws to meet their own individual needs until the dawn of the 20th century.

[12] The colonies tempered the adverse consequences of not having a discharge policy by modifying creditors' rights. Many colonies passed laws that prevented creditors from immediately seizing the assets of borrowers in default. These "stay laws" gave insolvent debtors breathing room to meet their obligations. That way, if the reason for their inability to meet debt payments was temporary, they were not deprived of their assets. Also, during times of general colony-wide financial distress, many colonies passed laws that discharged the debts of people who were insolvent on a particular date. In this fashion, many colonies provided relief to debtors on an ad hoc basis without having an official discharge policy in place. See the article by Ian Domowitz and Elie Tamer for a description of how business conditions influenced bankruptcy legislation.

[13] Pennsylvania did not enact a discharge policy, but a discharge policy for the residents of the county of Philadelphia was enacted and allowed to stand for a brief period. New Jersey had a discharge policy in place during 1771-1787 but abolished it thereafter. Delaware did not permit discharge until 1900. Massachusetts, the place where America's industrial revolution took root, enacted a discharge policy in the mid-19th century.

colonies stood out for being heavily commercialized. In these colonies we would expect a discharge policy to reflect the needs of entrepreneurs, a class of people for whom risk-sharing is more critical.[14]

After independence, the U.S. Constitution granted the federal government the right to enact a uniform bankruptcy law. But attempts to do so failed miserably for almost a century. Historians have puzzled over why it took so long for a bankruptcy bill to pass and what led to its passage and success in 1898. As with any other piece of legislation, special interest groups had a lot of influence in shaping the character of various bankruptcy bills. But because of the ubiquity of debt in early America, the fairness and practicality (or lack thereof) of any bankruptcy law became quickly apparent to people, and if the law performed poorly, it did not last.

Put differently, the economic logic of a fresh start was a constant reality check on the interest-group logic of relief laws passed by lawmakers.[15] It is significant that the 1898 bankruptcy bill – the one that eventually lasted long enough to become permanent – allowed U.S. states to have a say in local discharge policy. Thus, a discharge policy suited to local needs became possible, and the law itself found acceptance. It is perhaps also significant that by the end of the 19th century, America was no longer a nation of "rural shopkeepers, tidewater planters or backwoods farmers." It was a nation where three-quarters of industrial output was generated in business corporations. The rise of corporations meant that ordinary people were much more likely to be wage earners and thus less reliant on credit to earn a living.

Now, at the start of the 21st century, the situation has changed. Once again, debt has assumed greater importance in the lives of ordinary people. People and businesses expect to buy and sell all manner of consumer goods and services on credit, a development that began with the proliferation of consumer durables in the 1920s, most notably automobiles. Thus, credit for ordinary people (consumer credit) has again become an integral part of our economic system, and, predictably, this development has led to dissatisfaction with the policy of discharging debts.[16]

The latest bankruptcy bill puts significant restrictions on who can avail themselves of the right to discharge.[17] Recall that although a discharge policy is primarily meant to give the borrower an escape route if his or her capacity to repay is impaired, a lender must contend with the fact that a borrower might invoke discharge even when he or she has the capacity to repay. Indeed, the reason the creditor (in our example) had to restrict his lending to the debtor was to ensure that the debtor invoked discharge only when her capacity to repay was impaired. The latest bankruptcy bill is an attempt to relax this limitation on lending by insisting that the debtor cannot invoke discharge if she has the capacity to repay. In this spirit, the law does not allow households with above-median income to invoke discharge. The result of the law will be to make more credit available at cheaper terms – something the average consumer presumably wants and will benefit from.[18]

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CONCLUSION

U.S. law gives individual debtors the right to petition a bankruptcy court and ask to be released from their financial obligations to creditors. This right is referred to as the law's fresh start provision – after a famous Supreme Court ruling that succinctly captured the basic reasons for having such a policy. As discussed at length in this article, the reasons fall into

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[14] It is important for entrepreneurs to be able to borrow in order to get a venture going. If the initial venture is successful, further expansion can be financed by borrowing against accumulated assets.

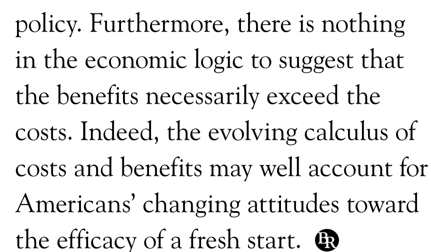
[15] Interest-group politics explains regulatory capture: how interest groups can use the law to their own benefit. It explains why regulation might end up serving the interests of the industry it regulates rather than the interests of society as a whole.

[16] There are more subtle changes at work as well. Because fresh start is a form of insurance, the need for it is not as great if there are other forms of insurance available. Since the early 1940s, unemployment insurance has become widely available in the U.S., and this development makes people more willing to accept limits on discharge policy in return for an increased capacity to borrow. See the article by Kartik Athreya for more discussion of the interaction between unemployment insurance and fresh start.

[17] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 did more than just restrict access to discharge for above median-income households. See Loretta Mester's article for a comprehensive discussion of the reform (when the act was still in the proposal stage) and the empirical research on bankruptcy and credit that bears on it.

[18] My article with Dean Corbae, Makoto Nakajima, and Vìctor Rìos-Rull examines this issue in a numerically specified model of the U.S. economy and concludes that restricting above-median-income households' access to fresh start will benefit the average U.S. household.

two categories. One justification for a discharge policy is that it eliminates the adverse effects that unrestricted creditor rights can have on an insolvent debtor's work incentives. A deeper justification is that a discharge policy provides a form of insurance benefit: The policy permits a debtor to not repay his or her debts when doing so would be very costly. Of course, these benefits come at the cost of a reduced capacity to borrow. Perhaps the most important lesson to be gleaned from an understanding of the economic logic of a fresh start is that there are both costs and benefits of adopting a discharge policy. Furthermore, there is nothing in the economic logic to suggest that the benefits necessarily exceed the costs. Indeed, the evolving calculus of costs and benefits may well account for Americans' changing attitudes toward the efficacy of a fresh start.



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