Is the Personal Bankruptcy System Bankrupt?

BY LORETTA J. MESTER

Over the past few years, several attempts have been made to reform the U.S. bankruptcy system, to help stem perceived abuses of the system. In this article, Loretta Mester outlines the components of reform proposals. She then looks at the empirical research on bankruptcy to evaluate the rationale for reforming the system and the effectiveness of proposed changes.

Neither a borrower nor a lender be;
For loan oft loses both itself and friend,
And borrowing dulls the edge of husbandry.

Polonius
Act 1, Scene 3
Hamlet by William Shakespeare

Over the past several years, Congress has attempted to pass legislation to resolve perceived problems in the personal bankruptcy system in the U.S. Although it has not proposed anything as drastic as Polonius recommended, Congress has proposed several significant changes to the current system. In the latest try, separate bills were passed in the House (HR 333) and in the Senate (S 420) in March 2001, but Congress adjourned before reconciliation of the bills could be completed. Legislation is again being considered this year, but regardless of the outcome, the debate about the U.S. personal bankruptcy system is unlikely to be resolved anytime soon. Indeed, a number of studies provide evidence on the rationale for changing the current system, on whether reform is necessary, and on whether the proposed revisions will have the intended effect.

After reviewing the current personal bankruptcy system and the proposed changes, we'll discuss some of the findings of these recent studies. These studies do shed some light on the debate and cast some doubt that the proposed changes will yield benefits as significant as intended. They also suggest further research is necessary to resolve all the issues.

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CURRENT PERSONAL BANKRUPTCY SYSTEM IN THE U.S.

As Joseph Pomykala discusses in his interesting article, the word "bankruptcy" has two roots. "Banca rotta" is Latin for broken board. In medieval Italy, "creditors would break the workbenches of defaulting merchants over the merchants' heads." "Banqueroute" is French for debtors on the lam (route), as bankruptcy was considered an act of debtor fraud. As Pomykala points out, before the mid-18th century, bankruptcy was considered a crime, and in England, certain bankrupt debtors were subject to capital punishment. The U.S. modified English law to be less harsh. For example, the Pennsylvania Bankruptcy Act of 1785 allowed for those convicted of bankruptcy to be flogged while nailed by the ear to a pillory, after which the ear would be cut off. (Of course, how much more lenient this was is clearly debatable.)

Bankruptcy protection has been part of U.S. federal law since 1898. Indeed, Article I, Section 8 of the U.S. Constitution authorizes Congress to enact "uniform Laws on the subject of Bankruptcies" (see the article by Leonidas Mecham). The structure of the current bankruptcy system was established in the Bankruptcy Reform Act of 1978. The idea is to allow a "fresh start" (within limits) for honest people who, often through unfortunate circumstances beyond their control, have gotten into trouble with debt and to allow for creditors to be repaid in an orderly fashion with the debtor's available assets.

The bankruptcy provisions allow for a sharing of risk between borrowers and creditors, offering some insurance to borrowers if they find themselves unable to repay their debts. The insurance gives consumers whose income may be low today but is expected to rise in the future the confidence to borrow now to pay for consumption. This raises consumers' economic well-being. If things go as planned, they will repay their debts. If some adverse event, like a job loss, prevents them from repaying, they can file for bankruptcy and protect their future income from creditors. Bankruptcy procedures better enable consumers to smooth their consumption over time, thereby increasing economic efficiency. The bankruptcy system also provides a joint debt-collection system for a debtor's creditors (see the CBO study for a nice review of personal bankruptcy fundamentals). A bankruptcy system that is too harsh would lower economic welfare by discouraging borrowing and risk sharing. However, a system that is too lenient and allows debtors to escape from their commitments too easily can hurt economic efficiency by causing creditors to restrict the supply of credit and raise its cost to creditworthy borrowers.

The federal bankruptcy courts administer the bankruptcy system. All bankruptcy cases are filed in these federal courts. There are 94 bankruptcy districts in the U.S. and its territories, each with a court. Pennsylvania is broken into three districts: eastern, central, and western, while New Jersey and Delaware are each separate and single districts. The courts in all three states (along with the District of the Virgin Islands) are part of the third federal circuit. A bankruptcy case is often overseen by a court-appointed trustee.

Under current law, individuals considering bankruptcy can file under Chapter 7 or Chapter 13 of the bankruptcy act.[1] Chapter 7, sometimes called straight bankruptcy, is liquidation — a filer hands over his assets (with some exemptions) to the trustee, who then sells the assets and uses the proceeds to repay the debtor's creditors. The remaining debts (with some exceptions) are then discharged — that is, wiped clean — and the debtor retains control of his or her future income.[2] In many cases there are few assets available to repay creditors, and most unsecured debt, such as credit card debt, is not repaid in bankruptcy (see the CBO study). In other cases, a debtor may want to keep control of an asset, like a car, that is pledged as collateral against a loan. In this case, the debtor can "reaffirm" the debt — the debtor and creditor agree that the debtor will pay the creditor all or part of the debt, even though the debtor has filed for bankruptcy, and the creditor will not repossess the property. A person can file for bankruptcy under Chapter 7 every six years.

Chapter 13 involves adjustment of debts of an individual with regular income. Under this chapter, some debts are reduced, but then debtors and creditors devise a plan by which the debtors repay their remaining obligations out of their future incomes. Repayment is made in installments over a three-year period (which the court can extend to five years). The debtor must repay creditors at least as much as they would have received under Chapter 7, and claims entitled to priority must be paid in full. The debtor cannot take on any new debt without the trustee's approval, and the debtor's secured and unsecured debt must be less than certain specified limits to allow him or her to file under Chapter 13. In exchange, debtors retain more of their assets than they would under Chapter 7. At the end of the repayment period, any remaining unpaid debt is discharged. Generally, someone can file for bankruptcy under Chapter 13 as often as he or she wants (except that, in some cases, the filing cannot be within 180 days of dismissal of a previous case).

As part of the filing under either chapter, the debtor submits a list of his assets, income, liabilities, creditors, and debts. After a debtor files under either chapter, an automatic stay stops creditors from collecting on unpaid debts. This prohibits creditors from filing lawsuits against the debtor for repayment, trying to garner the debtor's wages, or making telephone calls demanding repayment (see *Understanding the Federal Courts)*.

WHY THE CALL TO REFORM?

Bankruptcy protection is designed to help people get out from under the burden of excessive debt and to get a fresh start. Some people, though, point to abuses of the system: Debtors who actually have the ability to repay sometimes escape their obligations. Knowing this escape route exists may give borrowers an incentive to take on more debt, to the extent that lenders are willing to supply them credit. Of course, lenders should respond to a lenient bankruptcy law that permits many debts to be discharged by restricting credit or raising the cost of credit so that only the better credit risks could borrow. A bankruptcy system that is too

[1] They may also file under Chapter 11, but this is rare. Chapter 12, which is similar to Chapter 13, applies only to family farmers in financial distress. See Report 106-49 on S. 625, U.S. Senate, and Mecham for fuller descriptions of the U.S. personal bankruptcy system.

[2] According to Mecham, 18 categories of debt cannot be discharged under Chapter 11; there are fewer restrictions under Chapter 13. Certain types of tax claims, debts for spousal or child support or alimony, and debts for willful and malicious injuries to person or property are examples of nondischargeable debts.

lenient would lead to economic inefficiencies whereby the supply of credit was too restricted and its cost too high.

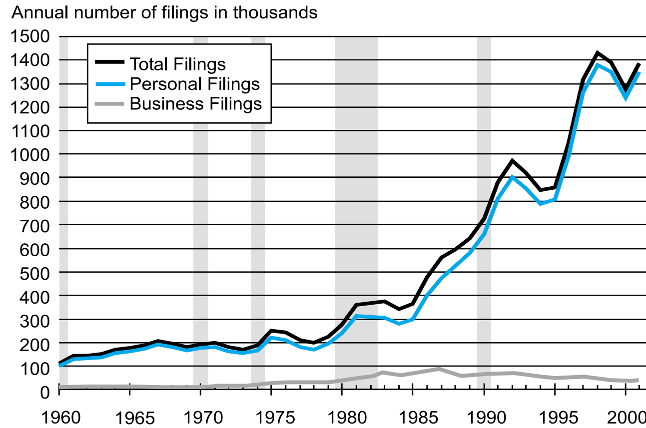
Over the years, changes have been made to the system to try to limit the scope for abuse. For example, in 1984, judges were permitted to dismiss Chapter 7 cases if they thought granting relief would constitute a "substantial abuse" of the bankruptcy code. But the term "substantial abuse" was not defined, and creditors and trustees were not allowed to present evidence to the judge in a particular case on whether relief should be viewed as substantial abuse (see Report 106-49, Senate).

Filings Have Increased in Recent Years. One factor pointed out in the most recent round of legislative consideration of the bankruptcy system was the substantial increase in the number of filings that began in the 1980s. Total bankruptcy filings, including personal and business filings, hit a record 1.43 million in the year ended June 1998, and they have been very high since then, with 1.39 million filings in the year ended June 2001 (Figure 1).[3] Indeed, the 400,000 filings in the second quarter of 2001 was the most ever for a three-month period. Over 97 percent of these filings are personal as opposed to business, and 70 percent of personal filings per year are typically Chapter 7 filings (Figure 2).[4]

FIGURE 1

Annual Number of Bankruptcy Filings

(12-month periods ending in June)

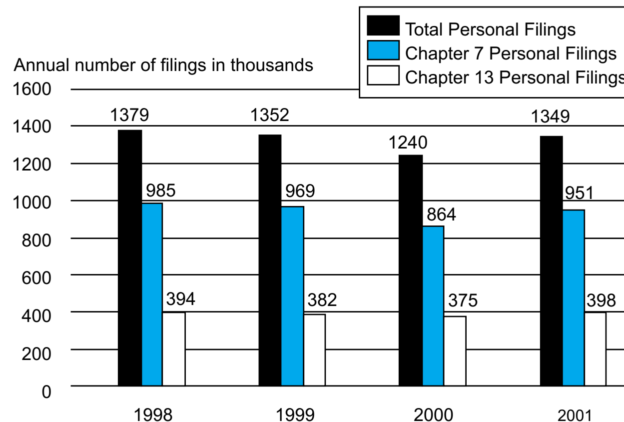


Note: Shaded areas represent economic recessions.
Source: Bankruptcy data from Administrative Office of the U.S. Courts.

FIGURE 2

Number of Personal Bankruptcy Filings, Total and by Chapter

(12-month periods ending in June)



Source: Administrative Office of the U.S. Courts.

[3] The number of personal filings before and after 1979 are not directly comparable because the Bankruptcy Reform Act of 1978 allowed for spouses to file a joint petition for bankruptcy protection. See the CBO study for further discussion.

[4] Note that some of the personal filings could actually represent business failures because some small businesses are funded by the personal credit lines of their owners. See Appendix A of the CBO study for further discussion of the data on personal bankruptcy filings.

Figure 3 shows the number of personal bankruptcies per thousand households (the bankruptcy rate) in the three states in the Third Federal Reserve District (Delaware, New Jersey, and Pennsylvania) and in the U.S.[5] As you can see, these numbers ranged between nine and 13 bankruptcies per 1000 households in 2001. In other words, in 2001, 0.9 to 1.3 percent of households filed for bankruptcy in the nation and in our three states. (Note that there is much wider variation in the personal bankruptcy rate across the other states in the U.S. In 2001, Tennessee, which had 24.5 filings per thousand households, had the highest rate; Iowa, which had 4.1 filings per thousand households, had the lowest rate. See the Table.)

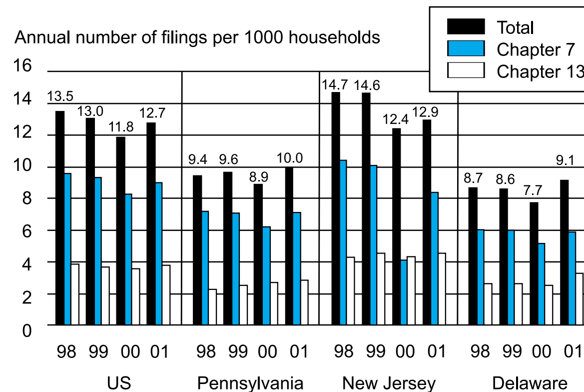
The number of personal bankruptcy filings began accelerating in the 1980s, with an especially large increase between 1995-98.[6] For example, from 1961 to 1980, the personal bankruptcy rate rose, on average, about 3 percent per year. Since 1980, the average increase in the personal bankruptcy rate has been almost 8 percent per year, with an especially sharp increase of 14 percent per year between 1995 and 1998 (Figure 4). We can look at the increase another way: In 1980, there was one personal bankruptcy filing for every 336 households in the U.S.; in 2001, there was one personal bankruptcy filing for every 78 households.

Some of the rise in bankruptcies in the 1980s can be attributed to bad economic times: There was a short recession from January 1980 to July

FIGURE 3

Personal Bankruptcy Rate, Total and by Chapter

(12-month periods ending in June)

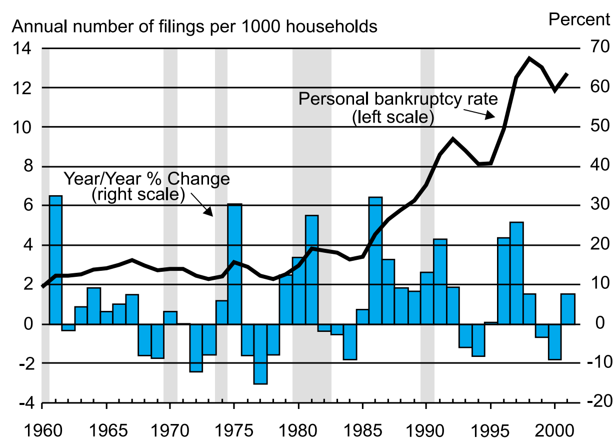


Note: Sum of Chapter 7 and Chapter 13 does not equal total because there are a few personal business filings under Chapter 11. Personal bankruptcy rate is the number of personal bankruptcy filings per thousand households.
Sources: Administrative Office of the U.S. Courts and U.S. Census.

FIGURE 4

Personal Bankruptcy Rate and Growth in Personal Bankruptcy Rate

(12-month periods ending in June)



Note: Shaded areas represent economic recessions.
Personal bankruptcy rate is number of personal filings per year per 1000 households.
Sources: Bankruptcy data from Administrative Office of the U.S. Courts; household data from the Bureau of Census, www.census.gov.

[5] Delaware has about 300,000 households, New Jersey about 3.1 million households, Pennsylvania about 4.8 million households, and the U.S. about 106 million households.

[6] In contrast, business filings, which increased in the early 1980s, fell back in the latter half of the 1980s and in the 1990s.

TABLE

Personal Bankruptcy Rate by State in Year Ended June 2001

(Number of Personal Bankruptcies per 1000)

State	Total Nonbusiness Filings	No. of Households (2000 Census)	Personal Bankruptcy Rate (Nonbus. Filings per 1000 Hhs)
Tennessee	54,730	2,232,905	24.51
Utah	16,915	701,281	24.12
Georgia	63,800	3,006,369	21.22
Nevada	15,833	751,165	21.08
Alabama	36,116	1,737,080	20.79
Mississippi	20,561	1,046,434	19.65
Arkansas	19,466	1,042,696	18.67
Indiana	42,537	2,336,306	18.21
Maryland	32,956	1,980,859	16.64
Idaho	7,578	469,645	16.14
Oklahoma	20,892	1,342,283	15.56
Washington	34,087	2,271,398	15.01
Louisiana	24,730	1,656,053	14.93
Kentucky	23,609	1,590,647	14.84
Oregon	19,667	1,333,723	14.75
Illinois	66,817	4,591,779	14.55
Virginia	38,361	2,699,173	14.21
Ohio	61,906	4,445,773	13.92
West Virginia	9,630	736,481	13.08
New Jersey	**39,575**	**3,064,645**	**12.91**
Missouri	27,989	2,194,594	12.75
California	143,174	11,502,870	12.45
Florida	78,702	6,337,929	12.42
Wyoming	2,343	193,608	12.10
Kansas	12,554	1,037,891	12.10
Hawaii	4,712	403,240	11.69
Arizona	22,036	1,901,327	11.59
Rhode Island	4,690	408,424	11.48
New Mexico	7,420	677,971	10.94
Michigan	41,251	3,785,661	10.90
Colorado	16,921	1,658,238	10.20
Pennsylvania	**47,708**	**4,777,003**	**9.99**
Montana	3,578	358,667	9.98
Washington, DC	2,410	248,338	9.70
North Carolina	30,215	3,132,013	9.65
Nebraska	6,382	666,184	9.58
Wisconsin	19,624	2,084,544	9.41
Delaware	**2,730**	**298,736**	**9.14**
New York	63,642	7,056,860	9.02
Texas	66,290	7,393,354	8.97
Connecticut	11,144	1,301,670	8.56
South Carolina	12,868	1,533,854	8.39
Maine	4,198	518,200	8.10
Minnesota	15,216	1,895,127	8.03
North Dakota	2,021	257,152	7.86
South Dakota	2,228	290,245	7.68
New Hampshire	3,545	474,606	7.47
Massachusetts	16,676	2,443,580	6.82
Vermont	1,580	240,634	6.57
Alaska	1,361	221,600	6.14
Iowa	9,662	2,336,306	4.14

1980 and a long one from July 1981 to November 1982 (recessions are shown by shaded bars in the figures). But the rapid rise in the bankruptcy rate in the 1990s is more difficult to understand, since this was a period of very good economic conditions — economic growth averaged 3.2 percent per year in the 1990s, and the unemployment rate had fallen to 4 percent by the end of the decade. Even this is not unprecedented: The rate of bankruptcy filings rose rapidly in the mid-1980s in the midst of an economic expansion, and it has risen in other periods of economic expansion as well. (Note that the rise is not necessarily a bad thing, as it accompanied an increase in credit availability to households.)

Households did increase their borrowing in the 1990s, and the rise in household debt-service burdens — that is, required payments on mortgages and other consumer debt as a percentage of disposable income — in that decade may explain part of the rise in the bankruptcy rate (Figure 5, *see next page*). Yet the debt-service burden was at comparable levels in the mid-1980s, and the bankruptcy rate was much lower.[7] So factors other than debt-service burdens appear to play some role in the decision to file.

The most recent increase in filings in the first half of 2001 might be the result of pending legislation to change the bankruptcy system, as people contemplating bankruptcy may have accelerated their filings to get in under the old rules. Still, the fact that the bankruptcy rate rose in the late 1990s during good economic times and remains high is taken by many as an indication that the system is being abused by people who actually have

[7] There have been periods — for example, between 1988 and 1991 — when debt-service burden and filings moved in opposite directions.

the wherewithal to repay their debts. This view has led many observers to believe that the bankruptcy system needs to be revamped and has led to proposed legislation to change the system. Whether changes to the bankruptcy system will have much of an effect on the rate of filings depends both on what changes will be enacted and whether the bankruptcy system itself has encouraged filings.

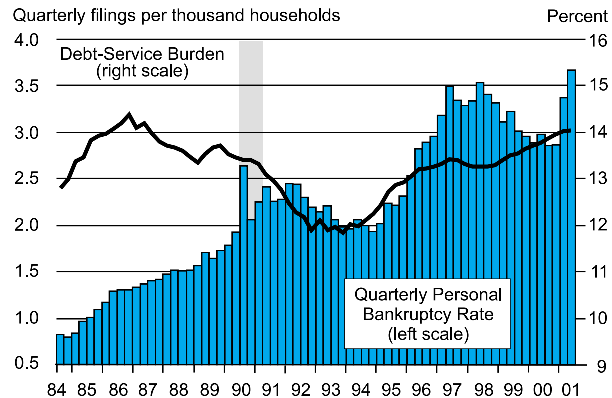
BANKRUPTCY REFORM LEGISLATION

Although there have been many attempts to pass legislation over the past several years, bankruptcy reform legislation has yet to be signed into law. In March 2001, the House and Senate passed their own versions of bankruptcy reform legislation (HR 333 and S 420); similar bills were passed the previous year by the 106th Congress, and hearings were held in 1997 by the 105th Congress. Last year, Congress adjourned before reconciliation of the bills could be completed, but bankruptcy reform legislation is again being considered this year. While the versions passed by the House and the Senate in 2001 differed in some ways, those differences have narrowed as legislation has worked its way through several sessions of Congress. In last year's bills, there was general agreement on basic aspects of reform. Here I'll review eight proposed changes to the bankruptcy system. The first five of these reforms favor creditors by limiting the benefits to debtors from declaring bankruptcy. The last three reforms might be considered debtor protections.

(1) Chapter 7 Means Testing. The bankruptcy system would be changed to what proponents of the bills call a "needs-based" system. If a debtor has sufficient income to repay a large part of his or her debts, he or she could not pursue Chapter 7 liquidation but only a Chapter 13 repayment plan.

FIGURE 5

Personal Bankruptcy Rate and Debt-Service Burden



Note: Shaded areas represent economic recessions.
Source: Bankruptcy data from Administrative Office of the U.S. Courts; debt-service burden data from the Federal Reserve Board. Debt-service burden is household required payments on mortgage and consumer debt as a percentage of disposable personal income. Quarterly personal bankruptcy rate is quarterly filings per thousand households. Note, sum of quarterly filings equal annual filings. Correlation between debt-service burden and quarterly personal bankruptcy rate was 0.84 from 1980 to 1987, −0.71 from 1988 to 1991, and 0.88 from 1992 to 2000.

A means test would be applied to determine which debtors would be forced into Chapter 13 and how much debt would have to be repaid over a five-year period. Debate has centered on whether means testing is necessary. Creditors favor such testing, saying that some debtors have abused the current bankruptcy system. Consumer groups say only 3 percent to 5 percent of Chapter 7 filers would have to repay some of their debt under the proposed means tests, and they argue that reform is not necessary, since the rate of filings dropped in 1999 after the record rate in 1998. As discussed below, arguments for and against means testing are in dispute.

The 2001 bills barred Chapter 7 filing if, after living expenses and the cost of other necessities, the debtor could afford to repay at least $100 per month over a five-year period. The bills generally used the standards the IRS uses to figure out living expenses for people owing back taxes, but the bill specified the use of actual costs of other necessities (for example, child care, union dues, and so forth). Some income, such as Social Security and war crimes compensation, would be excluded from the calculations. Those earning less than the median income in the applicable state would qualify for Chapter 7 regardless of their ability to repay.

Under current law, if a debtor files under Chapter 13, the repayment period is three years unless the court, for cause, extends it to a maximum of five years. This provision would remain the same for debtors whose family income is less than the median family income in the applicable state. However, for families with higher income (who would be forced to file under Chapter 13 by the means test), the repayment plan would be extended to five years.

(2) Nondischargeable Debts. Bankruptcy courts currently presume that if a debtor bought more than $1000 in luxury goods or services or took $1000 in cash advances in an open-ended credit plan within 60 days before filing for bankruptcy, these debts were fraudulently incurred, and so they are not dischargeable. Any debt incurred to pay an existing nondischargeable debt is non-dischargeable if it was incurred with the intent of not repaying. Non-dischargeable debts include certain taxes, family support obligations, and debts arising from fraud. The proposed legislation would make more debts nondischargeable in bankruptcy.

The 2001 bills extend the definition of fraudulently incurred (and, therefore, nondischargeable) debt. In the House bill, the threshold for presumption of fraudulent purchases of luxury goods was lowered to $250 within 90 days of filing for bankruptcy, and the threshold for cash advances was lowered to $750 within 70 days of filing. The Senate bill agreed with the House, except that the threshold for luxury goods was lowered to only $750.

(3) Homestead Exemption. Many states allow a debtor to keep possession of his or her residence (up to some limit) when filing for bankruptcy; the residence would not be available to pay off creditors. Five states (Florida, Iowa, Kansas, South Dakota, and Texas) put no limit on the exemption for a primary residence; other states are quite restrictive (for example, New Jersey allows no homestead exemption).[8] One of the major differences between the House and Senate bills passed last year was their treatment of the homestead exemption. The Senate version would put a federal cap of $125,000 on the exemption for a primary residence. This cap would apply to all states. The House bill maintained states' ability to opt out of the federal limit and reestablish an unlimited or other exemption by passing legislation.[9] Both bills lengthened the time from six months to two years that a debtor must live in a state before being able to claim that state's exemption.

(4) Lien Strip-Down. Currently, debts are secured only to the value of the collateral, with any remainder treated as unsecured debt. Thus, a debtor could pay the amount of the collateral's current market value and keep the collateral — this is a strip-down. For example, a debtor could purchase a car, file for bankruptcy, and keep the car by paying off the value of the car, even though this is less than the amount he contracted to pay in the loan. Debtors who bought furniture, which has little resale value, are able to keep the furniture by repaying the low resale price rather than paying off the much larger debt. Consumer groups argue that changing the rules to allow creditors to repossess the collateral would force reaffirmations, wherein debtors agree to pay certain debts and not discharge them in bankruptcy. The 2001 legislation sought to limit strip-downs. The House bill barred strip-downs for a motor vehicle acquired by the debtor within five years prior to filing bankruptcy and for other personal property bought within one year prior to filing. The Senate bill differed from the House bill in setting the period for motor vehicles at three years prior to filing.

(5) Repeat Filings. Currently, debtors can file for Chapter 13 bankruptcy at any time (except, in some cases, within 180 days of a prior dismissal). Debtors can file for Chapter 7 bankruptcy six years after a discharge in bankruptcy. The legislation would have limited repeat filings. Both bills would have barred a Chapter 7 filing within eight years of prior discharge. The Senate bill would have barred a Chapter 13 discharge within three years of a prior discharge under a Chapter 7, 11, or 12 filing, and within two years of a prior discharge under Chapter 13. The House bill was harsher, disallowing a Chapter 13 discharge within five years of any prior discharge.

(6) Reaffirmation of Debts. Consumer advocates say creditors are pressuring debtors into reaffirming debts — in other words, pressuring them into saying that they will pay the debt and not discharge it in bankruptcy. Such reaffirmations are supposed to be filed with and approved by the bankruptcy court. But Sears was recently held liable in a class action based on reaffirmations of debt that were not filed with bankruptcy courts. The case involved Sears' pressuring debtors into reaffirming their debts with Sears rather then having them discharged in bankruptcy. Sears admitted to criminal fraud and paid a fine of $60 million.

The bills passed in 2001 sought to stem abusive reaffirmation agreements by mandating that certain specific disclosures be made in writing to the debtor, explaining the terms of the underlying credit agreement and the reaffirmation. The bills asked the attorney general to

[8] These data are as of January 1, 2000. See footnote 13, page 490 of Report 107-3, House of Representatives.

[9] Prior to 1978, there was no federal exemption; the states controlled exemptions. The Bankruptcy Reform Act of 1978 set federal exemptions for certain assets, including personal goods, tools of trade, autos, and homesteads. But individual states were allowed to opt out and set their own limits, and by 1983, all of them had. The Bankruptcy Reform Act of 1994 raised the federal exemption level and tied it to the Consumer Price Index starting in 1998. As of January 1, 2000, the federal exemption was $16,150 per debtor; 35 states had set their own exemption levels and did not allow the federal exemption; and the remaining states allowed debtors to choose between their state exemption or the federal exemption when filing for bankruptcy. See footnote 13, page 490 of Report 107-3 Part 1, House of Representatives and the study by Jon Nelson.

enforce prohibitions against abusive reaffirmations.

(7) Consumer Credit Disclosures. Some argue that creditors have led consumers into bankruptcy by misleading them about the true cost of credit. The legislation sought to make credit card companies disclose more about the consequences to the borrower of making only the minimum monthly payment.

The bills would have amended the Truth-in-Lending Act to require disclosures on credit-card bills. Credit card issuers would have had to provide generic examples of the consequences of making only minimum payments on bills in terms of how long it would take to pay off the debt. Issuers also would have had to give a toll-free number where holders could get specific information about repayment scenarios for their own accounts. Enhanced disclosures for home-equity loans, introductory loan rates, and late payment deadlines and penalties would have been required. Both bills would have barred the termination of a credit card just because a customer hadn't incurred a finance charge.

In testimony before the House in March 1999, Federal Reserve Governor Edward Gramlich said the Board of Governors wondered whether repeated disclosures to consumers might create "information overload." He said the Board does not generally favor laws that restrict a creditor's discretion to determine which accounts or transactions it deems as economically viable. The Board's view is that if creditors are terminating accounts of customers who use their credit cards only for transactions purposes, they are doing so because they consider these accounts unprofitable.

(8) Credit Counseling. Provisions are included to address the issue of unsophisticated borrowers. These provisions are intended to ensure that the debtor made a good-faith effort to negotiate a repayment plan with his creditors on his own. However, the requirement might also delay filings until debtors are unable to come up with a repayment plan in Chapter 13. Both bills required the debtor to have undergone credit counseling within 180 days before filing under Chapter 7 or Chapter 13.

The implications of the empirical work [on bankruptcy] to date is mixed.

As suggested by this overview, while the House and Senate bills passed in 2001 differed in some of their details, there was general agreement on major items of reform. The real question is whether these reforms are necessary and, if so, whether they will be effective.

EVIDENCE RELEVANT TO BANKRUPTCY REFORM

There have been several studies of personal bankruptcy. The implications of the empirical work to date is mixed as to whether the proposed bankruptcy reform is needed and whether it will have the intended effect. Partly at issue is the extent to which borrowers respond to the incentives provided by the bankruptcy law — borrowing more than they otherwise would and declaring bankruptcy even though they could eventually repay their debts — or, alternatively, whether they declare bankruptcy when they face an unexpected hardship that makes it impossible for them to repay their debts.

There are four main issues. First, I'll discuss empirical evidence on the source of the recent rise in bankruptcies and the extent to which market forces place limitations on the number of bankruptcies. If these forces are effective, reforms are less needed. Similarly, I'll discuss empirical evidence on the relationship between social forces (stigma) and the number of bankruptcy filings. A lessening in the effectiveness of these social forces would help support arguments for reform. Next I'll discuss evidence on the extent to which the current bankruptcy system is being abused. High levels of abuse favor the reformers. Finally, I'll discuss evidence concerning the efficacy of proposed reforms. Even if one believes the current system needs reform, it is not clear that the proposals will yield the desired effect.

(1) Market Forces. In a study done in 2000, Lawrence Ausubel argued that market forces have tempered some of the recent acceleration in personal bankruptcy filings and that legislation is unnecessary. As the bankruptcy rate increased, lenders responded by tightening their credit standards, thus leading to the decrease in the number of bankruptcies between 1998 and 1999. In Ausubel's view, if there ever was a "bankruptcy crisis," it is self-correcting.

In congressional testimony in 1998, Ausubel argued against the means-test approach because, in his view, the immediate cause of the record number of bankruptcies is the high level of household debt, which he attributes in part to aggressive lending tactics. In a 1999 study, Ausubel found that in randomized trials on preapproved credit-card solicitations conducted by a major U.S. issuer of credit cards, offers that included higher interest rates and fees tended to attract riskier borrowers with higher delinquency, charge-off, and bankruptcy rates than offers with better terms. In other words, issuers face a so-called adverse selection problem.[10]

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[10] Adverse selection in the credit-card market has also been documented in my paper with Paul Calem. The fact that credit-card rates are very sticky and don't tend to come down when other rates do is partly attributable to this adverse selection problem.

Ausubel places some of the blame for higher bankruptcies on the creditors who have issued the debt. He favors the approach of earlier proposed legislation that would restrict the claims of lenders who caused a debtor's ratio of unsecured debt to income to exceed 40 percent. He also favors a time priority in bankruptcy: unsecured lenders would be repaid in the order in which they lent, with the earliest lender repaid first and the latest lender repaid last, giving the later lenders more incentive to monitor the borrower's credit position.

Joanna Stavins reviewed studies that have shown riskier borrowers have gotten better access to credit-card loans over time, noting that the rise in credit-card borrowing in the mid-1990s has coincided with the increase in bankruptcy filings. Using data from the Terms of Credit Card Plans, a survey of about 200 of the largest bank credit-card issuers conducted twice a year by the Federal Reserve Board, Stavins provided empirical evidence that credit-card issuers that offer higher rates and fees in order to compensate for higher risk do tend to experience higher delinquency rates (measured by the fraction of outstanding credit-card loans 60 days or more overdue), a finding similar to Ausubel's. But unlike Ausubel, Stavins found that these issuers did not seem to have higher charge-off rates (the fraction of outstanding credit card loans that are written off). Indeed, her empirical results showed that banks that charged higher rates and fees earned higher net income from credit cards than banks that charged lower fees. This implies that at least over the period covered (1990-99), when the economy was in good shape, it was profitable for issuers to extend credit to riskier borrowers. Whether that would continue to be true in an economic downturn remains to be seen.

The relationship between debt levels and bankruptcies is more complicated than the studies by Ausubel and Stavins might suggest. There is no doubt a strong correlation between debt burdens (measured by the debt-to-income ratio, debt-to-assets ratio, or debt-service burden) and number of bankruptcies, since a higher debt burden means a negative shock can have a more severe effect on a household. However, we also know that in the aggregate, debt and debt-to-assets seem to increase after households see their incomes rise and expect their future incomes to rise. Debt seems to facilitate growth rather than inhibit it. Debt levels have been expanding not only because of aggressive lending but also because of the expanding economy and because technological advances have allowed creditors to offer loans to more borrowers at a lower cost (see my 1997 article on credit scoring).

> Another factor that may have contributed to the increase in the bankruptcy rate is the decreased social stigma associated with declaring bankruptcy.

(2) Stigma. Another factor that may have contributed to the increase in the bankruptcy rate is the decreased social stigma associated with declaring bankruptcy. Certainly, bankruptcy continues to have a negative connotation. It can harm a person's reputation, and it can make it more difficult to gain access to credit in the future. Federal law allows credit bureaus to continue to report a bankruptcy filing in the person's credit report for up to 10 years after the filing. A study by David Musto showed that this does restrict the person's access to credit. His work using credit-file data from 1994-97 showed that when the bankruptcy flag was removed from the report, the more creditworthy past filers initiated new credit relationships, especially high-limit credit cards, at a much faster rate than normal — evidence that the flag was a constraint on their getting credit.[11] Nevertheless, some of the negative effects from filing may have declined over time. Filing for bankruptcy may be more accepted these days, since it has become more common. There are other costs associated with filing that may have fallen as the number of filings has risen. For example, it is easier to find information on how to file (the forms and the information are readily available on the Internet); more people have experienced bankruptcy, so there are more people who can give advice; and there are more bankruptcy lawyers competing for business.

In an interesting study, David Gross and Nicholas Souleles assembled a panel of over 25,000 individual credit-card accounts, chosen to be representative of all open accounts in June 1995. They studied the behavior of these accounts for the next 24 months or until they first defaulted

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[11] Similarly, Stavins presented some data from the Survey of Consumer Finances for 1998 indicating that among those who have ever filed for bankruptcy (8.51 percent of respondents), the average level of credit-card debt is largest for those who filed nine or more years ago. But she also found that the average credit-card debt for someone who filed one or two years ago was higher than for those who filed three to nine years ago. Stavins posited that this might be because once someone files under Chapter 7, he or she cannot file again for six years, so issuers might feel relatively safe lending in the initial period after a filing.

or were closed in good standing, in an attempt to see whether the recent increase in bankruptcies is better explained by supply effects or demand effects. That is, did lenders increase the supply of credit to less creditworthy borrowers, who account for the increase in bankruptcy filings? Or, even after researchers control for creditworthiness, have people become more willing to default over time? Has their demand for bankruptcy increased? According to Gross and Souleles' estimates, riskier borrowers — for example, those with lower credit scores, larger credit card balances, and smaller monthly payments — are much more likely to default. Default rates were also higher for people living in states where unemployment was higher, house prices were lower, and fewer residents had health insurance.[12]

The authors documented that there was an increase in credit to riskier borrowers. But increases in credit limits and other changes in risk-composition explain only a small part of the significant increase in default rates between 1995 and 1997. They found that all accounts, even those with the same risk characteristics, age, and other economic fundamentals, became more likely to default over the sample period. And this increase in the probability of bankruptcy — about 0.06 percentage point per month between the start of the sample period in June 1995 to its end in June 1997 — is comparable to that which would occur if the credit score of every account in the sample were reduced by one standard deviation, which would be a very large increase in the overall riskiness of the sample. While not conclusive, this evidence is consistent with the stigma hypothesis, that is, that a decline in the cost of declaring bankruptcy — either the social, legal, or information-gathering costs — is largely responsible for the increased level of filings.[13]

(3) Abuse. A basic premise of bankruptcy reform legislation is that the current system is being abused by people who declare bankruptcy when they can still afford to repay their debts. Here the evidence is very mixed, and the results depend on the various assumptions made about the type of means test that would be enacted and the way different types of debt would be handled. A 1997 study by John Barron and Michael Staten published by the Credit Research Center at Georgetown University estimated that if all secured debt was reaffirmed, about 32 percent of Chapter 7 debtors in their sample could repay about 31 percent of their nonhousing, nonpriority debts. This would be an average payment per filing of $3570 over five years. The study was based on a sample of 3798 families who filed for bankruptcy in 13 major U.S. cities during the spring and summer of 1996. It was not a nationally representative sample, and a review by the General Accounting Office disputed some of the study's findings on a number of methodological grounds. For one thing, the study used the information debtors provided at the time of filing about their income, expenses, and debts without verification and assumed that the filer's ratio of income to expenses remained constant over the five-year repayment period.

Increases in credit limits and other changes in risk-composition explain only a small part of the significant increase in default rates between 1995 and 1997.

Visa and MasterCard have funded several studies, including three by Ernst &Young (by Tom Neubig and co-authors). The latest of these studies, published in March 1999 and based on a nationally representative sample of 1997 filings, estimated that 10 percent of Chapter 7 debtors would be affected by a means test for ability to pay either 25 percent or more of unsecured debts or $5000 over five years. This would yield $3 billion in debt recovery over five years. But these results assumed that the debtors remained in payment plans for the full five years and that their incomes rose as fast as their expenses and debt (Report 106-49, Senate, p. 88).

Marianne Culhane and Michaela White got significantly different results from the Ernst & Young studies. Their results were based on a different sample of bankruptcy filings (from 1995) and different assumptions about, among other things, how long

[12] Gross and Souleles also documented a seasoning effect: They found that the probability of delinquency rises from the time the account is opened until it is about two years old, then the probability falls.

[13] There is a debate in the legal literature about whether an economic modeling approach or a sociological approach is the appropriate methodology for studying bankruptcy decisions, especially when stigma is the factor being investigated (see Michelle White's 1997 article for an interesting discussion). The economic modeling approach, favored, for example, by White (1997), assumes that consumers act to maximize their welfare and, therefore, may act strategically when it comes to filing for bankruptcy, as we'll discuss below. The sociological approach, favored, for example, by Teresa Sullivan, Elizabeth Warren, and Jay Westbrook (1989) and Rafael Efrat (1998), assumes that people file for bankruptcy when their financial problems become severe enough that they can no longer handle their debt; it is not something they anticipate or plan for, and they do not act strategically regarding filing for bankruptcy. My training puts me in the economic modeling camp; hence, the studies I review here largely follow that approach.

debtors remain in their payment plans and debtors' automobile expenses. They estimated that 3.6 percent of Chapter 7 debtors could afford to repay some of their debts, with total recoveries of $450 million over five years. Because of their different sample, even when Culhane and White changed their assumptions to those used by Ernst &Young, they still estimated significantly lower recoveries — $930 million — than Ernst & Young.

One of the drawbacks of many of these types of studies is that they assume lender behavior would remain the same after bankruptcy reform. But if lenders lend even more aggressively, the number (and cost) of bankruptcies might increase after reform. The studies also assume that borrower behavior would remain the same, but models suggest that this need not be the case.[14]

For example, one potential drawback of the means test as proposed in the legislation is that shifting debtors with incomes above a certain threshold from Chapter 7 to Chapter 13 essentially imposes a high tax on future earnings, since Chapter 13 requires debtors to use some portion of their future earnings to repay their debt. Michelle White's 1999 study pointed out that this sets up perverse incentives, reducing debtors' willingness to work and even giving them an incentive to quit their jobs to avoid the tax. She and Hung-Jen Wang have proposed combining Chapters 7 and 13 so that debtors filing for bankruptcy would have to use their assets and their future earnings, after certain exemptions, to repay their debts. Their simulations suggest that this system would not have deleterious effects on debtors' incentives to work.

Wenli Li also developed a general equilibrium model of bankruptcy chapter choice and showed that individuals with fewer assets but higher income were more likely to choose Chapter 7, while those with more assets and lower income were more likely to choose Chapter 13 and they work less.[15] The author's theoretical analysis of proposed reforms indicated they will affect borrowers differently, depending on their level of wealth and income. For example, a means test that shifts filers into Chapter 13 would hurt the ones with few assets and medium income levels. Anticipating this, those filers with a higher probability of filing for Chapter 13 will reduce their borrowing but also not work as hard. This has important implications for trying to assess the economic benefits of bankruptcy reform or the amount of debt that borrowers would be able to repay in Chapter 13.

a home in New Jersey but an unlimited exemption in Texas. So there is an economic incentive to move to a state with a higher exemption before declaring bankruptcy.

In their provocative 1999 study, Ronel Elul and Narayanan Subramanian, using data from the Panel Study of Income Dynamics (PSID), estimated that about 3 percent of all moves to states with higher exemptions are driven by bankruptcy considerations. This percentage doubles for moves made by households "at risk" for bankruptcy (that is, with an estimated probability of filing for bankruptcy equal to the average filer).

Using data from the University of Michigan's Panel Study on Income Dynamics (PSID) for 1984-1995, Scott Fay, Erik Hurst, and Michelle White found evidence that borrowers respond to the incentives to file for bankruptcy. They measured these benefits as the amount of debt that is dischargeable under bankruptcy less any assets over the exemption level, which would have to be given up under bankruptcy. The authors found that for each $1000 increase in benefits, the probability of a household's filing rises, on average, by 0.021 percentage point, which would imply a 7 percent increase in filings per year.[16] To see what this effect means,

A corollary of the premise that people are abusing the bankruptcy system by filing when they can repay is that people act strategically when filing for bankruptcy.

Strategic behavior. A corollary of the premise that people are abusing the bankruptcy system by filing when they can repay is that people act strategically when filing for bankruptcy. But the empirical evidence on just how strategically people are behaving when they file is mixed. "Forum shopping" is one strategy. The exemption levels for personal bankruptcy vary widely across states. For example, as discussed earlier, a single filer receives no exemption for

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[14] In addition, these studies do not account for the administrative expenses of imposing a means test.

[15] In an empirical study, Ian Domowitz and Robert Sartain found that Chapter 13 filers more often tend to be married and employed and have higher income and higher equity-to-debt ratios than Chapter 7 filers.

[16] One drawback of the study is that only 254 households included in the PSID had filed for bankruptcy. The rate of filings in the PSID was only half of the national rate, suggesting that PSID households underreported their bankruptcy filings. See Fay, Hurst, and White and the CBO study for further discussion of this point.

consider that there were about 580,000 personal filings in the year ended June 1989, about the middle point of the period covered in the study. A 7 percent increase in filings would have meant 40,000 more filings in 1989. If the size of the effect were the same in 2001, an increase of $1000 in benefits would have added 94,000 filings to the 1.35 million personal filings in 2001.

Culhane and White also studied strategies and found that sophisticated debtors could avoid being classified as having the ability to repay under a means test by taking on more debt or increasing charitable contributions. Note that if such strategic behavior is the rule, then estimates of cost savings under means testing that do not account for these reactions will be overstated.

Other studies reviewed by Michelle White (1998b) did not find that personal bankruptcy rates are significantly related to the incentives to file.[17] Indeed, the real conundrum might not be why the bankruptcy rate increased so much in the 1990s, but why it didn't increase more[18] and why more people haven't moved to Texas and Florida where the homestead exemption is unlimited. Two reasons suggested by White (1998a) include the fact that sometimes creditors do not take legal action against borrowers who default, so borrowers have less incentive to file for bankruptcy protection, and that borrowers may want to preserve the option to file in the future, so they refrain from filing immediately. Another possibility is that there is indeed stigma associated with filing, which deters households from declaring bankruptcy.

(4) Efficacy of Repayment Plans. The reform proposals assume that Chapter 13 repayment plans work. But a 1994 study by the Administrative Office of the U.S. Courts found that 36 percent of debtors who voluntarily entered Chapter 13 repayment plans between 1980 and 1988 completed their plans. The study did not indicate why 64 percent of the plans failed. Only 14 percent of all Chapter 13 cases were converted to Chapter 7. This finding on the efficacy of repayment plans is important and contrary to the assumption in many of the studies that found that bankruptcy reform would lead to significant cost savings, since the studies assume that debtors remain in the repayment plans the full five years.

SUMMARY

Congress continues to try to pass legislation to reform the bankruptcy system. While the rate of bankruptcy filings has risen over the past several years, the reason for that increase is still debatable and that means the rationale for reform is debatable too. Some proponents of reform argue that people with the wherewithal to repay their debts are taking advantage of the system and that significant cost savings would be forthcoming from reform. Others argue that the real reason bankruptcies have increased is that the level of debt has increased, perhaps because lenders have encouraged risky borrowers to take on excess levels of debt.

The empirical work on the causes and incentives to file for bankruptcy and whether the proposed bankruptcy reform will have the desired effect is decidedly mixed. While this means that proponents on each side in the debate can find the ammunition they need by choosing the right study, it also means that more research is necessary in order to fully understand the bankruptcy phenomenon.

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[17] White (1998b) and "Notes" review the literature on whether debtors behave strategically regarding bankruptcy decisions. See also the CBO study.

[18] Fay, Hurst, and White found that about 18 percent of households would have benefitted from filing for bankruptcy over the 1984-94 period, and White (1998a) found that 15 percent of households would have benefitted from filing in 1992. Yet, on average, fewer than 1 percent of households filed over these periods.

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