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One Million Personal Bankruptcies a Year: Economic Implications and Policy Options

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ABSTRACT

This report examines various explanations for the rapid rise in personal bankruptcy filings in the United States since 1980, the economic significance of the phenomenon, and policy options. This discussion and analysis provide a background for consideration of legislation before the 105th Congress (H.R. 3150 and S. 1301), which proposes to reform the consumer bankruptcy process. For a more detailed analysis of these proposals, see CRS Report 98-276 A. This report, which does not assume extensive familiarity with bankruptcy law, will be updated as legislative developments warrant or as new economic data become available.

One Million Personal Bankruptcies A Year: Economic Implications and Policy Options

Summary

In 1996, the number of personal bankruptcies in the United States exceeded one million for the first time in history. In 1997, the figure climbed to 1.35 million, more than triple the number recorded in the early 1980s. That the number of households in severe financial difficulty should have risen so dramatically is perplexing, given that unemployment and interest rates have been falling since 1980 and that the economy has enjoyed two long periods of expansion.

The rise in bankruptcy filings is often attributed to a rise in household debt burdens. Since 1980, household debt (mortgage plus consumer credit) has risen from about 61% to 85% of total disposable personal income. Credit card debt (a component of consumer credit) has risen at a much faster rate, but accounts for less than 10% of the total household debt. Nevertheless, credit cards are at the center of the bankruptcy debate: creditors complain of debtor abuse and imprudence, while others criticize the aggressive marketing efforts of credit card issuers.

Why has household debt risen? Different explanations focus on (1) weakness in the economy (such as stagnant or falling real wages, corporate downsizing, lack of universal medical insurance, etc.) or (2) the strength of the economy (spending and borrowing grow with wealth and income gains and with confidence in future economic prospects).

Other explanations for the rise in bankruptcy rates involve social factors such as a declining sense of shame or stigma associated with debt and bankruptcy, divorce and single parenthood, legalized gambling, and so on. Others focus on local factors: automobile insurance requirements, state bankruptcy laws, etc. These various explanations are not contradictory; no single cause for the bankruptcy phenomenon can (or need be) identified.

Although loan losses from bankruptcy run into the billions of dollars, there is no immediate threat to banking institutions, even those that specialize in consumer lending. Likewise, there is no evidence that consumers will soon react to rising debt levels by cutting spending, and thus pushing the economy toward recession.

Policy options to reduce the incidence of bankruptcy or to make the bankruptcy system more fair and efficient focus on amendments to the bankruptcy code, which is often criticized as too lenient toward debtors. Possible changes might include incentives (or requirements) for Chapter 13 bankruptcies (where debtors with regular incomes agree to pay off some of their debts over time) rather than Chapter 7 cases (where the debtor's property is sold and remaining debts discharged, or canceled), provisions to deter fraud and abuse, and greater uniformity in the administration of the law. Bankruptcy reform legislation is pending before the 105th Congress, which also has received the report of the National Bankruptcy Review Commission, created in 1994 to study the law and recommend changes.

Contents

Background	1
Chapter 7	2
Chapter 13	3
The Choice of Chapters	3
Who Files for Bankruptcy?	4
Explanations for the Rise in Bankruptcy Filings	6
Credit Market Conditions	7
Why Has Household Debt Risen?	9
Sociological Factors	10
Local Factors	11
Bankruptcy's Effects on the Economy	13
What Can Be Done?	14

List of Figures

Figure 1. Bankruptcy Filings, 1980-1997	5
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List of Tables

Table 1. Personal Bankruptcy Filings by Chapter, Selected Years	4
Table 2. Personal Bankruptcies, 1980-1997: Number and Rate per 1,000 Population	6
Table 3. Selected Components of Household Debt as a Percentage of Disposable Personal Income, 1980-1996	8
Table 4. Bankruptcy Rates (Filings per 100 Households) for Selected States: 1980, 1990, and 1996	12

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One Million Personal Bankruptcies a Year: Economic Implications and Policy Options

In 1996, the number of personal, or nonbusiness, bankruptcy petitions filed exceeded 1,000,000 for the first time. The 1,125,006 personal bankruptcies represented about 1.2% of all American households. During 1997, the Administrative Office of the U.S. Courts recorded 1,350,118 personal bankruptcy petitions, an increase of 20% over 1996.

The rise in personal bankruptcy has not been easy to explain. Current bankruptcy filings are about triple the levels of the early 1980s, when rates of interest and unemployment were significantly higher than today. Moreover, there has been no corresponding rise in business failures: 1996 business bankruptcies (53,549 filings) stood at 65% of their 1987 peak. Many observers are troubled by the apparent rise in financial distress in the household sector over a period when business and macroeconomic conditions have showed steady improvement. Some seek the causes not in economics, but rather in sociological and legal factors, such as long-term shifts in consumer attitudes towards bankruptcy. In 1994, Congress created a National Bankruptcy Review Commission to study and recommend changes in the bankruptcy law. The Commission's report, completed October 1997, contains 178 proposals for changes in bankruptcy law. Legislation that would make significant changes in the bankruptcy code has been reported out of committee (H.R. 3150 and S. 1301) in the 105th Congress.

This report analyzes the explanations put forward for the rise in personal bankruptcy and considers their economic implications. Do the various factors that may have played a causal role reveal economic weaknesses hidden behind generally positive macroeconomic news? Or, is financial fragility a by-product of increasing wealth and income? Another section of the report deals with what bankruptcy filings at current or increased levels portend for the economic future. Will consumers at some point cut back on spending and try to reduce their debt loads, sending the economy toward recession? Is the soundness of banks and other creditors at risk? Finally, what actions can or should be taken to reduce the number of filings?

Background

To the individual, bankruptcy is a means of escaping a burden of debt that has become unmanageable. Upon the filing of a bankruptcy petition, all debt collection efforts must cease, and a process of court-supervised negotiation or accommodation between debtor and creditors begins. The bankruptcy code offers two principal alternatives for individuals: Chapter 7 (liquidation) and Chapter 13 (wage-earner) bankruptcy. A debtor will usually choose between the two procedures after

consulting with a lawyer, who will consider how the individual's particular financial situation meshes with the complexities of the bankruptcy law. The discussion that follows summarizes the major advantages and disadvantages of each chapter, from the debtor's point of view.

Chapter 7

Chapter 7, or "straight" bankruptcy, is the most common bankruptcy procedure. Under the supervision of a trustee appointed by the federal bankruptcy court, a debtor's assets are sold and the proceeds divided among the creditors. Debt that remains is discharged, or wiped out, and the debtor is free to make a fresh start.

There are a few complications to this simple arrangement. First, not all the debtor's property becomes part of the bankruptcy estate, to be sold for the benefit of creditors. Federal law provides a number of exemptions — property which the debtor is allowed to keep. Exempt property includes household items with less than a certain value, specified amounts of equity in a home or an automobile, life insurance policies, pension rights, and so on. There is also a provision in federal law permitting individual states to make their own lists of exemptions: 35 states have done so, with the result that bankrupt debtors in some states are allowed to keep substantially more of their property than in others.¹

Second, not all forms of debt can be discharged. Secured debt, where the lender is protected by a lien on the borrower's property or some collateral arrangement, cannot be discharged. Thus, home mortgages survive bankruptcy, as do most loans for automobiles and other "big-ticket" consumer items. Some forms of unsecured debt cannot be discharged, either. Most back taxes, alimony and child support, student loans made or guaranteed by the government, and tort judgements arising from intentional harm to others or from drunk driving cannot be wiped away by a Chapter 7 proceeding. The court may also refuse to discharge any debt that was incurred through fraud — if the debtor lied on a loan application, for example, or exhausted a line of credit just prior to filing for bankruptcy.

Debts that are otherwise dischargeable may remain in force if the debtor voluntarily agrees to repay a particular creditor. Debtors may sign such reaffirmation agreements out of guilt, friendship, or pressure from the creditor. If the reaffirmation agreement is approved by the bankruptcy judge, that debt will not be included in the general discharge of debt that is the conclusion of the Chapter 7 proceeding.² Some view such agreements as conflicting with a central principal of Chapter 7: equal treatment for all unsecured creditors.

¹In some states, for example, debtors are allowed to keep their homes, with no limit on value. In others, this homestead exemption is zero.

²Sears, Roebuck & Co. Recently agreed to refund \$100 million collected from 200,000 bankrupt customers pursuant to reaffirmations that were not approved by the bankruptcy court. See: Segal, David. Sears Agrees to make \$100 Million in Refunds. Washington Post, June 5, 1997. p. D1.

Chapter 13

Chapter 13 bankruptcy is available to debtors who have a regular income and who wish to repay at least part of what they owe. Under the supervision of the court, the debtor puts forward a repayment plan, which lasts from 3 to 5 years, at the end of which debts are formally discharged and the debtor emerges from bankruptcy. Under the Chapter 13 plan, the repayment of secured debt may be stretched out, and unsecured debt may be reduced. (Home mortgages are the exception: the terms cannot be altered by Chapter 13.) The law provides for minimum payments by the debtor, and specifies that priority claims, such as taxes and alimony, must be paid in full.

There are two major advantages for the debtor in Chapter 13: personal assets are not seized, and the range of debts that can be discharged is greater than in Chapter 7. The drawback is that if the debtor fails to make payments according to the repayment plan, the case can be dismissed, whereupon the debtor loses all protection of the bankruptcy court. Creditors can resume their collection efforts under state law. Often, the failed Chapter 13 debtor has no recourse but to file a Chapter 7 bankruptcy, incurring another set of legal fees. Approval, or confirmation, of a Chapter 13 plan is contingent upon a judge's finding that the debtor has a reasonable chance of meeting its terms.

The Choice of Chapters

Generally, debtors with steady income and assets they wish to protect have an incentive to choose Chapter 13, while those with few assets (or whose dischargeable debts far outweigh the value of their assets) will prefer the quicker Chapter 7 process, which leaves their future income unencumbered. However, the complexity of bankruptcy law — only hinted at here — makes the choice highly dependent on the type of assets owned, the forms of debt owed, and other factors of the individual debtor's financial situation.³

Individual debtors may also use Chapter 11, the bankruptcy procedure that is most often used by large businesses.⁴ Chapter 11 provides for the reorganization of the debtor's finances and requires an extensive judicial process involving committees of creditors, proposed plans, negotiation, and voting. Legal fees tend to be much higher, with the result that relatively few personal bankruptcies take place in Chapter 11, as the table below shows.

³For a more thorough summary of the bankruptcy code see CRS Report 95-302 A, *A Bankruptcy Primer: Liquidation and Reorganization Under the U.S. Bankruptcy Code*, by Robin Jeweler.

⁴See CRS Report 96-426 E. *Chapter 11 Bankruptcy: The Economic Issues*, by Mark Jickling.

Table 1. Personal Bankruptcy Filings by Chapter, Selected Years
(As a percentage of total filings)

	Chapter 7	Chapter 11	Chapter 13
1980	75.0	0.2	24.9
1985	69.6	0.9	29.5
1990	70.6	0.4	29.1
1997	70.9	0.1	29.0

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

These figures show that Chapter 7 remains the most common procedure, although the proportion of Chapter 13 cases is somewhat higher than in 1980. (Congress in 1984 amended the bankruptcy code to encourage more debtors to choose Chapter 13.) A number of the Chapter 7 filings, of course, represent failed Chapter 13 cases. No comprehensive data are available on the number of Chapter 13 plans that convert to Chapter 7 before completion of the repayment plans, but some studies and estimates run as high as two-thirds.⁵

Who Files for Bankruptcy?

Government statistics on bankruptcy filings are extremely limited. The Administrative Office of the U.S. Courts collects and publishes data on the number of filings, divided into business or nonbusiness, and broken down by chapter of the bankruptcy code and by court district. (Court districts are sometimes identical to state borders; some states contain up to four districts.) No financial information of any kind is regularly compiled, although court records include listings of filers' assets and liabilities. Thus, trends in aggregate indebtedness, debtors' wealth and income, debt-to-asset ratios, and so on are impossible to discern from official figures, as are the demographic characteristics (other than geographic) of those who file bankruptcy petitions.

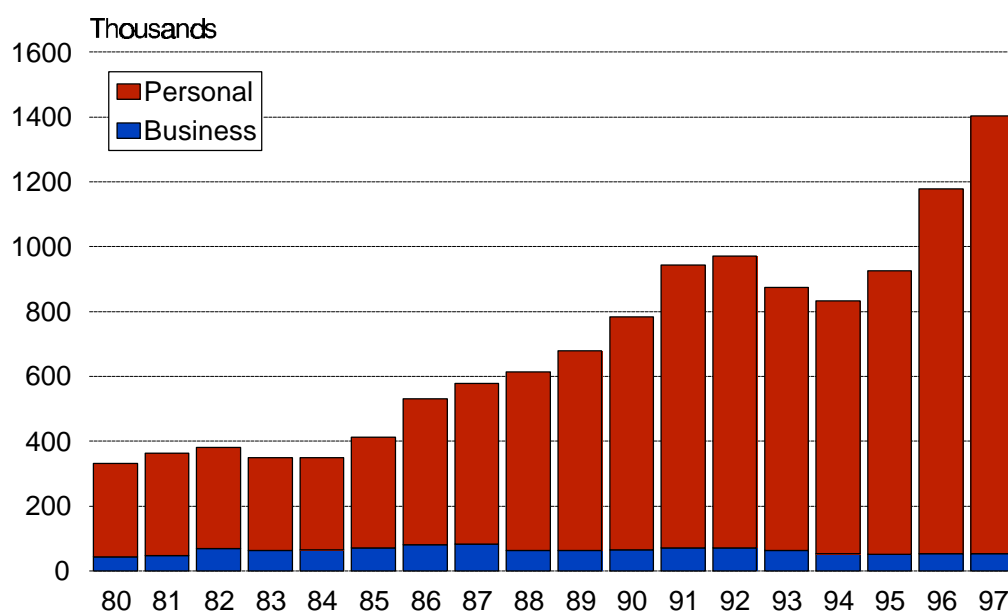
The private and academic studies that attempt to fill this information void have been sporadic.⁶ Among the leaders in research into consumer bankruptcy have been the Credit Research Center at Purdue University and, recently, some of the major credit card companies. These studies seek to shed light on the causes of bankruptcy, but differ in their focus, methodologies, and samples. Because of these differences, the various studies cannot easily be compared, making them of limited value to analysis of long-term trends in bankruptcy.

⁵Sullivan, Teresa A., Elizabeth Warren, and Jay Lawrence Westbrook. *As We Forgive Our Debtors*. New York, Oxford University Press, 1989. p. 217.

⁶For an overview of empirical research on personal bankruptcy, see: A Reformed Economic Model of Consumer Bankruptcy. *Harvard Law Review*, v. 109, April 1996. p. 1338.

The discussion of the causes and economic implications of personal bankruptcy that follows must be read with this lack of empirical data in mind. We do not have the statistical knowledge that would allow construction of a profile of a typical bankruptcy, let alone how that profile may have changed. There is a wealth of anecdotal evidence to support any explanation or theory or policy prescription, but also to support the opposite view. There are some signs (based on anecdotal evidence, to be sure) that the definition of a “typical bankrupt” is becoming even more elusive: bankers and other consumer lenders report a rise in “surprise” bankruptcies, involving debtors who have shown no signs of financial distress prior to filing for bankruptcy.⁷ This phenomenon suggests that the causes of bankruptcy are becoming more opaque even to those who have a direct financial interest in understanding and quantifying them. Who are the average bankruptcy filers? According to Elizabeth Warren, a bankruptcy scholar who worked with the National Bankruptcy Review Commission, “they look like your neighbors.”⁸ The one empirical trend not in dispute is the rise in bankruptcy filings, shown in the figure below.

Figure 1. Bankruptcy Filings, 1980 - 1997



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

Table 2 below examines the figures for personal bankruptcy filings in the light of population growth. The rise in personal bankruptcies remains impressive even expressed as a rate of filings per 1,000 individuals. The data make clear that bankruptcy has grown at a pace that cannot be explained by population growth.

⁷Frank, Stephen E. Go Directly to Bankruptcy, Do Not Pass Delinquency. *Wall Street Journal*, August 28, 1996. p. C1.

⁸Ward, Sandra. Bailing Out. *Barron's*, June 17, 1996. p. 17.

**Table 2. Personal Bankruptcies, 1980-1997:
Number and Rate per 1,000 Population**

Personal Bankruptcies			Personal Bankruptcies		
Year	Number	Rate/1,000 population	Year	Number	Rate/1,000 population
1980	287,570	1.26	1989	616,226	2.49
1981	315,818	1.37	1990	718,107	2.87
1982	310,951	1.34	1991	872,438	3.45
1983	286,444	1.22	1992	900,874	3.53
1984	284,517	1.20	1993	812,898	3.15
1985	341,233	1.43	1994	780,455	2.99
1986	449,203	1.87	1995	874,642	3.33
1987	495,553	2.04	1996	1,125,006	4.24
1988	549,612	2.24	1997	1,350,118	5.02

Source: Administrative Office of U.S. Courts; Bureau of the Census.

Explanations for the Rise in Bankruptcy Filings

Explanations for the increase in personal bankruptcy filings since the early 1980s fall into several categories. These include:

- changes in supply and demand conditions in credit markets;
- changes in labor markets and in society that tend to make household finances more precarious;
- growing consumer confidence in the strong economy, leading to an increased willingness to take on debt;
- sociological factors, such as a decline in the stigma associated with debt and bankruptcy;
- perceptions that current law, beginning with the Bankruptcy Reform Act of 1978, has made bankruptcy too attractive; and
- local factors, which may be legal, sociological, or economic.

Credit Market Conditions

Since bankruptcy is by definition a situation of excessive debt, trends in household indebtedness are a logical first place to look for evidence bearing on the rise in bankruptcies. The Federal Reserve, in its flow of funds accounts, tracks changes in household liabilities. The two major components of household debt are mortgages (including home equity loans) and consumer credit (credit card debt — called revolving credit — and loans for vehicles, education, and other purposes). These two items account for virtually all household debt. Table 3 shows the amounts outstanding in these components of household debt at year-end from 1980-1996, expressed as a percentage of disposable personal (that is, after-tax) income (DPI).

The figures in table 3 indicate that household debt has been rising as a percentage of disposable income. The two categories of debt equaled 85.6% of DPI in 1996, up from 60.6% in 1980. Other things being equal, a rise in debt burden relative to income indicates an increased probability of bankruptcy in the event of an interruption in income or an unexpected rise in other expenses.

In the literature on bankruptcy, very little attention is devoted to mortgage debt, even though the amount is three times the amount of consumer debt, and even though it may be increasingly substitutable for other kinds of debt, in the form of home equity loans. As noted above, mortgage debt is generally not affected by the bankruptcy process: it can be neither discharged nor rescheduled by the bankruptcy court. Therefore, there is no incentive to file bankruptcy for a borrower having trouble meeting mortgage obligations. However, such a household would likely have other forms of debt as well, so there may be a correlation between mortgage debt and the incidence of bankruptcy. That is, if a greater proportion of a household's DPI must go to repay mortgage or home equity loans, less income remains to cope with unexpected financial adversity from other sources.

Consumer credit is much more often cited as a cause of bankruptcy. Table 3 shows that consumer credit as a percentage of DPI reached a post-1980 high in 1996, but that the increase over 1986 was small. However, the revolving credit, or credit card, component of consumer credit, which is a central focus of the bankruptcy debate, has been growing steadily over the 1980-1996 period. Why is credit card debt singled out, when it represents less than 10% of total household debt? borrower having trouble meeting mortgage obligations. However, such a household would likely have other forms of debt as well, so there may be a correlation between mortgage debt and the incidence of bankruptcy. That is, if a greater proportion of a household's DPI must go to repay mortgage or home equity loans, less income remains to cope with unexpected financial adversity from other sources.

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Table 3. Selected Components of Household Debt as a Percentage of Disposable Personal Income, 1980-1996

Year	Home Mortgages (as % of DPI)	Consumer Credit (as % of DPI)	
		Total	Revolving Credit
1980	43.5	17.1	2.7
1982	41.7	16.1	2.8
1984	42.1	17.9	3.5
1986	49.5	20.3	4.2
1988	54.2	19.8	4.7
1990	58.5	19.1	5.2
1992	59.4	16.9	5.4
1994	61.7	19.2	6.9
1996	64.1	21.5	8.5

Note: Consumer credit consists of car loans, loans for education, boats, trailers, and vacations, and revolving credit — credit cards issued by banks, stores, and oil companies.

Source: Department of Commerce, Bureau of Economic Analysis; Federal Reserve, Flow of Funds.

card, component of consumer credit, which is a central focus of the bankruptcy debate, has been growing steadily over the 1980-1996 period. Why is credit card debt singled out, when it represents less than 10% of total household debt?

There are a number of reasons: credit card borrowers are charged relatively high interest rates, meaning that a dollar of credit card debt requires a higher debt service payment than a dollar of other debt. Regardless of the total household debt picture, the use of credit cards has grown in highly visible ways. The credit card industry has become highly competitive and is characterized by aggressive and ubiquitous marketing. Finally, it is widely believed that many households in financial distress use credit cards as a lender of last resort, which means (1) that a large proportion of bankruptcy filers will have unpaid credit card balances and (2) credit card issuers will bear much of the loss from debt discharged in bankruptcy proceedings (since credit card debt is unsecured).

The causal relationship between credit cards and bankruptcy is controversial. Credit card issuers are among the most vocal of those calling for a “tightening up” of the bankruptcy code, which they believe creates an incentive for and rewards consumer behavior that is imprudent at best and fraudulent at worst. Consumer advocates maintain that lenders, in search of high profits based on high interest rates, have over saturated the market by sending out billions of unsolicited offers of credit

each year. In the process, some believe lenders lowered their credit standards to the point where a dramatic increase in defaults was to be expected. The two sides agree that excessive credit card debt is related to the rise in bankruptcies, but differ over whether to blame the supply or demand side of the consumer credit market.⁹

Why Has Household Debt Risen?

That the number of bankruptcies and the household debt burden have risen together is not surprising. The question then becomes how to account for the increase in household debt relative to income. There are two sets of answers: one set considers various weaknesses in the labor market as sources of financial distress, while the other views rising debt as a natural result of prosperity and economic confidence.

Among the explanations of higher consumer debt burdens that involve weaknesses in the economy are the following:

- Real wages in the United States have been flat since the 1970s as productivity growth has stalled. Moreover, the aggregate wage figures are said to mask growing income inequality: substantial gains for some high-income workers are offset by actual income losses for many lower on the economic ladder. The losers may go into debt rather than accept a lower standard of living.
- A similar argument applies to workers displaced, or downsized, from high-paying jobs (in manufacturing, for instance) into low-wage service sector industries, where much of the recent growth in employment has taken place.
- Many workers (employed and unemployed) do not have health insurance benefits and cannot afford to pay the full premiums out of their own pockets. Debt resulting from a serious illness or hospital stay can easily precipitate a financial crisis.

Each of these scenarios is plausible and no doubt applies to many individual bankruptcy cases. However, it is not easy to accept any of them (or all together) as a sufficient explanation for the dramatic rise in bankruptcy filings that has been observed. Would not the impact of long-term transitions in labor markets have been cushioned by the decline in the unemployment rate (which was in the 7%-10% range during the early 1980s, but has fallen in recent years to below 5%)? The relation between bankruptcy filings and recession is interesting. The latest periods of economic recession, in 1980-1982 and 1990-1991, were both followed by drops in bankruptcy filings. It may be that for every household that was cast into bankruptcy by a job loss or a sales slump caused by recession, several other households took fright and began to save more and borrow less. In both post-recession periods, the upward trend in bankruptcy resumes after about two years, as appears in figure 1 above, perhaps as the memories of the recession fade.

⁹ For an analysis of credit card debt and personal bankruptcy, see CRS Report 98-277 E, *Bankruptcy and Credit Card Debt: Is There a Causal Relationship?*

The high cost of medical care and the lack of universal insurance coverage are doubtless serious problems, but they are not new problems. Although medical costs have been rising, they were very high in 1980. To the average family, the bills stemming from a serious illness or accident were already impossible to meet in 1980 without the aid of insurance. Thus, while many bankruptcies are no doubt attributable to unforeseen medical expenses, it is not clear that the overall health care situation has worsened sufficiently since 1980 to account for the rise in personal bankruptcy.

Two economists from the Federal Reserve Bank of New York have put forward an alternative explanation for the rise in household debt burdens and the consequent increase in debt defaults.¹⁰ They observe that two factors seem to dictate the amount of debt that households are willing to take on: age and wealth. According to the “life-cycle” theory, individuals in youth and middle-age tend to borrow against future income to maintain a stable standard of living. The years of heaviest borrowing are between the ages of 25 and 54; thereafter, incomes generally cease to rise and individuals begin to work down their debt levels. The second factor is wealth: as wealth rises, so do spending and the demand for credit. Looking back as far as the 1950s, Morgan and Toll find that these two variables — real net worth per capita and the share of the population between 25 and 54 years of age — moved in opposite directions until 1983 when, thanks to the demographics of the baby boom and the bull market in stocks, both began to rise in tandem. In other words, the two effects on the demand for debt financing were offsetting until 1983 but have been complementary since. “This convergence,” they conclude, “has fueled the demand for credit and has driven up debt burdens, making borrowers riskier.”¹¹

Sociological Factors

Another set of explanations for the bankruptcy increase is grounded not in economic trends and conditions, but in what might be called sociological factors. These explanations are based on moral judgements, and many find them persuasive. The essence of this view is that the shame, or stigma, that formerly attached to debt, “failure,” and bankruptcy has diminished. As a result, people are now more willing to borrow more than they can repay and feel less compunction about using the legal system to walk away from their debts. Moral rectitude, in other words, has lost ground to immediate economic gratification.

Related and more specific instances of decline in traditional values are also cited. Divorce and single parenthood push many individuals into poverty, and some of them end up in bankruptcy court. Losses from legalized gambling are said to figure in a rising number of bankruptcy cases. Bankruptcy lawyers, who were prevented by professional codes of conduct from advertising their services until a few decades ago, come in for a share of blame. Some claim that a significant fraction of personal bankruptcies involve outright fraud — debtors who go on spending sprees before filing, who transfer assets to friends or family members to keep them from creditors, or who file incomplete or misleading documents with the bankruptcy court. (Current

¹⁰Morgan, Donald P. and Ian Toll. *Bad Debt Rising. Federal Reserve Bank of New York Current Issues in Economic and Finance*, v. 3, March 1997. 6 p.

¹¹*Ibid.*, p. 5.

law allows judges to reject petitions where fraud or abuse has occurred, but the volume of cases is said to make effective supervision nearly impossible.)

It is difficult to evaluate the role these sociological factors have played in the increase in personal bankruptcy since 1980. The difference between anecdotal and statistical evidence is important here. Divorce, for example, will be cited by a number of respondents to any survey of the causes of bankruptcy, yet the divorce rate in the general population was higher in the early 1980s than in the 1990s. Other phenomena, such as gambling and single parenthood, may have become more common since 1980, but the data we have do not permit statistical testing of their contribution to the rising bankruptcy rate.

The general argument that people feel less shame about borrowing and not repaying involves a moral judgement that is not subject to empirical proof or refutation. It is not implausible, but some skepticism is in order. Every generation detects moral decay in its successor. Besides, the implicit comparison in these sociological explanations is not between the present generation and the likes of Lincoln and Washington, but between current behavior and that of Americans of the 1960s and 1970s, in whom we surely recognize many of our own faults, but who nonetheless were much less likely to file for bankruptcy.

Local Factors

The preceding attempts to identify causes of the rise in bankruptcy filings assume that the factors at work are nationwide. Other analysts focus on local factors that may account for higher rates of bankruptcies in certain states and judicial districts, and thus inflate the national bankruptcy figures.¹² Higher than average bankruptcy rates have been observed in areas where one or more of these factors occur:

- automobile liability insurance is not mandatory;
- the divorce rate is higher than the national average;
- medical insurance coverage is below average; or
- state law provides generous property exemptions for Chapter 7 filers.

Table 4 illustrates the differences among states in the rate of bankruptcy filings per hundred households. The table includes the ten states with the highest personal bankruptcy rates in 1996, the ten with the lowest, and the national average. Several features of the data are noteworthy. There is a wide range in rates: Tennesseans were over four times as likely to declare bankruptcy in 1996 than Alaskans. The variation seems to persist: the top ten states in 1996 had higher than average bankruptcy rates in 1980 and 1990 as well, while the bottom ten, without exception, were below average in the earlier years. This suggests that regional differences do influence the bankruptcy rate independently of national trends. At the same time, the

¹²See, e.g., Bleakley, Fred R. Debate Mounts Over Rising Bankruptcies. *Wall Street Journal*, May 23, 1996. P. A2.

general upward trend in the bankruptcy rate is unmistakable; national factors are clearly at work, too.

**Table 4. Bankruptcy Rates (Filings per 100 Households)
for Selected States: 1980, 1990, and 1996**

State	1996	1990	1980
Tennessee	2.22	2.38	0.81
Georgia	1.97	1.70	0.56
Alabama	1.85	1.72	0.77
Nevada	1.59	1.39	0.72
California	1.52	1.04	0.52
Mississippi	1.41	1.23	0.56
Utah	1.35	1.47	0.60
Oklahoma	1.30	1.27	0.43
Virginia	1.30	0.94	0.49
Oregon	1.27	1.10	0.50
U.S. AVERAGE	1.20	0.85	0.41
N. Carolina	0.70	0.50	0.37
W. Virginia	0.70	0.54	0.26
Hawaii	0.64	0.25	0.27
S. Carolina	0.64	0.44	0.12
S. Dakota	0.63	0.59	0.29
N. Dakota	0.62	0.46	0.26
Pennsylvania	0.62	0.40	0.18
Vermont	0.56	0.33	0.17
Maine	0.55	0.39	0.25
Alaska	0.50	0.58	0.38

Source: Bureau of the Census; Administrative Office of U.S. Courts.

Bankruptcy's Effects on the Economy

The preceding section considered various explanations, based on changes in the economy, the law, and in society, for the rise in personal bankruptcies. Another side of the issue is the reverse perspective: what are the effects of current levels of bankruptcy filings on the economy and society? Can economic growth be sustained in the face of a million bankruptcies a year?

Sometimes bankruptcy is thought of as a loss to the economy. Borrowers receive money and purchase goods and services; this is the normal process by which credit expands economic activity. When loans are not repaid, or goods and services consumed but not paid for, the supplier of credit suffers a loss of wealth, which may be borne by its owners, its employees, or others who have a stake in the firm. To economists, however, this loss represents a transfer payment from creditor to debtor, which is not the same as a loss of national income or a decline in economic activity. The distribution of wealth has been affected, but not the amount.

The existence of loan defaults, even in large numbers, is not necessarily an indication that credit markets are malfunctioning. Extenders of credit do not expect all loans to be repaid. The price of a loan should reflect the risk of default. Thus, the common statement, that all borrowers have to pay the costs of bankruptcy in higher interest rates, is technically not true. In a competitive market, a lender cannot charge one class of borrowers for the risk represented by another class. A borrower asked to pay above market rates (which are a function of the risk that borrower represents) will go to another lender. This is what economic theory has to say about bankruptcy, but in historical experience credit markets do not always function perfectly.

During the 1980s, many banking institutions came under financial pressure or failed as a result of widespread mispricing of credit risk in several episodes involving lending to commercial real estate developers, entrepreneurs in the oil patch, and issuers of high-yield (junk) bonds. Are consumer loans likely to develop into the next banking crisis? In 1996, as credit card default rates reached record highs, Congress held several hearings on this issue, receiving testimony from bank regulators. The consensus view was reflected in this statement by Federal Reserve Governor Janet Yellen:

To sum up, the rapid growth in consumer lending by banks, particularly that involving credit cards, reflects a natural evolution of banking activities toward the household sector and has generally enhanced consumer convenience and produced significant profits for banks....[Banks determine] price and reserve [levels] for credit card loans with the expectation of occasional periods of relatively high rates of loss. Therefore, unless future conditions deteriorate dramatically, we believe that the industry is well positioned to absorb any problems resulting from the competitive consumer underwriting practices of the recent past.¹³

¹³Statement before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions and Regulatory Relief, July 23, 1996. In: *Federal Reserve Bulletin*, v. 82, September 1996. p. 818.

Another concern is that households may change course and begin reducing their debt instead of accumulating more, causing a decline in consumer spending and a general economic slowdown. Some speak of a consumer “debt bomb,” with the potential to trigger a recession or exacerbate a recession caused by other factors.¹⁴ Economic research finds, however, that high consumer debt levels in the past have not predicted more cautious spending behavior. Recent studies suggest that households increase both debt and spending as their perceptions of their income prospects improve,¹⁵ and that the current consumer debt burden is not alarming in the context of rising wealth and “a generally healthy economic situation for U.S. households.”¹⁶

What Can Be Done?

If reducing the number of bankruptcy filings is to be a policy goal, the many factors that can be offered as causes of bankruptcy suggest that there may be no single path of action that will be quick and efficacious. Government intervention can do little to restore a sense of financial shame, to put real wages on an upward path again, or to prevent families from breaking up. Achieving universal access to affordable health care has proven difficult. Government action could certainly restrict the supply of credit, but this cure might be worse than the disease. As a Federal Reserve official put it:

From an economic point of view, there is nothing wrong with consumers increasing their debt, per se.... Suffice it to say that there are good reasons for any American family to take on additional debt and that it would be wrong for a Federal Reserve Governor to opine that some particular American family is too much in debt. Individuals know their own circumstances far better than any government official.¹⁷

What can be done is to amend the bankruptcy code. The current law, which dates from the Bankruptcy Reform Act of 1978, has been criticized almost since its enactment for being too lenient towards debtors.¹⁸ On October 20, 1997, the National Bankruptcy Review Commission (NBRC), created by legislation in 1994, delivered a 1498-page report, *Bankruptcy: The Next 20 Years*, to the Congress, the President, and the Supreme Court. The NBRC report contains 172 recommendations for changes in the bankruptcy law. The report does not recommend a through-and-

¹⁴Epstein, Gene. Bankrupt Theory. *Barron's*, February 3, 1997. p. 17.

¹⁵McCarthy, Jonathan. Debt, Delinquencies, and Consumer Spending. *Federal Reserve Bank of New York Current Issues in Economic and Finance*, v. 3, February 1997. 5 p.

¹⁶Garner, C. Alan. Can Measures of the Consumer Debt Burden Reliably Predict an Economic Slowdown? *Federal Reserve Bank of Kansas City Economic Review*, Fourth Quarter 1996. p. 74.

¹⁷Testimony of Lawrence B. Lindsey in: U.S. Congress. House. Committee on Banking and Financial Services. *Consumer Debt*. Hearing, 104th Cong., 2nd sess. September 12, 1996. (Serial No. 104-74). p. 12.

¹⁸See, e.g., Carter, Charlie. The Surge in Bankruptcies: Is the New Law Responsible? *Federal Reserve Bank of Atlanta Economic Review*, January 1982. p. 20.

through rewriting of the law, as did the 1970 commission which led to the Bankruptcy Reform Act of 1978 (which replaced the existing law in its entirety); in the words of NBRC Chairman Brady Williamson, it does not “disturb the fundamental tenets of current law.”¹⁹

In addition to the NBRC report, several bills before the 105th Congress, H.R. 2500, H.R. 3146, H.R. 3150, and S. 1301, propose amendments to the bankruptcy code that would affect many of the issues discussed in this report.²⁰ The last two of these bills, as noted above, have been reported out of the Judiciary committees in House and Senate in 1998. Major areas of reform that bear upon consumer bankruptcy, as proposed in these bills and in the NBRC report, are described below:

- Require Chapter 13 Rather than Chapter 7 Filings.** This is a shift strongly supported by lenders, who believe that many debtors file Chapter 7 even though their income is sufficient to repay at least part of what they owe. H.R. 3150 and S. 1301 introduce the concept of “needs-based” bankruptcy — Chapter 7 would be available only to those debtors who are too weak financially to meet a Chapter 13 repayment plan. H.R. 2500 and H.R. 3150 contain a formula that subtracts payments on secured debts, other financial obligations (child support, alimony, etc.), and living expenses from gross income to yield a net income figure. If this amount is sufficient to allow the debtor to repay at least 20% of unsecured debts over the next 5 years, the debtor *must* file Chapter 13 and turn over all net income to his unsecured creditors. S. 1301 does not include the formula, but requires a Chapter 13 filing if the bankruptcy judge determines that the debtor could pay back at least 20% of unsecured debt. In addition, S. 1301 would allow creditors to challenge a Chapter 13 filing if they believed a debtor had sufficient income to repay. H.R. 3146 would allow bankruptcy petitions to be dismissed as “abusive” if debtors were able to repay all of their unsecured debts over three years, provided that they met a minimum income level (adjusted for family size). The NBRC report does not include a means test among its recommendations.

“Needs-based” bankruptcy, in some form, is supported by the credit industry. A potential drawback is that many Chapter 13 plans confirmed under present law fail, suggesting that many debtors, who enter Chapter 13 because they feel it is the right thing to do, simply lack the financial resources to keep up with the payments. A failed Chapter 13 plan benefits neither debtor nor creditor, and increases the courts’ workload considerably: the petitioner must appear again with a Chapter 7 filing. Whether the needs test would produce a fairer bankruptcy system depends on the financial condition of bankruptcy petitioners, about which we have little comprehensive data.

¹⁹ Review Commission Releases Report Recommending Changes to Bankruptcy Code. *Bureau of National Affairs Daily Report for Executives*, October 21, 1997. p. AA-1. (The report is available on the Internet at: [<http://www.access.gpo.gov/nbrc/reportcont.html>].)

²⁰ See CRS Report 98-277A, *Consumer Bankruptcy Reform: Proposals Before the 105th Congress*, by Robin Jeweler.

- **Uniform Federal Exemptions.** As noted above, the amount of property a Chapter 7 debtor can keep varies widely according to state law. The NBRC report calls for national limits on the amount of property that could be exempted from the bankruptcy estate. The homestead exemption (value of equity in a home that the debtor could keep, would still follow state law, but the NBRC calls for a maximum exemption of \$100,000 and a minimum of \$20,000. Exemptions for other personal property could not exceed \$20,000, except that debtors who did not claim a homestead exemption would be allowed to exempt another \$15,000 in personal property.

H.R. 3146 would adopt the \$100,000 figure as a ceiling on homestead exemptions under certain circumstances and would establish the existing federal homestead exemption as a national minimum figure.

H.R. 3150 contains a uniform definition of “household goods” for purposes of exemption from bankruptcy estates.

H.R. 2500 would create a national commission to study the issue of uniform levels of exemption, and the appropriate size of those exemptions.

- **Integrity of the Bankruptcy System.** H.R. 3150, S. 1301, and the NBRC propose to establish a system of random audits to detect and deter bankruptcy fraud and call for improved collection and publication of data regarding the financial condition of bankrupts. An NBRC proposal would increase lawyers’ responsibility for the accuracy of filings submitted by their clients. The NBRC report also calls for the establishment of a national bankruptcy registry to prevent abusive multiple filings by single individuals in different jurisdictions.

A serious constraint on improving the efficiency of the system and deterring fraud and abuse is the high workload. With only 325 bankruptcy judges in the country, it is estimated that a judge must dispose of the average case in only 35 minutes.²¹

What makes bankruptcy reform difficult, apart from the complexity of the law itself, is the lack of comprehensive information about the millions who are filing bankruptcy petitions. If large numbers of people abuse the system — by borrowing, spending on luxuries, and walking away from debts rather than living within their means — legal reforms intended to make bankruptcy more difficult and painful may be appropriate. If, on the other hand, the rise in bankruptcy filings reflects a rise in genuine financial insecurity and distress, those same reforms may deprive many households of the chance to make a fresh start. The law seeks to balance the interests of debtors and creditors; the bankruptcy numbers have raised the stakes in the debate.

²¹Testimony of Stephen H. Case before the House Committee on the Judiciary, Subcommittee on Commercial and Administrative Law. Hearing, 105th Cong., 1st sess, on the operation of the bankruptcy system. April 16, 1997.