Bankruptcy should provide a fresh start, not a financial windfall

What's Wrong with U.S. Personal Bankruptcy Law and How to Fix It

By Michelle J. White

We need a bankruptcy system, but the present system is inefficient and inequitable.

Bankruptcy filings in the United States have risen from fewer than 300,000 in 1984 to 1.4 million in 1998. Because the U.S. bankruptcy system makes defaulting on consumer debt an attractive option for many borrowers, about 5 percent of consumer loans are never repaid. Lenders compensate for those losses by raising interest charges; the average borrower pays about $500 a year in extra charges to cover lenders' losses.

In effect, the present bankruptcy system imposes a heavy tax on borrowers who repay their debts. Why? The system allows a high proportion of households to gain financially from filing for bankruptcy, inviting them to borrow heavily and then go bankrupt rather than repay.

The system is inequitable as well, because in many states those households with the greatest ability to repay their debts stand to gain far more by declaring bankruptcy than those that are least able to repay.

After filling in the details about the present system and its shortcomings, I will discuss the inadequate bankruptcy-reform bill now before Congress, then propose reforms that would make the system more efficient and equitable.

THE PRESENT SYSTEM

The U.S. bankruptcy code gives debtors who file for bankruptcy the right to choose between two procedures, Chapter 7 and Chapter 13, both of which discharge most unsecured debts.

Debtors who choose Chapter 7 bankruptcy must use all their wealth above an exemption level to repay their debts, but their postbankruptcy earnings are entirely exempt. The states set exemption levels. Nearly all states have separate exemptions for equity in owner-occupied housing ("homesteads"), personal property, retirement accounts, and the cash value of life insurance. Homestead exemptions are usually the largest. They vary from zero in the District of Columbia and Maryland to unlimited in Texas, Florida, and a half-dozen other states.

All assets are exempt under Chapter 13, but debtors must propose plans to repay part of their debts from future earnings.

Most debtors in bankruptcy have no nonexempt assets; therefore, about 70 percent of filers choose to file under

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Chapter 7. Even if debtors have nonexempt assets, the right to file under Chapter 7 means that the amount they are willing to repay under Chapter 13 is limited to the amount they would be obliged to repay under Chapter 7. For example, a household with $5,000 in nonexempt assets would only file under Chapter 13 if it expected to pay less than the equivalent of $5,000 from future earnings.

Because of the close linkage of the two Chapters, I will analyze the bankruptcy decision as a decision to file under Chapter 7.

THE NEED FOR A BANKRUPTCY SYSTEM—AND ITS COST

DEBTORS FACE UNCERTAINTY ABOUT THEIR ABILITY TO repay their debts because their future incomes and wealth are uncertain. Risk-averse debtors dislike uncertainty and are willing to pay for insurance that reduces it. The economic justification for a personal bankruptcy system is that, by discharging debt when debtors are least able to repay, debtors are better off as long as the cost of the insurance (i.e., higher interest charges) is not too high.

Consider, for example, a household whose members are young and have a high demand for household goods. The household borrows because its workers expect their incomes to be higher when the loans must be repaid. Suppose the household borrows $20,000 and promises to repay $23,000 at a future time. It faces the risk of an adverse event, such as a worker's illness or unemployment. Suppose, further, that the household expects its future income to be $60,000 but that an adverse event reduces that amount to $30,000.

Without a bankruptcy system, the household must repay its debt in full whether or not an adverse event occurs. If the household does not face an adverse event, its net future income would be $37,000 ($60,000 minus $23,000). With an adverse event, the household's net future income would be only $7,000 ($30,000 minus $23,000).

In summary, there may be great uncertainty about a household's net income in the absence of a bankruptcy system.

The Cost of a Bankruptcy System with Naïve Behavior Consider what would happen to our illustrative household under a system that allowed it to file for bankruptcy and obtain discharge of its debts when an adverse event occurred. The household would pay nothing when it filed for bankruptcy under a system that exempted household goods and future income. But because of the bankruptcy system, some borrowers would default on their debts, causing lenders to raise their interest charges to earn the same returns as they would in the absence of a system.

Suppose the default rate rises from 0 percent to 2 percent when the bankruptcy system is introduced. If lenders respond by raising the amount that must be repaid to $23,469 (the amount required to realize $23,000 after deducting a 2-percent loss), the illustrative household's future net income will be either $36,531 ($60,000 minus $23,469) or $30,000 ($30,000 minus $0).

Bankruptcy insurance thus raises the household's net income after an adverse event by $23,000, from $7,000 to $30,000. The cost of the insurance is $469, the difference between the household's net future income if there is no adverse event without a bankruptcy system ($37,000) and with a bankruptcy system ($36,531).

The example suggests that if a household is risk-averse it is better off if there is a bankruptcy system.

The Cost of a Bankruptcy System With Strategic Behavior Suppose our illustrative household studies the bankruptcy system and learns that:

- Bankruptcy courts do not check whether a household that files for bankruptcy has experienced an adverse event.
- If a household has accumulated financial assets it can file for bankruptcy and keep those assets because the state (1) has a high wealth exemption or (2) permits households to shift wealth from nonexempt to exempt categories before filing for bankruptcy.

> The U.S. bankruptcy system encourages debtors to file even when they have not experienced adverse events and could really pay their debts.

Armed with that knowledge, the household has a strong incentive to file for bankruptcy without experiencing an adverse event—to behave strategically—because by doing so it can increase its net income from $36,531 to $60,000.

But as more households behave strategically, default rates will rise and lenders will raise interest rates accordingly. Suppose strategic behavior causes the default rate to rise from 2 percent to 4 percent. Lenders, to earn the same return as they did when there was no strategic behavior, must raise the amount to be repaid by our illustrative household to $23,958 (the amount required to realize $23,000 after deducting a 4-percent loss). Strategic behavior therefore raises the household's cost of bankruptcy insurance by another $489. And the cost will rise further as more households behave strategically.

A household that does not behave strategically—even a risk-averse one—may seek to reduce its interest charges by promising lenders not to file for bankruptcy under any circumstances. But such a promise would be worthless because it is legally unenforceable—participation in the bankruptcy system is mandatory for anyone who borrows money in the United States.

In summary, a bankruptcy system provides insurance to risk-averse borrowers who may experience adverse events that reduce their future ability to repay debt. But the U.S. bankruptcy system encourages debtors to file for bankruptcy even when they have not experienced adverse events and could readily pay their debts.

WHO COULD BENEFIT FROM BANKRUPTCY?

ANY HOUSEHOLD THAT COULD BENEFIT FINANCIALLY FROM bankruptcy might file for bankruptcy. The group of such households is large and includes many that are well-off.

Percentage of Households That Could Gain from Bankruptcy If a household files for bankruptcy under Chapter 7, its immediate financial gain is the value of debt discharged. (The types of debt most commonly discharged in bankruptcy are credit card and installment loans, medical bills, utility bills, and damage claims.) The household's immediate financial cost is the value of nonexempt assets, if any, that it must give up. The net financial gain (or loss) from bankruptcy is the difference between discharged debt and surrendered assets.

Column 1 of Table 1 gives the percentage of households that could gain financially from filing for bankruptcy, for each of 13 states and the United States in total. The lowest and highest figures are 10 percent for Louisiana and 32 percent for Texas. The figure for the United States as a whole is 17 percent.

Louisiana has a relatively low homestead exemption of $15,000 and low exemptions for other assets. In contrast, Texas has an unlimited homestead exemption, which is favorable to homeowners, and also allows debtors to use the federal bankruptcy exemption, which is favorable to renters. In general, the higher a state's exemption, the higher the proportion of households that could benefit financially from bankruptcy.

Column 2 takes into account the out-of-pocket cost of filing for bankruptcy (typically, about $350), which reduces the proportion of U.S. households that could gain from filing by 2 percentage points.

Columns 3 through 6 illustrate the effects of various strategies and combinations of strategies on the proportion of households that could gain from filing. In Strategy I (column 3), debtors whose home equity is less than their states' homestead exemptions sell their nonexempt assets and use the proceeds to reduce the mortgages on their principal residences. The largest gains are in states that have high or unlimited homestead exemptions. In Mississippi, which has a homestead exemption of $75,000, 36 percent of households could benefit from bankruptcy if they followed Strategy I. For the United States overall, the figure is 20 percent.

In Strategy II (column 4), debtors use their nonexempt assets to pay for home improvements or to buy more valuable homes in their states, up to the point at which they exhaust their nonexempt assets or reach their states' homestead exemptions. By using Strategy II, 42 percent of households in Texas and 41 percent of households in Mississippi could gain from filing for bankruptcy. The figure for the United States as a whole rises to 24 percent.

Strategy III (column 5) assumes that debtors fully use their unsecured lines of credit but do not obtain new lines of credit and do not adopt Strategy I or II. In this case, 44 percent of households in Texas and 38 percent of households in Mississippi could benefit financially from bankruptcy. The figure for the United States as a whole is 24 percent. The figures would be even higher if debtors opened new lines of credit (e.g., obtained new credit cards).

If debtors were to pursue all three strategies (column 6), 61 percent of households in Texas and 53 percent of households in Mississippi could benefit financially from bankruptcy. The figure for the United States as a whole would be 34 percent.

Table 1

Percentage of Households That Could Gain from Bankruptcy

	Base case	Cost = $350	Strategies I	Strategies II	Strategies III	Strategies All
	(1)	(2)	(3)	(4)	(5)	(6)
California	16	14	20	24	23	35
Colorado	12	10	15	20	17	29
Florida	14	12	19	30	21	48
Illinois	14	12	14	17	18	21
Louisiana	10	8	11	16	15	21
Maryland	15	12	15	15	19	19
Massachusetts	18	16	22	29	25	42
Michigan	14	12	14	16	19	20
Mississippi	30	25	36	41	38	53
New Jersey	14	12	14	16	19	20
New York	16	13	17	19	20	23
Ohio	11	10	12	15	15	19
Texas	32	27	36	42	44	61
United States	17	15	20	24	24	34

Data source: Estimates are based on data from the 1992 Survey of Consumer Finances, Board of Governors of the Federal Reserve. The Survey of Consumer Finances gives detailed information about the assets and liabilities of a representative sample of 3,500 U.S. households.

Method of estimation (illustrated for Michigan): In 1992, Michigan had a homestead exemption of $3,500, an exemption of $1,000 for equity in vehicles, and unlimited exemptions for Keogh/IRA accounts and the cash value of life insurance. For each asset a household owned, determine the extent to which the asset was exempt and sum the values of all nonexempt assets. For each of the household's debts, determine whether the debt would have been discharged in bankruptcy and sum the values of all such debts. Michigan (like many states) allows married couples to double its exemptions when both spouses file for bankruptcy; therefore, adjust the exemption depending on whether the household included a married couple. Michigan (like 15 other states) allows debtors to choose between its exemption and a uniform federal bankruptcy exemption; therefore, calculate the household's net gain using each exemption and assume that the household chooses the exemption that gives it the largest financial gain.

Although the bankruptcy-filing rate has been rising, only about 10 percent of U.S. households have filed for bankruptcy during the 1990s. Because a significant percentage of households could benefit financially from bankruptcy, the bankruptcy-filing rate will continue to rise if (1) more households learn about the bankruptcy system and (2) more households act strategically. But if households tend not to act strategically, they will file for bankruptcy only if adverse events occur, regardless of the size of the potentially large pool of filers.

The U.S. bankruptcy system is inequitable because well-off households are more likely to gain financially than are households with a low ability to pay.

Effect of Ability to Pay on Potential Gains from Bankruptcy Households' potential gains from bankruptcy vary with their ability to pay. Because ability to pay depends on both income and wealth, I have defined it as net worth plus three times annual household earnings. I then ranked households by their ability to pay and divided that ranking into deciles. The 10 percent of households with the lowest ability to pay are in decile 1 of the ability-to-pay distribution; the 10 percent of households with the greatest ability to pay are in decile 10 of the distribution. The Base Case and All Strategies panels in Table 2 give results for the odd-numbered deciles of Louisiana and Texas—states with relatively low and high exemptions, respectively. (The Proposed Reform panel in Table 2 gives estimates of the effect of the reforms I propose below.)

The Base Case panel of Table 2 applies to the base case of Table 1, that is, the case in which households do not behave strategically. In Louisiana, 23 percent of households in decile 1 of the ability-to-pay distribution could benefit financially from bankruptcy, compared with 20 percent, 12 percent, 3 percent, and 1 percent in deciles 3, 5, 7, and 9, respectively. Thus, the proportion of households that could gain from bankruptcy declines as ability to pay increases, so that the financial gain from bankruptcy is equitably distributed. Not surprisingly, because the Texas exemption is more generous than the Louisiana exemption, a much higher proportion of Texas households could benefit from bankruptcy. Even in decile 7, nearly a third of Texas households could benefit, a higher proportion than for Louisiana's decile 1.

The All Strategies panel in Table 2 gives results for a case in which households use all strategies; that is, they take full advantage of the homestead exemption and borrow to the limit of their lines of credit to accumulate exempt assets (maximizing their unsecured debt). Strategic behavior, as expected, causes more households to benefit from bankruptcy in each decile of the distribution. The results for Texas are startling: in each decile above the first, 59 percent or more of all households could benefit financially from bankruptcy. Thus, when households behave strategically and the bankruptcy exemption is high, well-off households are far more likely to benefit financially from bankruptcy than are households at the bottom of the ability-to-pay distribution.

Implications The results in Tables 1 and 2 are an indictment of the present bankruptcy system:

- Almost any creditworthy household can gain financially from filing for bankruptcy if it behaves strategically. Because there are so many effective strategies, the bankruptcy system gives too many households an incentive to file.

- The bankruptcy system is inequitable because well-off households are more likely to gain financially from bankruptcy than are households with low ability to pay. The higher the bankruptcy exemption level, the greater the benefit to households at the high end of the ability-to-pay distribution. Thus, bankruptcy often provides debt relief to those with little need for it.

WHO ACTUALLY FILES FOR BANKRUPTCY?

THE EVIDENCE SUPPORTS MY CONCLUSIONS ABOUT THE

Table 2

Equity Effects of Bankruptcy: Percentage of Households That Could Gain from Bankruptcy, by Ability to Pay

BASE CASE			ALL STRATEGIES			PROPOSED REFORM	
Decile of ability-to-pay distribution	Louisiana	Texas	Decile of ability-to-pay distribution	Louisiana	Texas	Decile of ability-to-pay distribution	United States
1	23	38	**1**	34	43	**1**	38
3	20	50	**3**	41	63	**3**	9
5	12	46	**5**	31	73	**5**	2
7	3	31	**7**	12	67	**7**	1
9	1	8	**9**	2	59	**9**	0

nature of the incentives in the present bankruptcy system.

In a recent study with Scott Fay and Erik Hurst, I tested the proposition that the greater the potential gain from filing for bankruptcy, the more likely it is that a household will file. We used data from the University of Michigan's Panel Study of Income Dynamics, a large-scale study of U.S. households, to model households' filing decisions. We found that, holding other factors constant, financial gain is a statistically significant determinant of filing decisions: an increase of $1,000 in the average household's financial gain causes about 12,000 additional households to file for bankruptcy each year. Clearly, at least some households behave strategically in making their bankruptcy decisions, and the prospect of greater financial gains entices more households to file.

The proposed system would improve efficiency by reducing the proportion of households that could gain from filing for bankruptcy. It would improve equity by shifting most of the potential gains to households with the lowest ability to pay.

We also considered whether households behave nonstrategically—filing for bankruptcy only when adverse events reduce their ability to repay debt—by examining whether health problems or spells of unemployment in the preceding year increased the probability of filings. We did not find a significant relationship.

But we did find other influences on filings:

- Holding other factors constant, a household head's divorce in the preceding year raised the probability of filing by 26 percent.

- Again, holding other factors constant, every $1,000 reduction in the income of a household increased by 0.5 percent the probability that it would file for bankruptcy.

These results suggest that while some households behave strategically others behave nonstrategically.

THE SHORTCOMINGS OF PENDING LEGISLATION

CONGRESS IS CONSIDERING A BANKRUPTCY BILL (H.R. 833) that would fall far short of the reforms that are needed.

H.R. 833 would keep both the Chapter 7 and Chapter 13 procedures, but a household would have to file under Chapter 13 if its income is above the national median at the time of filing and its disposable income is high enough to repay a fourth of its debt over five years. Households that file under Chapter 13 would be required to use all their earnings above a formula amount set by the Internal Revenue Service to repay creditors, for five years or until their debts are repaid in full. Chapter 13 thus would be much less attractive to debtors than it is now because H.R. 833 would, in effect, impose a 100 percent bankruptcy "tax" on a household's future earnings above the formula amount. The Congressional Budget Office has estimated that about 5 percent to 10 percent of bankruptcy filers would be forced into Chapter 13 by the provisions of H.R. 833.

The bill nevertheless has two major disadvantages. First, the present system, with all its problems, would remain in effect for all filers whose incomes are below the national median. Second, above-median-income households that are considering bankruptcy would have an incentive to lower their incomes and run up their debt before filing, to avoid being forced into Chapter 13. Members of such households might quit their jobs, reduce their work hours, or borrow money they do not intend to repay. Both debtors and creditors would lose as a result.

A PROPOSAL FOR EFFICIENT AND EQUITABLE REFORM

Essential Elements The obligation to repay debt should depend on the ability to pay, which is the basis on which lenders extend credit in the first place. In contrast to the present bankruptcy code, which allows debtors to choose between using only wealth to repay debt (Chapter 7) or using only future earnings to repay their debt (Chapter 13), debtors should have to repay from both sources. But there should be exemptions for both income and wealth.

Specifically, I recommend the following changes in the U.S. Bankruptcy Code:

- Combine Chapters 7 and 13 into a single personal-bankruptcy procedure.

- Require filers to use 10 percent of their annual gross earnings in excess of $7,500 to repay debt for the first three years after filing. (I chose $7,500 because that is the minimum exemption allowed under federal law when creditors garnish debtors' wages outside of bankruptcy.)

- Exempt all earnings less than $7,500 per year and all receipts from transfer payments (e.g., unemployment compensation, welfare, or child support).

- Require debtors to use all their wealth above $30,000 to repay debt. The $30,000 wealth exemption would apply in all states and to all types of wealth.

Predicted Effects Only 9 percent of households in the United States could benefit financially from filing for bankruptcy under my proposed system. That is a 47-percent reduction from the 17 percent of households that could benefit financially under the present system. Therefore, to the extent that households behave strategically, there would be fewer filings because the proposed system would reduce the number of households that stand to gain financially.

Further, almost all the households that could benefit financially from bankruptcy would be in the bottom third of the ability-to-pay distribution. (See the Proposed Reform panel in Table 2.) Notably, 38 percent of households in the lowest decile of the ability-to-pay distribution could benefit financially—as high as the figure for Texas under the present bankruptcy system. Only 9 percent of households in decile 3 could gain financially; the figure falls to 2 percent, 1 percent, and 0 for deciles 5, 7, and 9, respectively.

The reform would deter filings by debtors who have a relatively high ability to repay debt from either wealth or future earnings. Debtors who a have low ability to repay from either source could still gain from filing for bankruptcy.

In summary:

- The proposed system would improve efficiency (reduce the cost of bankruptcy insurance) by reducing the proportion of households that could gain from filing for bankruptcy.

- It would improve equity by shifting most of the potential gains to the lower deciles of the ability-to-pay distribution.

- The reduction in filings would benefit debtors who do not file for bankruptcy because it would lead to a reduction in the cost of bankruptcy insurance.

- There would still be bankruptcy insurance for households that have the lowest ability to pay and therefore the greatest need for debt relief.

Observations About the Proposed System Although the requirement to repay debt from future earnings would be a modest 10 percent of annual earnings above $7,500 for three years, it would, as noted, sharply reduce the proportion of households in the middle and upper deciles of the ability-to-pay distribution that could gain financially from bankruptcy. That reduction would occur because most households have far greater future earnings than wealth.

Because the $30,000 exemption for wealth would apply to all types of assets, the reform would greatly reduce debtors' incentives to behave strategically. For example, households could no longer benefit by converting financial assets into exempt home equity. Also, because the separate homestead exemption would be abolished, the bankruptcy system would no longer favor homeowners over renters.

The particular exemption levels are somewhat arbitrary; higher or lower values could be substituted for them, and the reform would still have the same favorable effects on efficiency and equity; for example:

- A higher exemption than $7,500 for future earnings would enable a higher proportion of households in decile 3 of the ability-to-pay distribution to benefit financially from bankruptcy.

- Keeping the $7,500 earnings exemption but replacing the $30,000 wealth exemption with the states' present wealth exemptions would reduce from 9 percent to 8 percent the fraction of households that could gain financially from filing for bankruptcy.

Even with such changes, the proposed reforms would result in a bankruptcy system that is more efficient and more equitable.

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