

The Economics of Bankruptcy

BY KARTIK ATHREYA

Few people seriously challenge the idea that there should be some form of personal bankruptcy protection. In most circles it's taken for granted that the availability of an option allowing people to erase their debts is a proper response to the hazards of modern-day financial life. The elderly get sick and can't pay their medical bills. Young mothers get divorced and are awarded sole custody of their children — and then they lose their jobs. Bankruptcy is the ultimate safety net.

Reforms signed into law this spring by President Bush make it harder for individuals to walk away from their debts. But the new rules don't address this basic question: From an economic perspective, is bankruptcy protection — even after the latest overhaul — really sensible?

The answer is not perfectly straightforward. But recent research, including some of my own, leads me to be skeptical about what economists call the “welfare-improving” virtues of bankruptcy, particularly for non-entrepreneurs. By that I mean the wider costs of maintaining the personal bankruptcy system appear to outstrip the benefits.

At its heart, personal bankruptcy is an insurance program. It aims to provide a backstop against financial misfortune for which there exist few private-sector alternatives. Drivers can be insured against accidents because it's relatively easy for insurers to assess the level of risk each driver represents. But it's not as easy to size up a person's financial risk. How hard an unemployed person is looking for new work, for example, is tricky for an outsider to gauge. So instead of private insurance, we have opted for a de facto government-mandated insurance program in bankruptcy protection.

The problem with this system is that it raises costs for everybody. In particular, it raises the cost of unsecured credit — chiefly, credit cards and bills for medical care — for the people who most need it, young people and poor people, both of whom usually lack collateral.

The law says that people have a right to avoid unsecured debts by seeking bankruptcy protection. Creditors know that everybody they lend to has this option. It's expensive to borrow in this kind of world because lenders must charge extra for the very real possibility that they won't be able to fully collect. In effect, bankruptcy law disables those who possess few assets from making commitments to fully repay debts.

Why do we foist this “protection” on all households? If we lived in a society that allowed borrowing but forbade

defaulting under any circumstances (an admittedly extreme and unrealistic scenario) it would become significantly cheaper to borrow. In the models I've looked at, the gains accruing per U.S. household would be equivalent to as much as \$280 a year. These gains encompass everything from cheaper borrowing costs to eliminating after-the-fact punishments like stigma.

Another way to see this is to consider the difference between borrowing on a home equity line versus a credit card. The roughly 10 percent wedge in interest rates between home equity lines, which are backed by the collateral of property, and credit cards, which are unsecured, is a striking indicator of the value of a credible commitment to repay debts. On a loan of \$10,000, this “credibility gap” may cost unsecured borrowers \$1,000 more annually than their collateralized counterparts.

Given the large costs bankruptcy law imposes on households, especially poor ones, there is too much at stake to allow policy to be guided by the current, somewhat hysterical debate. What I want is a policy debate that relies less on emotionally charged stories about tragically unlucky filers or

wealthy abusers of the system. We must focus more on a careful and hard-headed accounting of bankruptcy's actual costs and benefits.

Roughly 1 million U.S. households filed for Chapter 7 bankruptcy protection last year. Tougher bankruptcy eligibility rules than those that have been presented so far would improve the terms and availability of credit for all Americans. In particular, such

rules would benefit the 60 million people between the ages of 20 and 35 who today face the highest costs in obtaining unsecured credit.

In a world of competing and evolving insurance programs, does personal bankruptcy still serve us well? Among economists addressing these questions, there is an emerging consensus against bankruptcy as it's currently practiced. But this conclusion leaves the door open for some extreme cases — sudden medical setbacks in particular. More generally, we should think harder about other ways to help people facing catastrophic health events.

That may be just another way of saying that I believe we should offer some form of bankruptcy, albeit with strings attached. Means-testing, while piecemeal, seems like a small step in the right direction. The more fundamental task of understanding bankruptcy's redistributive- and incentive-related implications remains squarely in front of both lawmakers and researchers. **RF**

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