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U.S. consumer bankruptcy choice: The importance of general equilibrium effects ☆

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Abstract

We study the implications of U.S. personal bankruptcy rules for resource allocation and welfare. Our analysis shows that general equilibrium considerations along with bankruptcy chapter choice and production matter crucially for the effects of policy reform. Contrary to previous work, we find that completely eliminating bankruptcy provisions causes significant declines in output and welfare by reducing capital formation and labor input. Furthermore, subjecting Chapter 7 filers to means testing, as suggested by recent legislative proposals, would not improve upon current bankruptcy provisions and, at best, leave aggregate filings, output, and welfare unchanged. However, we do find that an alternative tightening of Chapter 7, in the form of lower asset exemptions, can increase economic efficiency.

JEL classification: D52; G18

Keywords: Consumer bankruptcy; Chapter 7; Chapter 13

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1. Introduction

The economics of personal bankruptcy is a subject of increasing interest for economists in general and macroeconomists in particular. By allowing households to stop or delay the repayment of debts, the option to file for bankruptcy helps complete markets and promotes risk sharing. Thus, recent research has focused on the implications of bankruptcy rules for resource allocation and welfare. This literature, however, has confined itself to both partial equilibrium settings and only one of the options available to debtors under current U.S. bankruptcy law.[1]

In contrast, we show that the analysis of consumer bankruptcy requires (i) a general equilibrium framework with endogenous factor supply, risk premia, and wages, and (ii) both bankruptcy chapters currently available to debtors, Chapters 7 and 13, each of which has its own incentive effects on labor supply and capital formation. Any study of U.S. consumer bankruptcy that ignores these features is potentially misleading for two reasons. First, defaulting under Chapter 13, while letting debtors keep their assets, requires them to enter a partial repayment plan that acts as a powerful wage tax (Posner, 1999; Wang and White, 2000). Hence, by discouraging labor effort, Chapter 13 directly affects production and welfare. Second, by allowing for the discharge of all unsecured debt net of exemptions, Chapter 7 defaults affect risk premia which then induce further changes in the overall volume of debt and, ultimately, capital accumulation.

Contrary to previous work, our analysis indicates that eliminating bankruptcy options entirely carries significant social costs. It is true that getting rid of bankruptcy provisions remove important ex post bankruptcy costs such as exclusion from credit markets. Absent production, and without any feedback effects from prices, this elimination of bankruptcy costs is a driving force that leads to the significant welfare gains found in the existing literature. However, with production explicitly considered, changes in risk premia lead to declines in output. Specifically, because the risk premium falls sharply as consumers can no longer default, households find it cheaper to borrow. While this effect is immaterial for efficiency concerns in exchange economies, it directly reduces the stock of capital available for production in our framework. In addition, the fall in capital reduces labor demand. With both lower capital formation and labor input, our model yields a decline in output that more than offsets the welfare gains associated with the elimination of bankruptcy costs.

Our analysis also indicates that tightening Chapter 7 provisions through ‘‘means testing’’, as suggested by recent congressional reform proposals aimed at restricting Chapter 7 to only the neediest households, leads not to just greater debt repayment but also more Chapter 13 bankruptcies. Contrary to the stated objectives of the proposals, these effects can induce a *fall* rather than an increase in output and welfare. Because Chapter 13 repayment plans reduce expected earnings, a higher rate of Chapter 13 bankruptcies discourages labor effort. Furthermore, the fact that creditors collect more effectively on their loans under tighter Chapter 7 provisions lowers the lending rate which

[1]See Adler et al. (2000), Zha (2001), Chatterjee et al. (2002), Lehnert and Maki (2002), as well as Livshits et al. (2003). Athreya (2002) does allow for an endogenous interest rate, but the environment is that of an exchange economy with no production and a single bankruptcy chapter. Wang and White (2000) explore both bankruptcy chapters allowed under U.S. law but do so in a partial equilibrium framework.