UP, UP and AWAY

Personal Bankruptcies Soar!

By Thomas A. Garrett and Lesli S. Ott

Bad credit? No Credit? Bankruptcy? No problem. So go the large number of ads placed by businesses that cater to the financially overextended. Such ads are an example of the evolving view that bankruptcy is seen as an acceptable alternative to continued financial hardship. As evidence of our growing bankruptcy culture, personal bankruptcy filings in the United States increased from 1.2 per 1,000 people in 1980 to over 5.4 per 1,000 people last year, an increase of nearly 350 percent.[1] In terms of annual growth, personal bankruptcy filings per 1,000 people have been growing at an average rate of nearly 7 percent, about 1.5 times greater than the average rate of annual per capita GDP growth.

These statistics, however, disguise the fact that personal bankruptcy filings are not equal across the country. For example, at the state level, Tennessee had the highest rate of personal bankruptcy filings in the nation, with over 10 filings per 1,000 persons last year—nearly twice the U.S. rate—whereas Massachusetts ranked last with 2.8 filings per 1,000 people.

Explaining Bankruptcy

Researchers have found that the primary cause of personal bankruptcy is high levels of consumer debt often coupled with an unexpected insolvency event, such as the loss of a job, a major medical expense not covered by insurance, divorce or death of a spouse.[2] Lower-income individuals are more likely to file for bankruptcy in response to an insolvency event, given their relatively limited access to financial counseling and fewer and less-diversified financial resources. The typical bankruptcy filer is a blue collar, high school graduate who is the head of a household in the lower middle income class with heavy use of credit, according to consumer economists' surveys.[3]

Several studies point to the decline in the social stigma related to bankruptcy as being partly responsible for the increase in filings. Also, the Bankruptcy Reform Act of 1978 is seen as an impetus for the record levels of bankruptcy filings in the 1980s and early 1990s.[4] This law relaxed asset exemption levels and made it easier for individuals to file for bankruptcy.

The rise and spread of casino gambling since the early 1990s also has been considered to be responsible, in part, for the rise in bankruptcies. However, the research on casino gambling and personal bankruptcy is mixed.[5] The research that does find a positive effect of casino gambling on bankruptcy rates usually finds that this effect is localized and very small—much smaller than the effect from the aforementioned factors.

Research suggests that bankruptcies may actually increase during periods of economic growth rather than during economic downturns.[6] For example, personal bankruptcies have grown over the past 25 years in the presence of relatively rapid income growth. In addition, consumer debt as a percentage of disposable personal income has risen from 11.1 percent in 1980 to over 13.1 percent last year.

Bankruptcy levels rise during times of economic growth as people become more confident in the future and are willing to take on a greater debt burden and finance their increasing obligations based on current income. However, as the supply of credit inevitably begins to tighten and interest rates and loan repayments begin to rise, the financial strain can become quite large. When this strain is coupled with an unexpected negative shock to income, an individual no longer has the ability to maintain the financial obligations undertaken in a time of economic exuberance.

Thus, although lower-income individuals may be more likely to file for bankruptcy in response to a negative income shock, income growth over time also creates the possibility that individuals may become financially overextended and, thus, see bankruptcy as a solution.

Bankruptcy Law

Debtors filing for personal bankruptcy protection may do so under two types of structured plans, Chapter 7 or Chapter 13. Under Chapter 7, a debtor is required to liquidate all non-exempt assets and have them distributed among his creditors as partial or full debt repayment.[7] Examples of exempt assets include equity in a home (called a homestead exemption) and 401(k) funds. In a relatively short time after liquidation, the debtor is forgiven the outstanding balance of his unsecured debts (remaining credit-card debt, for example). Under Chapter 13, in lieu of an asset liquidation, a debtor consents to a three- to five-year payment plan whereby he pays down a portion of his unsecured debts and is then forgiven the remaining balance. Under both plans, particular types of debt—such as government-backed student loans, child support and alimony payments, and recent income taxes—are ineligible for forgiveness and must be repaid. The overall trend has consistently been that over two-thirds of filers choose Chapter 7.

The federal government has recently implemented a policy aimed at reversing the increasing trend in personal bankruptcy filings that has occurred since the passage of the 1978 act. On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act, which is the most sweeping bankruptcy reform legislation passed in over 25 years. Previously, most major pieces of bankruptcy legislation slightly favored the consumer (debtor) over creditors. However, the 2005 act makes filing for bankruptcy more difficult through income-means testing, tougher guidelines for the homestead exemption, increased lawyer liability and required credit counseling.

Eighth District States vs. the Nation

The table provides a comparison of personal bankruptcy filings in Eighth District states with average bankruptcy filings in other states. Of the Eighth District states, Tennessee had the greatest number of filings per 1,000 people last year (10.5) and Illinois had the lowest (6.3). On average, Eighth District states had a filing rate of 7.7 per 1,000 people compared to an average filing rate of 5 per 1,000 people in other states. Thus, on average, states located in the Eighth District had roughly 2.7 more individuals per 1,000 filing for personal bankruptcy.

Although Eighth District states have a relatively higher rate of bankruptcy filing, the annual average growth in bankruptcies in the District since 1980 has been slightly lower than that of other U.S. states—7.2 percent vs. 7.8 percent. Within the District, Arkansas had the highest average annual growth rate (10.8 percent) and Illinois had the lowest (6.1 percent). Although Tennessee had the highest rate of bankruptcy of all District states (and the nation) last year, the average annual growth in bankruptcies in Tennessee was less than that in most other Eighth District states.

The table also shows that Eighth District states had an average per capita income that was nearly $3,000 less than other U.S. states' last year and an unemployment rate that was 0.6 percentage points higher than other U.S. states'. Comparing these data with the bankruptcy data suggests both per capita income and unemployment have a negative relationship with personal bankruptcy filings.[8] Note, however, that while Tennessee had a higher bankruptcy filing rate than other states did, it had per capita income that was higher than that of most other Eighth District states. Although a definitive causal relationship can be determined only by more rigorous statistical methods, the negative correlation is supportive of the finding that, at a given point in time, lower-income individuals may be more likely to file for bankruptcy, given relatively less financial literacy and less diversification of fewer financial assets.

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Personal Bankruptcies and Demographics Eighth District and U.S.

	Bankruptcies per 1,000 people 2004	Average annual percent change 1980 to 2004	Per capita income ($) 2004	Unemployment rate (%) 2004
Arkansas	8.6	10.8	25,725	5.7
Illinois	6.3	6.1	34,351	6.2
Indiana	8.8	7.3	30,094	5.2
Kentucky	7.0	6.7	27,709	5.3
Mississippi	7.2	8.7	24,650	6.2
Missouri	6.5	8.5	30,608	5.7
Tennessee	10.5	7.1	30,005	5.4
Eighth District states	7.7	7.2	30,560	5.7
U.S. excluding Eighth District	5.0	7.8	33,317	5.1
U.S. total	**5.3**	**7.6**	**32,937**	**5.5**

NOTE: Bankruptcy data are from the Administrative Office of the U.S. Courts, and demographic data are from the U.S. Census.

ENDNOTES

1. Bankruptcy data are from the Administrative Office of the U.S. Courts. See www.uscourts.gov/adminoff.html.
2. See Gropp et al. (1997), Buckley and Brinig (1998) and Nelson (1999).
3. See Shephard (1984).
4. See Domowitz and Eovaldi (1993).
5. See Nichols et al. (2000) and Thalheimer and Ali (2004).
6. See Eckstein and Sinai (1986) and Clark (1997).
7. See www.bankruptcydata.com and www.bankruptcyinformation.com for a comprehensive overview of bankruptcy laws and procedures.
8. The correlation between per capita income and bankruptcy filings is –0.18, and the correlation between filings and the unemployment rate is –0.55.

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