Testimony of

Professor Todd J. Zywicki

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Bio

TODD J. ZYWICKI is Visiting Professor of Law at the Georgetown Law Center for the 2004-05 academic year. He will be visiting from George Mason University School of Law where he is a Professor of Law and Senior Research Fellow of the James Buchanan Center, Program on Politics, Philosophy, and Economics. From 2003-2004, Professor Zywicki served as the Director of the Office of Policy Planning at the Federal Trade Commission. He teaches in the area of Bankruptcy, Contracts, Commercial Law, Law & Economics, and Public Choice and the Law. He has also taught at Boston College Law School and Mississippi College School of Law and is a Fellow of the International Centre for Economic Research in Turin, Italy.

Professor Zywicki clerked for Judge Jerry E. Smith of the U.S. Court of Appeals for the Fifth Circuit and worked as an associate at Alston & Bird in Atlanta, Georgia, where he practiced bankruptcy and commercial law. He received his J.D. from the University of Virginia, where he was Executive Editor of the Virginia Tax Review and John M. Olin Scholar in Law and Economics. Professor Zywicki also received an M.A. in Economics from Clemson University and an A.B. cum Laude with high honors in his major from Dartmouth College.

Professor Zywicki is the author of more than 40 articles in leading law reviews and peer-reviewed economics journals. He is widely recognized as a leading authority on issues of consumer credit and consumer bankruptcy. He served as the Editor of the Supreme Court Economic Review from 2001-02. He has testified several times before Congress on issues of consumer bankruptcy law and consumer credit and is a frequent commentator on legal issues in the print and broadcast media.

I am pleased to testify on the subject of the Bankruptcy Reform Act. For the fourth Congress in a row, this body will be considering a bankruptcy reform bill that would bring balance and sanity to a bankruptcy system that is threatening to spiral out of control. Last year, consumer bankruptcy filings exceeded 1.6 million for the first time. Clearly the time is right to address some of the problems of fraud and abuse that is endemic in the current bankruptcy system. Recognizing this, I am pleased to see that this Committee has acted promptly to introduce a bankruptcy reform Bill and to hold hearings on the issue. I am pleased to provide my views on the matter. I am currently a Visiting Professor of Law at the Georgetown University Law Center. From 2003-04, I served an appointment as the Director of the Office of Policy Planning at the Federal Trade Commission, where I assisted in helping to shape FTC policy on

matters of consumer credit, subprime lending, and related topics. I hold both a J.D. and a Master's Degree in Economics. I was also a John M. Olin Fellow in Law & Economics at the University of Virginia and am a tenured member of the faculty at George Mason University School of Law, one of the premier centers for the study of economic analysis of law. In addition to my publications in law reviews, I have also published several articles in peer-reviewed economics journals. As such, I believe that I am in a sound position to discuss both the legal and economic aspects of the current bankruptcy system as well as the probably effects of the bankruptcy reform Bill.

This Bill represents a thoughtful and well-considered effort to address many of the problems that are manifest in the bankruptcy system today. The Bill makes incremental reforms to the consumer bankruptcy system to address many of the loopholes and technicalities that opportunistic debtors have found to evade their financial and personal responsibilities. The reforms provided for by this Bill are grounded in common-sense and experience derived from the observation of the day-to-day operation of the bankruptcy system in practice.

The current system has been little-changed since its enactment in 1978. Since that time the number of personal bankruptcies is roughly five times larger than when the Code was enacted. Today, some 1.6 million Americans troop through the bankruptcy courtrooms every year. This growth in numbers has been matched by a growing sophistication among lawyers and the public about the opportunities for fraud and abuse--both legal and illegal--in the bankruptcy system. Few reasonable observers believe that even a small fraction of the fraud and abuse present in the system is caught. As a result, similarly-situated debtors and creditors throughout the country suffer from dissimilar and unpredictable treatment on the basis of accident of geography or judicial whim. By guaranteeing unequal treatment for similarly-situated individuals, the system mocks the rule of law. In turn, this undermines public confidence that the bankruptcy system is operating fairly and efficiently. Instead, it is increasingly viewed as a system prone to cynicism and manipulation, and a free-ride for debtors lacking in conscience and personal responsibility.

In a forthcoming law review article, I systematically examine the factors that have caused the rise in consumer bankruptcy filings in recent years. See Todd J. Zywicki, An Economic Analysis of the Consumer Bankruptcy Crisis, ___ NORTHWESTERN LAW REVIEW ___ (Forthcoming 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=587901. The Figures presented in this Testimony are drawn from that article. In the Appendix to this Testimony I present additional discussion of the causes of the consumer bankruptcy crisis.

As Figure 1 indicates, although bankruptcy filings were low and generally cyclical for most of the Twentieth Century there has been a stunning increase in consumer bankruptcy filing rates during the past twenty-five years, which has increased at accelerating rates over the past two decades.

Source: Annual Report of the Attorney General of the United States (through 1939) and Administrative Office of the United States Courts.

Astoundingly, today more bankruptcies are filed every year then the entire decade of the Great Depression combined.

In addition, since the enactment of the Bankruptcy Code in 1978, bankruptcy filings have been on an irresistible upward trend, accelerating during the 1990s:

Source: Bankruptcy Filings, Admin. Office of U.S. Courts; Number Households, U.S. Census Bureau

As Figure 3 indicates, the per capita bankruptcy rate in America has dramatically risen over time, accelerating in the 1980s and 1990s. The total number of bankruptcies more than doubled during the 1980s and then doubled again from 1990 to 2003, such that by 2003 annual consumer bankruptcy filings were five times higher in 2003 than just twenty year earlier. This rapid increase in filings has been especially difficult to explain in light of the prosperous state of the American economy during most of the past two decades, and especially, the extraordinary prosperity of the late 1990s. Although the American economy set new records for economic growth, low unemployment, and low interest rates, this was matched by record-high bankruptcy filings as well.

It is thus evident from this, and the evidence presented in the Appendix to this Testimony, that today the consumer bankruptcy system today is no longer being used as a "last resort" for consumers. Instead, the anomaly of record-high bankruptcy filings after almost 20 years of uninterrupted economic prosperity indicates the need to reconsider America's consumer bankruptcy rules.

The current system suffers from a crisis of both real and perceived abuse. This Bill addresses both of these problems. This Bill rebalances the bankruptcy system, by taking sensible steps to address many of the most prominent abuses by both debtors and creditors that have been manifested in recent years. At the same time, it preserves the commitment to the fresh start for all debtors who need it. By preserving the fresh start but also addressing abusive behavior, this Bill will restore fairness and efficiency to the bankruptcy system and thereby restore public confidence in the system. A failure to act in a sensible and rational way today will lead to continuing

abuse and continuing public frustration. Acting sensibly today will head-off more drastic and ill-considered action later.

Being pro-debtor is not the same as being pro-consumer. When some people get a free-ride in bankruptcy, the rest of us are forced to pick up the slack. The overwhelming majority of Americans pay their Bills and live up to their financial responsibilities. But it should not be forgotten that those who pay their Bills inevitably have to pay more to make up for those who do not. Bankruptcy losses are a cost of business. Like all other business expenses, when creditors are unable to collect debts because of bankruptcy, some of those losses are inevitably passed on to responsible Americans who live up to their financial obligations. Every phone bill, electric bill, mortgage, furniture purchase, medical bill, and car loan contains an implicit bankruptcy "tax" that the rest of us pay to subsidize those who do not pay their bills. Exactly how much of these bankruptcy losses is passed on from lenders to consumer borrowers is unclear, but economics tells us that at least some of it is. We all pay for bankruptcy abuse in higher down payments, higher interest rates, and higher costs for goods and services.

This bankruptcy "tax" takes many forms. It is obviously reflected in higher interest rates. But it is also reflected in higher down-payment requirements, as creditors desire greater up-front payments to reduce the risk of nonpayment. It is reflected in shorter grace periods for paying bills and higher penalty fees and late-charges for those who miss payments. Finally, it is reflected in fewer benefits to consumers, whether the co-branding benefits offered by credit cards today or such things as greater customer service or extended business hours. Retailers raise their prices or close their credit operations. Hospitals and other medical providers are forced to restrict services or increase prices still higher to compensate for unpaid medical debts. Regardless of which of these forms it takes, it is evident that the rest of us suffer when some people choose not to pay their bills.

Moreover, it is lower-income and fixed-income Americans who suffer the most, as it is they who already have the fewest credit choices and the least ability to absorb increased credit and other costs that result from avoidable bankruptcy losses. When furniture stores are forced to discontinue their credit operations because of bankruptcy losses, or when department stores are forced to raise prices to offset losses due to bankruptcy, lower-income Americans are hurt the most. When upper-income individuals file bankruptcy and walk away from debts that they could pay but choose not to, the bill gets sent to you, me, young, and low-income Americans alike. I cannot see any reason why lower-income Americans should pay a higher price for goods, services, or credit simply to preserve the privilege of upper-middle class Americans to shirk financial obligations that they can pay. Consumers as a whole, and especially low-income consumers, are not made better-off when bankruptcy losses increase prices and decrease service.

Creditors also lose from a runaway bankruptcy system. Smaller businesses and small creditors suffer the most from a runaway bankruptcy system, as they tend to have the narrowest margins and the least ability to spread those losses among their customers. The small-town furniture store selling couches and end tables on credit suffers a lot when his customers don't pay up. As do independent car salesmen, jewelers, contractors, and other small businesses who extend credit to their customers. Thus, it is not surprising that support for bankruptcy reform comes from across the full spectrum of creditors, but small creditors, such as small retailers and credit unions, are among the strongest supporters of bankruptcy reform.

The Bill will also reinforce the lesson that bankruptcy is a moral as well as an economic decision. Filing bankruptcy reflects a decision to break a promise made to reciprocate a benefit bestowed upon you. The moral element of bankruptcy is reflected in the observation that the English word "credit" comes from the Latin word for "trust." Parents seek to teach their children values of personal and financial responsibility, and promise-keeping and reciprocity provide the foundation of a free economy and healthy civil society. Regrettably, the personal shame and social stigma that once restrained opportunistic bankruptcy filings has declined substantially in recent years. We have "defined bankruptcy deviancy downward" such that it has become a convenient financial planning tool, rather than a decision freighted with moral and social significance. Requiring those who can to repay some of their debts as a condition for bankruptcy relief sends an important signal that bankruptcy is a serious act that has moral as well as economic consequences. Moreover, reducing the number of strategic bankruptcies will reduce the bankruptcy tax paid by every American family on goods and services, giving them more money for groceries, vacations, and educational expenses.

The Bill establishes a much-needed system of means-testing to force high-income debtors who can repay a substantial portion of their debts without significant hardship to do so. Under current law, there are few checks on high-income debtors seeking to walk away from their debts and few safeguards to prevent bankruptcy fraud. Current law requires a case-by-case investigation that turns on little more than the personal predilections of the judge. The Bill narrows the judge's discretion by establishing a presumption of abuse where a high-income debtor has the ability to repay a substantial portion of his debts, as measured by an objective standard. At the same time, the judge will retain discretion to override this presumption in cases of hardship. Means-testing is not a panacea for all of the ills of the bankruptcy system. But by focusing judicial discretion on the existence of real hardship and reducing procedural hurdles to challenging abuse, the Bill's reforms will vindicate the rule of law and reduce abuse.

By targeting high-income bankrupts with substantial repayment capacity, it is estimated that means-testing will recover roughly $3 million of the $40 million discharged in bankruptcy every year. Although means-testing will affect only 7-10% of bankruptcy filers, but focusing scrutiny on those high-income debtors who can repay a substantial portion of their debts without significant hardship, the Bill makes possible the recovery of substantial losses with minimal administrative cost. Equally important, means-testing will have no effect on those making less than the minimum income threshold provided. Thus, for the 80% of filers whose income lies beneath the state median, means-testing will have no effect whatsoever.

It should also be stressed that means-testing will not prevent anyone from filing bankruptcy and receiving a bankruptcy discharge. Instead, it will simply condition the discharge for affected filers to pursuing a chapter 13 repayment plan rather than going into chapter 7. In fact, the means-testing rules will simply govern eligibility for chapter 7 relief; it has no impact on the confirmation of the debtor's chapter 13 plan. In approving the debtor's plan the court will still apply the budgetary processes provided for under current law without any consideration of the means-testing eligibility rules.

The means-testing provisions also provide an excellent example of the Bill's incremental and balanced approach to the problem of abuse and fraud in the system. Under current law, it is already the case that the primary factor for courts to consider in deciding whether to dismiss a debtor's case for substantial abuse under §707(b) is whether the debtor can repay a substantial portion of his debts without significant hardship. Overwhelmed by the number of cases they confront and lacking the will to enforce its provisions consistently, however, it has been observed by one scholar that many perceive §707(b) to be a "dismal failure." Jack F. Williams, Distrust: The Rhetoric and Reality of Means-Testing, 7 AM. BANKR. INST. L. REV. 105 (1998). The Bill simply creates a more formal and reliable mechanism for implementing the goals that bankruptcy courts are already seeking to apply, but will do so in a way that more efficient and fair than the current system. See Edith H. Jones and Todd J. Zywicki, It's Time for Means-Testing, 1999 BRIGHAM YOUNG UNIVERSITY L. REV. 177.

In addition, the Bill strikes at the most prominent abuses concerning the unlimited homestead exemption. It prevents opportunism by debtors who move from one state to a state with an unlimited homestead exemption immediately prior to filing bankruptcy by imposing a lengthy waiting period on their ability to avail themselves of the new state's exemption. This extended waiting period thus eliminates the largest objection to the a state-based exemption regime, as empirical evidence plainly demonstrates that credit markets operate in such a manner to keep most of the cost of excessive exemptions within the state, thereby eliminating interstate spillovers. See Reint Gropp, John Karl Scholz, and Michelle J. White, Personal Bankruptcy and Credit Supply and Demand, 112 Q. J. ECON. 217 (1997). As a result, while excessive exemptions may be bad policy in that they raise the cost of credit and reduce access to credit, this tradeoff is arguably one that falls within the discretion of the various states. Second, the Bill would create a 10 year statute of limitations to attack fraudulent use of the homestead exemption. Thus, although the Bill does not contain a flat cap on the use of the homestead exemption, it does attack the two leading causes of abuse by imposing a waiting period to prevent eve of bankruptcy exemption forum shopping and providing Judges with greater powers to attack fraudulent uses of the homestead exemption.

The Bill also takes a major step to reduce other forms of fraud and abuse, including such things as the use of "fractional interests" to prevent legitimate foreclosures and abuse of the cramdown provisions of the Code by filing bankruptcy simply to strip down the value of a secured creditor's claim. It creates new protections from bankruptcy "mills" and ensures that bankruptcy filers undergo credit counseling to try to workout a consensual solution to their financial problems. In short, it reflects practical solutions grounded in common-sense experience regarding the problems in the bankruptcy system. Contrary to the selective outrage of its critics, however, the Bill does not limit itself to reducing abuse of the homestead exemption but takes a comprehensive approach to rooting out all forms of bankruptcy abuse.

In the past, it has been claimed by some that the Bill would negatively impact the ability of divorced spouses to collect spousal and child support. This claim is based on vague, speculative, and inaccurate accusations about how the nondischargeability of certain debts will impact post-petition efforts to collect these obligations. In contrast to these speculative accusations, the Bill offers concrete assistance to non-intact families in several ways. Among its numerous provisions protecting the rights of former spouses and children are the following protections: (1) Extends the scope of nondischargeability of spousal support obligations to make nondischargeable certain property settlements, (2) excepts state child support collection authorities from the reach of the automatic stay, (3) elevates the priority level of child support to first priority, (4) makes exempt property available for the enforcement of domestic and child support obligations. It is well-established that alimony and child support creditors have a substantial number of tools at their disposal that other creditors lack, such as heightened garnishment protections, government-assistance in collection, intercept power over tax refunds and government benefit payments, and many other protections.

It is thus a simple falsehood to charge that the effect of the Bill would lead to spousal support creditors having to

"compete" with ordinary creditors for payment, because that is simply not the case. If this allegation is raised this time, I urge this Committee to ask exactly how this supposed competition takes place. The Committee will soon learn, I believe, that the allegation is unsubstantiated and amounts to little more than hand-waving. The primary problem for spousal support collection today is not a fictional competition with other creditors, but rather the obstructions and hurdles imposed by the current bankruptcy laws. The reforms in this Bill go a long way toward relieving the hurdles imposed by the bankruptcy laws that interfere with effective collection of such obligations today. This Bill unequivocally improves the position of divorced spouses attempting to collect alimony, child support, and property settlements. For seven years now divorced spouses and children have hoped for relief from the traps of the bankruptcy system; now is the time to give it to them.

Balanced bankruptcy reform preserves the protection of the bankruptcy system for those who need it, while limiting abuse by those who are preying on that generosity simply to evade their financial responsibilities. This Bill brings balance to a consumer bankruptcy system that has become a tool for rich and savvy debtors to evade their financial responsibilities. America has one of the most charitable and forgiving bankruptcy systems in the world and many of those who file bankruptcy truly need it as a consequence of personal trouble. But too many people today are preying on our charity and using the bankruptcy system not because they need it, but simply to evade their responsibilities or to maintain an unrealistic and extravagant lifestyle at the expense of those who live responsibly. Ignoring rampant abuse undermines public support for the bankruptcy system generally, which will eventually hurt those who legitimately need bankruptcy relief.

Now is the time to act to reform the bankruptcy laws. This Bill is a sensible, balanced, incremental, and well-considered attempt to deal with these problems before they become intractable. These reforms will make the bankruptcy system more fair, equitable, and efficient, not only for bankruptcy debtors and creditors, but for all Americans.

Appendix

Understanding the Causes of the Bankruptcy Crisis and the Need for Reform

There is little evidence to support the more general proposition that the rise in consumer bankruptcy filings has been caused by an increase in household financial distress rather than other factors. This Appendix briefly reviews the evidence regarding the purported causes of the rise in consumer bankruptcy filings during the past twenty-five years. More detailed discussion can be found at Todd J. Zywicki, An Economic Analysis of the Consumer Bankruptcy Crisis, ___ NORTHWESTERN LAW REVIEW ___ (Forthcoming 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=587901.

It has been argued that the upward filing trends of the past twenty-five years has been caused by high levels of household financial distress. This argument could explain rising bankruptcies in two possible ways. First, it is argued that consumers have "too much debt," either because they have borrowed recklessly or because creditors have somehow induced them to take on excessive levels of debt, such as through overly-aggressive promotion of credit cards. This excessive debt either catapults them into bankruptcy directly by making it impossible for them to pay all their debts, or by making them more vulnerable to financial shocks. Second, it is argued that unexpected financial shocks to consumer households have become more common or more severe, thus generating more bankruptcies. Neither of these theories is borne out by the available evidence.

Bankruptcy has two well-established measures of financial distress and insolvency. The first is "equity" or liquidity insolvency, which examines the ability to generally pay one's debts as they come due. This measurement is essentially a ratio of one's current income to current expenses, including current or monthly payments on debt obligations. The second is "balance sheet" or "bankruptcy" insolvency, which finds a debtor to be insolvent if the "sum of the debtor's debts is greater than all of the debtor's assets at fair valuation." Equity insolvency is a "flow" measure of current income and expenditures; balance sheet insolvency is a "stock" measure of total assets and total debt, or household net wealth.

Equity Insolvency and Bankruptcy

The first way to measure financial condition is through equity insolvency, or the ability to pay one's debts as they come due. Since the early 1990s interest rates have fallen and loan maturities have lengthened on average. As a result, even though total household indebtedness has gradually and consistently risen during this period, the household debt service ratio has remained fairly constant. Indeed, it is likely that total indebtedness has risen precisely because of falling interest rates and a lengthening of loan maturities. Low interest rates enable consumers to borrow more, such as to buy a larger house, without a substantial increase in monthly payments. Figure 4 compares the Federal Reserve's measurement of the household debt service ratio with consumer bankruptcy filings:

Source: Federal Reserve Board Household Debt-Service Burden and Figure 3

Moreover, the debt service ratio is relatively constant across households of varying wealth positions, in that low,

medium, and high-wealth households all spend roughly the same amount of their income on current debt-service obligations, although poor and wealthy households have slightly lower debt-service burdens than middle-class households. With respect to the lowest quintile of income earners, there appears to be little relationship between changes in the debt-service burden of the lowest quintile and overall bankruptcy filing rates, as shown in Figure 5:

Source: Survey of Consumer Finances and Figure 3.

Whereas the debt service ratio for the lowest income quintile of the population was unchanged between 1995 and 1998, the overall bankruptcy filing rate soared. Similarly, whereas the debt service ratio fell from 1998 to 2001, bankruptcy filings were the same in 1998 and 2001. The debt service ratio of the lowest quintile was also the same in 1992 and 2001, but bankruptcies were much higher in the latter period. In short, changes in the lowest-income sector of society do not explain rising bankruptcy filing rates. Thus, the aggregate debt-service measurements are not concealing some sort of unrecognized distress among poor households.

Balance Sheet Insolvency and Bankruptcy

A second standard measure of household financial condition is the ratio of total assets to total debt, also referred to as "balance sheet" or "bankruptcy" insolvency. In the context of consumer households, balance sheet insolvency can be measured by household net wealth. Like balance sheet insolvency, household net wealth is calculated as the difference between total assets and total liabilities. As shown in Figure 6 there has been a dramatic increase in household net wealth during the era of the consumer bankruptcy crisis:

Source: Philadelphia Federal Reserve Bank

Household wealth has risen steadily and dramatically over the past several decades. In fact, after a relatively stable level of net wealth for over half a century, net wealth began to rise rapidly in the 1970s, accelerating in the 1908s, and exploding in the 1990s. At the same time, bankruptcy filings have also risen steadily and dramatically. In the mid-1990s, for example, household net wealth grew by about ten percent per year, even as bankruptcies jumped as much as twenty percent per year. Moreover, the ratio of consumer credit to net worth has remained almost perfectly constant at four percent of net worth since 1956. This combination of rising bankruptcies and rising personal wealth contradicts the hypothesis that mounting bankruptcies reflects increased household financial distress.

Moreover, net wealth has risen for households of all wealth levels, including the poorest quintiles. Even though the poor remain poorer than average overall, low-wealth households have benefited from the asset growth along with everyone else. As shown in Figure 7, the average net worth of the lowest quintile of households has risen slowly but steadily over the past decade:

Source: Survey of Consumer Finances

Credit Cards and Bankruptcy

It has also been argued that increased use of credit cards has led to an increase in consumer indebtedness, resulting in more bankruptcies. In fact, credit cards have not worsened household financial condition, because although consumers have increased their use of credit cards as a borrowing medium, this increase represents primarily a substitution of credit card debt for other high-interest consumer debt. For many borrowers, credit card borrowing may be an attractive option relative to other corms of credit that are available to them, such as pawn shops, personal finance companies, retail store credit, and layaway plans, all of which are either more costly or otherwise less attractive than credit cards. The result, therefore, has not been to increase household indebtedness, but primarily to change the composition of debt within the household credit portfolio. This is also consistent with the finding reported above that the consumer debt-service burden has remained largely stable during this period. Figure 8 illustrates the nature of this substitution:

Source: Federal Reserve Board and Bureau of Economic Analysis

As Figure 8 indicates, the growth in revolving (credit card) debt has largely been a substitution from nonrevolving consumer debt to revolving debt, thus leaving overall consumer indebtedness (as a percentage of income) largely unaffected. Revolving debt outstanding has risen during this period from zero to roughly 9% of outstanding debt. Nonrevolving installment debt, by contrast, has fallen from its level of 19% of disposable income in the 1960s, to roughly 12% today. The increase in revolving debt has been almost exactly offset by a decrease in the installment debt burden. In fact the recent bump in total indebtedness in recent years was not caused by an increase in revolving debt, which has remained largely constant for several years, but by an increase in installment debt, primarily as a result of a recent increase in car loans for the purchase of new automobiles. Thus, because credit card debt has largely just substituted for other forms of consumer debt, there is little indication that increased use of credit cards has precipitated greater financial stress among American households.

It also has been argued that credit cards have contributed to increased bankruptcies through a profligate expansion of credit card credit to high-risk borrowers, especially low-income borrowers. Although often-repeated, empirical studies have failed to support this theory. First, as noted, the growth in credit card debt by low-income households primarily reflects a substitution for other types of debt, not an overall increase in indebtedness. In addition, two studies have examined the hypothesis empirically and have found little support. The first study, by economists Donald P. Morgan and Ian Toll concludes, "If lenders have become more willing to gamble on credit card loans than on other consumer loans credit card charge-offs should be rising at a faster rate [than non-credit card consumer loans] . . . . Contrary to the supply-side story, charge-offs on other consumer loans have risen at virtually the same rate as credit card charge-offs." Donald P. Morgan & Ian Toll, Bad Debt Rising, CURRENT ISSUES IN ECON AND FIN. March 1997, at 1, 4. Thus "suggest[s] that some other force [other than extension of credit cards to high-risk borrowers] is driving up bad debt." A second study, by David B. Gross and Nicholas S. Souleles, concludes that changes in the risk-composition of credit card loan portfolios "explain only a small part of the change in default rates [on credit card loans] between 1995 and 1997." David B. Gross & Nicholas S. Souleles, An Empirical Analysis of Personal Bankruptcy and Delinquency, 15 REV. FIN. STUD. 319, 324 (2002). Moreover, if it were true that lower-income households were dramatically increasing their indebtedness through credit card increase then this should be reflected in the debt service ratio for lower-income households. As previously noted, however, this ratio has remained largely constant for lower-income households as with all others.

Housing Costs and Bankruptcy

A recent book has argued that recent decades have seen an excessive "bidding war" for housing that has led to increased financial stress. See ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE (2003). Most of the support for the "bidding war" hypothesis is anecdotal. The only numerical data offered to support the thesis is an example of the balance sheet of an average household in the 1970s compared to an average household in the 2000s. Id. at 50-51 But on closer inspection, the data that is presented does not support the "bidding war" hypothesis offered up by the authors. In the standard one-wage earner household of the 1970s, median income was $38,700. Major expenses were $1,030 a year for health insurance, $5,310 in mortgage payments, and automobile loan payments and expenses equal $5,410. The effective tax rate was 24%, equaling $9,288 from the household salary, leaving $17,834 in discretionary income. The overall family budget is described in Figure 9:

Source: Warren & Tyagi, The Two-Income Trap

In the typical 2000s family with both spouses working, total family income is $67,800. Mortgage payments are $9,000, an increase of $3,690. The expense of two cars rises to $8,000, or an increase of $2,860. Day care is now needed because both parents are working, adding a total of $9,670 for two children. Health insurance has increased to $1,650, an increase of $620. Because of progressiveness of the tax code, the higher family joint income have increased taxes to 33%, or a total of $22,374, an increase in $13,086. Discretionary income has, in fact, fallen in the second period. But this appears to be primarily the result of a much higher tax burden and additional new child care expense. As seen in Figure 10, the supposed "bidding war" for housing, by contrast, has increased the family housing expense by only $3,690:

Source: Warren & Tyagi, The Two-income Trap

As Figure 10 indicates, mortgage, automobile, and health insurance expenses have all risen modestly in absolute terms from the 1970s to the early 2000s, but all have fallen as a percentage of the family budget. By contrast, taxes have increased by over $13,000, almost as much as all of the other expenses combined, and over three times the increase in housing expenses. Child care is a new expense that represents fourteen percent of the budget. But if the bidding war hypothesis is that the spouse is forced to work in order to pay for housing expenses, the fact that the family incurs $9,670 in new child car expenses in order to pay $3,690 in new housing expenses is inconsistent with the hypothesis. The Two-Income Trap focuses on the reduction in discretionary income between the two periods, but the culprit for this appears to be increased taxes and child care expenses, not increased housing expenses. Moreover, unlike new taxes and child care expenses, increases in the cost of housing and automobiles are offset by increases in the value of real and personal property as household assets that are acquired in exchange. In short, even though the debt obligation associated with housing has increased in recent years, it is not clear that the "bidding war" hypothesis is consistent with either economic theory or available empirical evidence.

Moreover, data from the Federal Reserve on the mortgage debt service ratio also fails to find any major or consistent upward trend that supports the "bidding war" hypothesis. Like the debt-service ratio presented above, the mortgage debt service ratio is the percentage of monthly income dedicated to mortgage debt service. Over the past twenty years the mortgage debt service ratio has hovered within a narrow range between 5.01 and 6.35 percent of monthly

income, rising from 1982 until 1991, then falling back off before rising slightly above 6 percent again in 2000, as shown in Figure 11:

Source: Federal Reserve Board and Figure 3

Thus, the mortgage debt service ratio has increased, but only slightly--a little over one percent of income--which is certainly not enough to explain the increase in bankruptcies. In addition, default rates on mortgages have remained fairly constant for many years. Moreover, while both the debt service ratio and financial obligations ratio has been constant for homeowners during this period, it is renters, not homeowners, who have experienced an increase in their financial obligations. On average, renters spend 17 percent of their total after-tax income on rent payments, more than twice as much in percentage terms than homeowners. If anything, therefore, the financial condition of homeowners has improved dramatically relative to that of renters during the past decade.

Unemployment and Bankruptcy

It has also been argued that factors such as unemployment has led to increased bankruptcy filings. This claim is not sustained by the evidence:

Divorce and Bankruptcy

Nor do trends in divorce rates appear to explain the bankruptcy crisis:

Alternative Explanations

It thus appears that the surge in consumer bankruptcy filings cannot be explained by a rise in household financial distress. What then explains the dramatic rise in bankruptcy filings during the past twenty-five years?

Two identifiable factors present themselves as explaining the rise in consumer bankruptcy filings in recent decades. First is a general decline in the personal shame and social stigma associated with bankruptcy. Second is a change in the relative costs and benefits associated with filing bankruptcy.

There is also little question that the social stigma associated with filing bankruptcy has declined over time. A few years ago, singer Toni Braxton filed bankruptcy, despite having recorded two albums that had earned $170 million in sales at the time, and despite owning a baby grand piano, a Porsche, and Lexus. She later appeared on Oprah Winfrey, who questioned Toni on her purchase of $1,000 in Gucci silverware shortly before filing bankruptcy. Toni's response: "I only spent about $1,000 on it. If that made me broke, then I was truly in bad shape. It's Gucci--I love it. I'd buy it again. And now that I get a huge discount because I've given them so much pub, I can really shop." This attitude, of course, is not limited to pop music stars, as evidenced by the comments of one individual to CNNfn, "When I found out--this was watching it on the news, in the newspapers--that more and more people are doing it [filing bankruptcy], and . . . it's not just a middle class you know, upper class too--rich people--everybody's doing it. And . . . I said: Why not me? You know, I'm just one more of them." Indeed, several scholars have attributed the rise in consumer bankruptcy filings to a decline in the traditional social "stigma" associated with filing bankruptcy. A review and summary of many of these articles can be found in, Gordon Bermant, What's Stigma Got to Do with It?, ABI JOURNAL 22 (July/August 2003)

Moreover, the excessive generosity of the current American bankruptcy system has also spurred more bankruptcy filings. It has been estimated that one-third of Americans would benefit financially from filing bankruptcy after engaging in some basic pre-bankruptcy planning. Moreover, because of the structure of property exemptions under bankruptcy and state law, wealthier individuals gain the greatest benefits from filing bankruptcy because they can protect larger amounts of property in bankruptcy. Given the financial benefits created by the enactment of the 1978 Code, it is little wonder that consumers have increasingly recognized and acted on the financial benefits of filing bankruptcy.

At the same time, the costs of learning about and filing bankruptcy have decreased dramatically. Daytime television and the Yellow Pages are awash in bankruptcy advertisements. The mass production of bankruptcy petitions by bankruptcy lawyers have driven down prices for bankruptcy services. In fact, scholars have reported that one of the most difficult tasks confronting lawyers is persuading their clients that there really is no catch to filing bankruptcy, because clients routinely object that the whole things sounds "too good to be true."

The role of attorney advertising and decreasing costs of learning about bankruptcy may be illustrated by the following chart:

As this chart indicates, there appears to be a very strong correlation between attorney advertising and consumer bankruptcy filings. Of course, there are limitations to the inferences that can be drawn from this chart. The chart measures all advertising, not just bankruptcy advertising. Moreover, it is focused purely on television advertising and ignores other sources of advertising. Nonetheless, attorney advertising for bankruptcy services seems to comprise a

substantial portion of attorney advertising in general, and may comprise even a larger percentage of advertising in non-television outlets, such as Yellow Pages, newspaper, Internet, and radio advertising.