



shame

AND BANKRUPTCY

The number of Americans filing for bankruptcy protection has surged fivefold in two decades. A Richmond Fed economist challenges the conventional wisdom that declining stigma is at the root of the increase

BY DOUG CAMPBELL

“At one time in our history, filing bankruptcy was regarded as shameful, and filers suffered social stigma and permanently ruined credit. The shame and stigma are no longer compelling.”

— The Hon. Edith Jones, former member of the National Bankruptcy Review Commission, March 1999

“Stigma is by no means dead.”

— Kartik Athreya, economist, Federal Reserve Bank of Richmond, 2004

The narrative sounds convincing: Crazy consumers, their wallets stuffed with maxed-out credit cards, rack up unseemly sums of debt and then shamelessly unload it all in bankruptcy court. Back in the good ol’ days — say, the 1920s, 1950s or even 1980s — this never would have happened, the conventional wisdom goes. Americans had integrity. They certainly wouldn’t bail themselves out by the million with bankruptcy protection. Their reputations were too important. That was then. Nowadays, with bankruptcy increasingly commonplace, the stigma has faded. It’s an embarrassment of riches in reverse.

How else to explain skyrocketing bankruptcy rates? Consider the case of the 1990s. Personal bankruptcy filings surged 35 percent to more than 1.4 million a year in 1997 from 924,000 in 1991. The median total of unsecured debt borrowers discharged in bankruptcy in 1981 was \$12,452. By 1997, it had soared more than 50 percent to \$19,515. The pace of filings was eight times higher than population growth. (Business bankruptcies account for less than 3 percent of total filings.) That unemployment was low, the stock market rising, and the economy generally humming as bankruptcy filings accelerated left analysts reaching for answers. The stigma rationalization

was as expedient as it was convenient. It squared with the gut feeling of many Americans that moral standards were falling. Credit cards had indeed become widely available, but why were so many people using their plastic with reckless abandon?

The trend continued into this century. In 2003, more than 1.6 million people filed for bankruptcy protection. By comparison, in 1983 only 286,444 Americans went bankrupt. About seven out of 10 debtors file under Chapter 7 bankruptcy protection, in which all their unsecured debts are erased. Chapter 7 filings account for \$36.4 billion of the total \$40 billion discharged each year in bankruptcy. Most of the rest comes in the form of Chapter 13 bankruptcies, in which payments for secured debts are rescheduled but still result in the discharge of most unsecured debt.

The Conventional Wisdom

The “declining stigma is the root of bankruptcy” way of thinking has gained currency. The winter 1999 issue of *Harvard Magazine* chimed in with a typical hand-wringing account: “Credit industry analysts hold that the stigma of bankruptcy has traditionally kept people honest about their ability to pay debts. Earlier generations of debtors lashed themselves to austerity budgets, sold off possessions, and worked extra shifts to avoid the shame of defaulting. But today, says the industry, many debtors have chosen to see bankruptcy as a convenient loophole against collections.”

Towson University economist Joseph Pomykala, in a 1999 article, offered up a virtual bankruptcy hall of shame: a doctor who filed for bankruptcy immediately after charging a \$60,000 European vacation on his American Express card; a waiter who accumulated \$170,500 in debt over just six months for items including a gambling trip to Atlantic City.

Funny thing is, this is old news. For decades, preachers, politicians, and ethicists of all stripes have railed about the decay of fiscal virtue. Economists Bradley Hansen of the

University of Mary Washington and Mary Eschelbach Hansen of American University note in a recent paper that worries about declines in stigma were shared by credit experts in the 1920s. The difference in the 1990s was the seemingly persuasive combination of shame and fast-increasing bankruptcy cases. The bankruptcy-and-shame theory officially entered the zeitgeist.

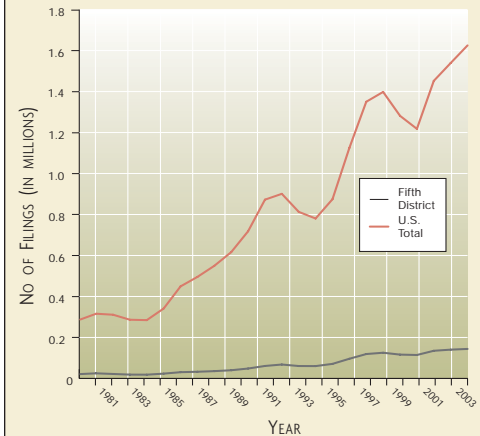
Intangibles like stigma aren’t usually fodder for number-crunchers. But it wasn’t long before economists began weighing in, albeit at first indirectly. David Gross of Lexecon Inc. and Nicholas Souleles of the University of Pennsylvania seized on a “demand-effect” explanation for escalating bankruptcy. People have become more willing to default over time in part because the costs of default, including nonmonetary costs like social stigma, have declined. Our work “is suggestive of a decline in social stigma or information costs, but it is not conclusive,” they wrote in an article published in the spring 2002 issue of the *Review of Financial Studies*.

Economists Michelle White of the University of California at San Diego, Erik Hurst of the University of Chicago, and Scott Fay of the University of Florida took that case to another level. White has long held that — shame aside — we should expect more people to file for bankruptcy because it is financially advantageous to do so. By her tally about 15 percent of U.S. households could gain from bankruptcy protection but less than 10 percent of those same households — and only a tiny fraction of all U.S. households — actually do. In their widely cited 2002 *American Economic Review* article, “The Household Bankruptcy Decision,” White, Fay and Hurst backed the “strategic model” of bankruptcy, which predicts that people file for protection not so much because of adverse events but because they see financial benefit.

White’s team took a stab at testing the bankruptcy-stigma theory. Basically, they found that people were more likely to file for bankruptcy

Consumer Filings

The steep climb in U.S. consumer bankruptcy filings (which also happened in the Fifth District) during the 1980s and 1990s led many to believe that people no longer felt shame in seeking court protection from paying their debts. A Richmond Fed economist attributes the rise to cheaper lending costs incurred by creditors.



SOURCE: Administrative Office of the U.S. Courts

when they lived in a district that had a higher filing rate relative to population. They argued that people are more likely to learn about bankruptcy from friends and family and to decide that bankruptcy is, by extension, socially acceptable if they live in a district with a higher filing rate. In an interview, White elaborates: “You get a subliminal message that it’s not stigmatized.”

So the issue seems largely settled: Bankruptcy is being accelerated by declining stigma. Well, not so fast. The debate over stigma’s role in bankruptcy is very much alive, and the implications for how it’s resolved are important.

The Challenge

Steering stigma-and-bankruptcy research in a new direction is Kartik Athreya, an economist with the Federal Reserve Bank of Richmond. His work leads him to conclude that it’s “shame as it ever was,” to borrow from the title of one of his recent papers.

Athreya says that bankruptcy rates are climbing because it’s much cheaper for creditors to make loans. As a result, riskier borrowers are eligible to accu-



Mounting consumer debt spawned big increases in bankruptcy rates during the 1990s. A Richmond Fed economist suggests that widely available credit — more so than falling stigma — was the driver behind the gains.

mulate levels of debt that in previous decades would have been unheard of. “If stigma really went down, it’s hard for me to understand creditors making loans on the favorable terms they’ve been making them,” Athreya says. “Declining stigma should have some impact on the cost of credit.”

Athreya is a relative newcomer to the shame-and-bankruptcy fray. Stumped for a dissertation topic in 1997 he took a year off from his graduate studies at the University of Iowa to work for Citibank’s credit card unit. One of his jobs was to figure out how much default the company should view as a simple cost of doing business, and how much ought to be either recovered or prevented from happening in the first place by not extending credit to risky consumers. Athreya headed back to campus the next fall with a fresh focus. Citibank had a specific business problem. What intrigued him was the wider role that bankruptcy played as an American institution. Was bankruptcy good for the country?

“Bankruptcy has always been talked about in terms of providing a kind of insurance or backstop against misfortune for honest people,” Athreya

says. “It’s got this really long history as an insurance product, broadly speaking, but the question that is of interest to economists is: Is this insurance product worth having around?”

Bankruptcy is of interest to economists because it’s supposed to be a safety net against all the hazards of modern-day life, from divorce to disability, and the consequences of maintaining this safety net are not to be taken lightly. Credit costs are higher for everybody because borrowers

always have the option to seek the sanctuary of bankruptcy court. To hedge their bets, lenders charge more.

In theory, economists say that in a world where shocks to people’s income are “transitory” — that is, temporary, surmountable setbacks like unemployment or brief illnesses — then it’s hard to justify a role for bankruptcy. In such a world, the costs of bankruptcy — making borrowing more expensive for everybody — outweigh the benefits an average person might obtain from being able to walk away from his debts. But those same economists concur that if income shocks are more severe and permanent, bankruptcy makes economic sense. And we see such shocks all the time: workers lose limbs in plant accidents; jobless mothers divorce and are awarded sole custody of their children. The ability of those people to dig their way out of debt is forever blunted, and so bankruptcy protection is the best answer.

On top of all this is the potential role of bankruptcy in fostering America’s entrepreneurial culture. Innovators must take risks, both financially and otherwise, and offering the option of bankruptcy court is viewed as an important part of cultivating entrepreneurship.

The Richmond Fed’s Athreya puts it this way: “We agree that bankruptcy in principle can provide people with

a type of insurance against certain outcomes. It makes them willing to borrow to tide over bad times. But if bad times persist, we give them an out through bankruptcy.”

Until recently, Athreya’s research had concentrated on the consequences of expanded unsecured credit combined with lax bankruptcy law. (He decided that it was a bad combination, helping a small number of poor people at the expense of other people in a manner that reduced overall welfare.) Additionally, he is looking into the interplay between U.S. social insurance programs like unemployment insurance and bankruptcy.

The trick with stigma was figuring a way to plug it into a mathematical model. Given that shame isn’t an observable statistic, like the unemployment rate or the gross domestic product, it’s quite a neat trick.

Here’s how he did it. First, he looked at some facts and found that from 1991 to 1997 bankruptcy rates roughly doubled. Next, he took the following actual data from 1991: bankruptcy filings, the median level of debt discharged in bankruptcy, and credit card charge-off rates. He then constructed a model designed to capture important factors influencing bankruptcy — including stigma — that approximately matched the 1991 data. Finally, he lowered the cost of stigma in the model to see what effects that produced.

When Athreya lowered the cost of stigma — as was supposedly happening in America during the 1990s — he came up with a bankruptcy rate of 0.18 percent in 1997, a close approximation to the actual 0.2 percent rate. But the model yielded results that were way off in terms of the level of debt held by Americans. In Athreya’s lowered-stigma model, the median debt-to-income ratio came out as 0.85 percent. In reality, it was 50 percent. Why the difference? In the model, when stigma falls and bankruptcy rates rise, lending becomes riskier. So lenders require a higher return to compensate for the increased risk. Facing higher interest rates, consumers become less willing to take on debt.

Then Athreya found a better fit. He ran the same exercise but kept stigma constant and cranked down the cost of lending money. Suddenly, actual and projected figures started matching. The projected bankruptcy rate was 0.19 percent (compared with the actual 0.2 percent) and the median debt-to-income ratio among filers was 40.3 percent (compared to the actual 50 percent).

Athreya's interpretation of these results is that in the first run, where stigma is lowered, "it becomes very expensive to get a loan in this era." By contrast, when stigma is held constant and the cost of issuing loans is reduced, the numbers start falling in place. "It's cheaper for creditors to figure out who they're lending to and to figure out information about their ongoing relationships," Athreya says. "This narrative fits together with a lot more facts that are observable than the stigma story does."

It also fits with other economic research. In a recent paper, economist Wendy Edelberg of the Federal Reserve Board documented the increase of high-risk borrowers taken on by creditors in the 1990s. Edelberg argued that technology-savvy creditors were able to in effect partition high-risk debtors from low-risk debtors by pricing them differently. In the end, this had the effect of "democratizing" credit, or lowering the cost of borrowing for a large population.

Methodological Questions

Athreya's research has turned a lot of heads, but it hasn't convinced every-

one. White, for one, isn't so sure that stigma is dead. "I'm not a simulation person. I'm not a fan of that approach particularly," she says, referring to Athreya's model.

"Stigma is still something we don't have any direct information about," White says. "It's hard to test very rigorously. There's a limit to what economists can do."

Within those limits, however, White tends to employ regression models — and therein lies her chief reservation about Athreya's research, which relies on simulation models. It's an ongoing debate among academics, and it is impossible to say with any authority which side is right.

In a nutshell, regression models use historical, empirical data in which households react the same way to market forces. By contrast, simulation models recalibrate household reactions to new market realities. For example: In football, historical data might indicate that lining up in "shotgun" formation would be a good idea all of the time, because in cases when shotgun has been used in the past the quarterback is seldom sacked. But in reality, defenses would adjust to offenses that always used shotgun formation, thus rendering the initial model's results pointless.

In favor of the regression approach are unassailable data: Every value plugged into a regression model is drawn from observable records. As such, regression is widely believed to be the best tool in evaluating big, con-

ceptual problems. But macroeconomists in particular consider the economy a miserable natural experiment. How can you possibly conduct a "natural" experiment in which some 10,000 values are fixed but one small variable is changed? That's what simulation tries to get around.

Athreya agrees that economic inquiries have their limits, but he remains satisfied with his research. He thinks it is the closest economists have come to identifying a value for stigma. And it advances the debate about what should be done, if anything, to reform U.S. bankruptcy policy. There may be no need, after all, for the breast-pounding over America's declining moral standards. "It's hard to figure out what shame looks like. That is what's allowed this story to exist for a long time. It floated in the ether and was hard to pin down," he says. "To kill stories like that you need stories for which everything is observable that fit the facts." Of course, the facts remain much in debate. Athreya, for example, concedes the distinct possibility that both declining stigma *and* declining transaction costs are at play in bankruptcy rates. "I can buy that," he says. "But then the task is, how big is the stigma? A small part? A big part?"

It takes a model to beat a model, Athreya says, and he has yet to see a model that discredits his. But he adds, "My model is certainly not the last word on this." The only shame would be in letting the inquiry drop. **RF**

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