Institutions, Incentives, and Consumer Bankruptcy Reform

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Abstract

Consumer bankruptcy filing rates have soared during the past 25 years. From 225,000 filings in 1979, consumer bankruptcies topped 1.5 million during 2004. This relentless upward trend is striking in light of the generally high prosperity, low interest rates, and low unemployment during that period. This anomaly of ever-upward bankruptcy filing rates during a period of economic prosperity culminated in Spring 2005 in the enactment of comprehensive bankruptcy reform legislation that places new conditions on bankruptcy relief. Although supported by a broad bipartisan consensus on Capitol Hill, these proposals have been controversial within the academy. Critics argued that these reforms are unnecessary and punitive, and that private market adjustments such as higher interest rates and more restrictive credit rationing are suitable policy responses.

Scholars have previously identified two models of the consumer bankruptcy process, the traditional "distress" model and the economic "incentives" model. Neither, however, can explain the observed bankruptcy filing patterns of recent decades. This Article offers a new model of consumer bankruptcy rooted in New Institutional Economics that explains the rise in consumer bankruptcy filings as reflecting changes in the institutions, incentives, and constraints surrounding the consumer bankruptcy filing decision. It is argued that this new model of consumer bankruptcy is both theoretically and empirically superior to the traditional model.

This Article identifies three institutional factors that can explain the observed rise in bankruptcy filings over the past several decades: (1) a change in the relative economic costs and benefits associated with filing bankruptcy; (2) a change in social norms regarding bankruptcy; and (3) changes in the nature of consumer credit, toward more national and impersonal forms of consumer credit. It is argued that all of these factors tend to increase the incentives for filing bankruptcy or reduce the constraints imposed on filing bankruptcy. The result has been to increase the equilibrium level of bankruptcy filings in America.

Finally, the article briefly discusses some policy implications of the model presented here. This discussion focuses on the proposals contained in the Bankruptcy Reform Act recently passed by Congress, but also considers more far-reaching proposals, such as efforts to reverse changes in social norms and proposals to allow contracting-around the mandatory discharge provision of current law.

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