

# Reckless Spending, Not Illness or Job Loss, Causes Most Bankruptcy

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(PhysOrg.com) -- Simple overspending has driven most personal bankruptcies in recent years, a change from previous decades when illness and unemployment were major factors, concludes a new study from the University of California, Davis, Graduate School of Management.

"The reasons people file for personal bankruptcy indeed have shifted during the past couple of decades," says Ning Zhu, the study's author and an associate professor of management at UC Davis. "Although our research supports the notion that adverse life events, like losing one's health or job, contribute to personal bankruptcy filings, excessive consumption contributes more to the recent increase in personal bankruptcy filing."

According to the American Bankruptcy Institute, 2,039,214 personal bankruptcies were filed in 2005, up nearly five-fold from the 412,510 bankruptcies filed in 1985. Indeed, personal bankruptcies jumped from 0.3 percent to 1.8 percent of all U.S. households during the same period.

The UC Davis study looked at all personal bankruptcy filings in Delaware in 2003, because the state was among the first to make its bankruptcy filings available through the Public Access to Court Electronic Record system and its demographics closely resemble those nationwide. The year 2003 was chosen because it allowed the study to follow cases to their conclusion, and permitted observation of filing patterns before 2005. (Filings may have been accelerated in the months

leading up to October 2005, when the federal Bankruptcy Abuse Prevention and Consumer Protection Act took effect, by households wanting to avoid the new act's stricter requirements.)

So that he could compare bankrupt households with solvent ones, Zhu also collected information from the Federal Reserve Board's national Survey of Consumer Finance about households that had never declared bankruptcy.

Overall, Zhu concluded that debt accounted for more than 50 percent of recent bankruptcies, while medical problems caused just 5 percent and unemployment led to only 13 percent.

Zhu found that bankrupt households have bigger mortgages, car loans and credit card balances than solvent ones, but make less than half as much money.

Among bankrupt homeowners, mortgages were 3.21 times higher than annual household income, versus 1.73 times for solvent households. Auto loans were double the annual income for bankrupt households, versus 0.4 times for solvent households. And bankrupt households carried credit card balances that almost equaled their annual household income, while the average credit card balance for solvent households was 6 percent of annual income.

In addition, bankrupt households had a median annual income of \$25,738, versus \$43,341 for solvent ones. (The median is the midpoint in a set of values; a median income of \$25,738 for bankrupt households means that half of the bankrupt households in the study made higher salaries and half made less).

Interestingly, more than 5 percent of bankrupt households owned at least one luxury automobile (average age of the car was 7 years), compared

with 8 percent of solvent households (average age was 8 years).

The study also suggests that some Americans deliberately spend beyond their means with the intention of using the bankruptcy system to erase some or all of their debt, and recommends reforms to discourage such abuse.

"Our results emphasize that bankruptcy law reform should aim to address the issue," Zhu writes. "Current means test focusing on income, rather than consumption patterns or adverse events, may not set the best criteria for sorting out the households who truly need bankruptcy protection from those that consume beyond their means to take advantage of the system."

The research has been presented at Boston College, the Massachusetts Institute of Technology, UCLA and Yale, and will be published in an upcoming issue of the Journal of Legal Studies, a publication of the University of Chicago Law School. The working paper is online at: [www.gsm.ucdavis.edu/Faculty/Zhu/PersonalBankruptcy](http://www.gsm.ucdavis.edu/Faculty/Zhu/PersonalBankruptcy) .

Provided by UC Davis

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