Study: Bankruptcy rates reflect policy, not people

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What do high bankruptcy rates in states like Tennessee and Utah tell us about the people that live in those places? Not much, according to a new 50-state bankruptcy study published in the latest issue of the *Journal of Law and Economics*.

The study, by Brigham Young University economists Lars Lefgren and Frank McIntyre found state-to-state differences in bankruptcy rates are mostly explained by bankruptcy laws, differences in legal institutions, and broad demographic factors. "Our findings don't say much at all about the people involved in bankruptcies," said Lefgren. "In large part, we found that there are different state policies that affect how people respond to financial crises."

Bankruptcy rates vary widely from state to state. Alaska traditionally has one of the country's lowest filing rates—an average one bankruptcy per 1000 individuals from 1999 through 2000. During that same period, the rate in Tennessee, the highest bankruptcy state, was nearly eight times higher. Texas had a rate of three per 1000, but right next door in Oklahoma, the number was double that.

Until now there had been very little research on why these numbers vary so much, according to Lefgren and McIntyre. "Press reports on this have often focused on people," Lefgren says. "What makes the people in high bankruptcy states so different than people in low bankruptcy states? Are they just strange or especially flaky about their debts?"

Not so, the study found.

Lefgren and McIntyre's analysis of 28,000 bankruptcies in all 50 states from 1999 to 2000 found that the best predictor of a state's filing rate is that state's wage garnishment law. Some states have laws that make it more difficult for creditors to dip into a delinquent debtor's paycheck. These states tend to have lower bankruptcy rates, the study found.

"If a state limits a creditor's ability to garnish wages, it's easier for the debtor to ignore the debt, creating an informal default rather than a bankruptcy." Lefgren explains. "But when someone gets slapped with a garnishment, he may be more likely to declare bankruptcy to get out from under it. The result is a larger number of bankruptcies in states where it's easier to garnish wages."

Another factor that increases a state's bankruptcy rate is the fraction of filings under Chapter 13 of the bankruptcy code rather than Chapter seven. Chapter 13 bankruptcies put filers on a payment plan designed to pay back at least a portion of their debts. Chapter seven, on the other hand, generally wipes out debt completely. In most Chapter 13 cases, the filers are unable to keep up with the payment plan, so the bankruptcy is dismissed. At that point, the debtor often files for bankruptcy again.

"So in states where people are pushed toward Chapter 13, we have families filing for bankruptcy multiple times," Lefgren says. "People are being counted in the bankruptcy statistics multiple times for the same debts."

So in reality, Lefgren says, the bankruptcy rate is not a terribly good indicator of default on debt. The amount of unpaid debt might be fairly similar from state to state, but in one state it goes on the books as a bankruptcy, while in another it remains an informal default. Meanwhile, in many states, bankruptcy rates are inflated by multiple Chapter 13 filings.

Taken together, garnishment laws and the fraction of Chapter 13 bankruptcies account for more than half of the state-to-state variation in filing rates.

While most state variation can be attributed to policy differences, the study did find several broad demographic factors that influence bankruptcy rates, such as age and income. Filing rates tend to be higher among those age 25 to 29, with household incomes between 30,000 and 60,0000 dollars. States with larger concentrations of younger, middle class people tend to see higher bankruptcy rates.

Lefgren and McIntyre found that other factors, such as asset exemption rates, often touted to explain bankruptcy rates actually have little influence at all. States that allow filers to keep large proportions of their assets through bankruptcy don't necessarily have higher bankruptcy rates, the study found.

Another factor that doesn't seem to matter: the size of the public safety net. Generous welfare, housing assistance and unemployment compensation programs seem to do little to mitigate a state's bankruptcy rates.

More information: Lars Lefgren and Frank McIntyre, "Explaining the Puzzle of Cross-State Differences in Bankruptcy Rates," *Journal of Law and Economics*, 52:2.

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