Tax rebates boost bankruptcies and why this isn't a bad thing

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Many cash-strapped American families are waiting on their tax rebate to file for bankruptcy, and this trend has gained steam as costs related to filing for bankruptcy have gone up.

Results of the new research are published as a National Bureau of Economic Research working paper by Tal Gross, PhD, an assistant professor of Health Policy and Management at the Columbia University's Mailman School of Public Health, and colleagues at the University of Chicago Booth School of Business and the Olin Business School of Washington University in St. Louis.

The researchers looked at the relationship between tax rebates and bankruptcy filings in 2001 and 2008, two years when many Americans received rebate checks. Total bankruptcies increased by about 2% after the 2001 rebates, and by 7% after the 2008 rebates. This uptick, they say, follows the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act legislation, which raised legal and administrative fees from an average of $921 to $1,477 and mandated credit counseling paid for by the filer. As a result, the number of bankruptcy filings quickly fell by more than half, although they have since rebounded to near pre-2005 levels.

The new rules have been hotly debated. Do they screen-out spurious and unneeded bankruptcies, or do they act as a barrier to those most in need? Dr. Gross says his new research supports the latter scenario. "Bankruptcy can be a Catch-22 when a substantial amount of money is needed to get out of situation defined by having little or no money. If it weren't for these rebate checks, many families would have to postpone filing for bankruptcy for months until they save enough money."

While bankruptcy is often seen in a negative light, Dr. Gross notes that it can be a boon—and not just to individual families. Bankruptcy allows for renewed spending, he says, acting as an economic stimulus. For these reasons, he says, lowering barriers to bankruptcy, as long as they don't encourage excessive consumer borrowing, would be a win-win.

Past research into the motivations for bankruptcy has focused on two areas—the role of short-sighted behavior (a shopping spree) and unanticipated events (a 2010 study by Dr. Gross found that approximately 26% of bankruptcies are driven by medical costs). The new paper may be the first to look at how new filings are affected by high filing costs combined with low cash. This "liquidity constraints" approach, he says, can also be used to study other social benefits like disability and unemployment insurance.

"This research provides a valuable look at the causes and consequences of bankruptcy for families as they make decisions that affect their health and financial security," says Michael Sparer, chair of Health Policy and Management at the Mailman School.

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