CBO TESTIMONY

Statement of
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on
Consumer Debt and Bankruptcy

before the
Subcommittee on Administrative Oversight and the Courts
Committee on the Judiciary
United States Senate

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NOTICE

This statement is not available for public release until it is delivered at 9:30 a.m. (EDT), Friday, April 11, 1997.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman and Members of the Subcommittee, I am pleased to be with you this morning to present some background information on the broad trends in nonbusiness bankruptcy filings at the national level. My statement focuses on the macroeconomic forces that may be driving filings overall, not the specific forces that drive individual filings. To summarize, I will make three main points:

- The rise in nonbusiness bankruptcy filings during the past two years is not unusual from a historical perspective. Nonbusiness bankruptcies have increased during previous economic expansions as well.

- The increase in nonbusiness bankruptcy filings since 1994, like past increases during economic expansions, mirrors an increase in the indebtedness of the household sector.

- The correlation between the increase in nonbusiness bankruptcies and the increase in the indebtedness of the household sector begs the question, Why has household indebtedness grown? Economic research does not provide an answer, but it appears that movements in the indebtedness of the household sector since World War II reflect long-term trends and economic developments in that sector as well as in the markets for consumer and home mortgage credit.

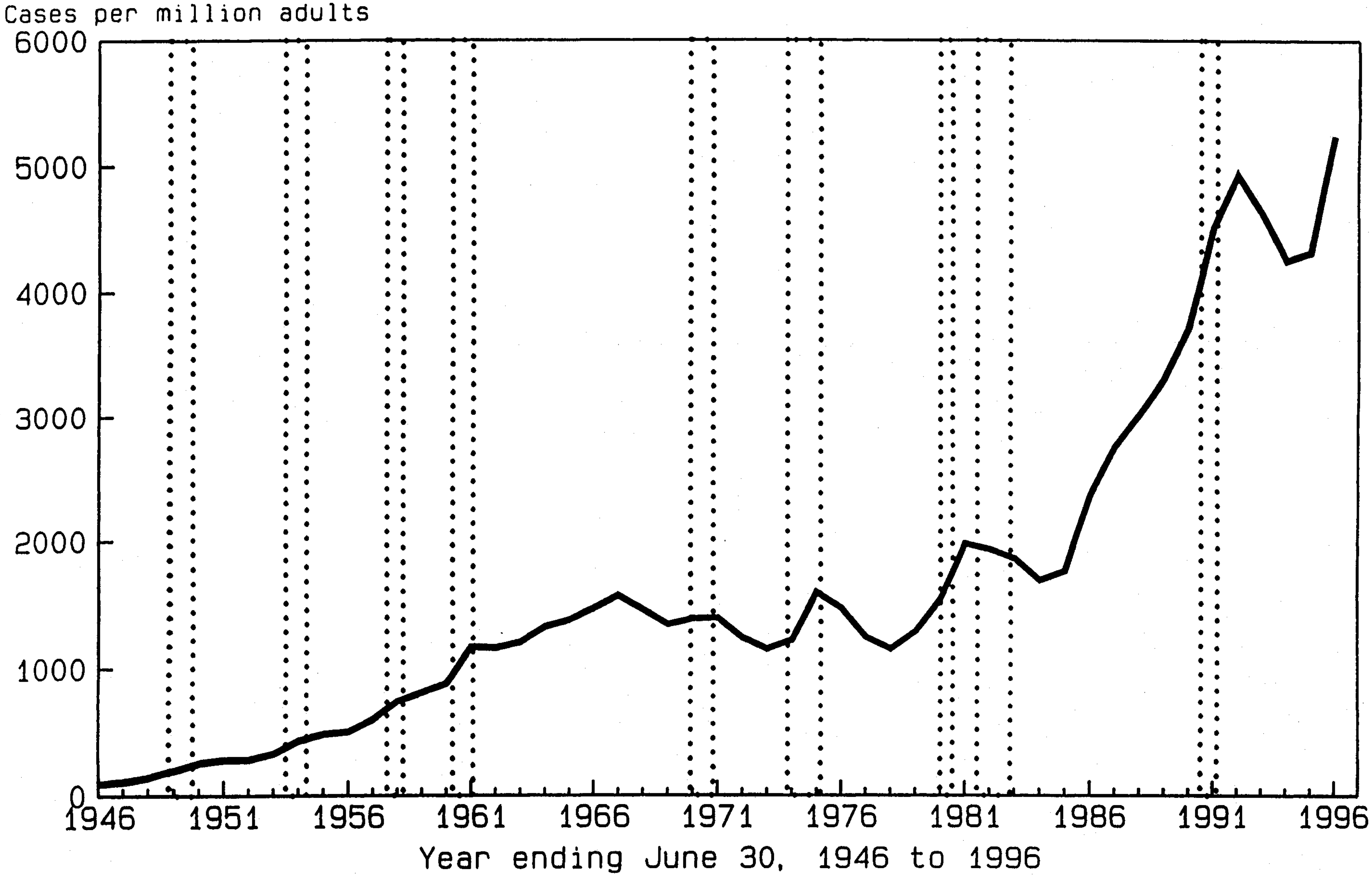
NONBUSINESS BANKRUPTCY FILINGS INCREASED DURING PAST ECONOMIC EXPANSIONS

A common view is that bankruptcies increase during recessions. Many people experience unexpected job and income losses during a recession and find that they cannot make their contractual debt payments on time. Some default on their loans, and some eventually file for bankruptcy. Data on bankruptcies support that common view. However, they also show that nonbusiness bankruptcies have risen even more during periods of economic expansion.

According to the Administrative Office of the U.S. Courts, nonbusiness bankruptcies have increased in every recession during the 50-year postwar period (see Figure 1). Although the 1981-1982 recession appears to be the exception, it was prefaced by a period of substantial economic hardship: the beginning of that decade was marked by a number of unusual developments, including a sharp rise in energy prices, the imposition of consumer credit controls in March 1980 and their removal in July 1980, and extremely tight monetary policy that began in late 1979 and continued until August 1982. Thus, the whole period from the first quarter of 1980 to the fourth quarter of 1982 can be viewed as one long recession rather than a very short one followed closely by a longer, more severe one. Figure 1 clearly shows that nonbusiness bankruptcy cases were higher at the end of the 1981-1982 recession than they were at the beginning of the 1980 recession.

Figure 1

Nonbusiness Bankruptcy Cases



Dotted areas are recessions as defined by the NBER.

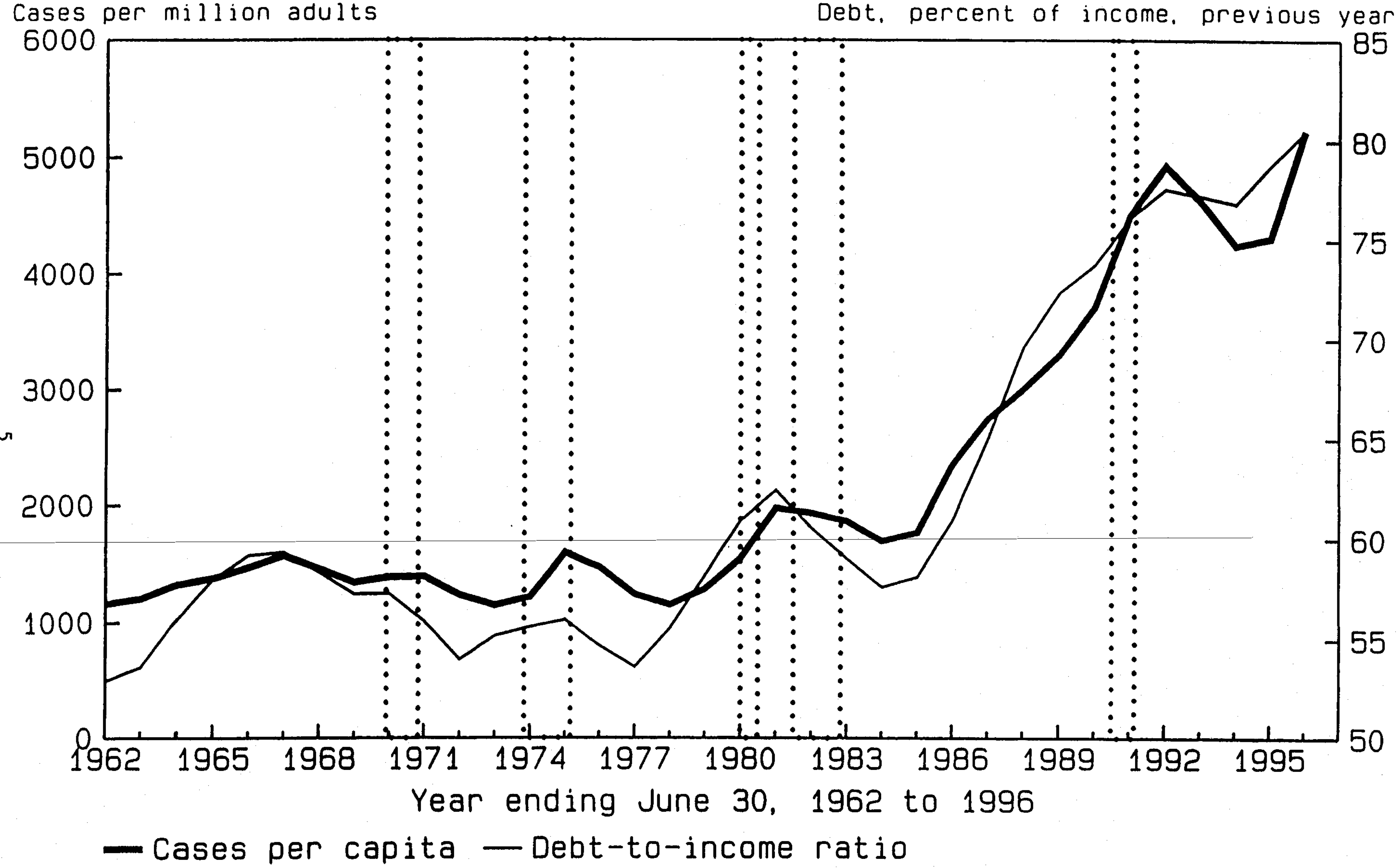
Although nonbusiness bankruptcies have risen during recessions (and typically fallen immediately afterwards), they have tended to increase even more dramatically during economic expansions. Indeed, as Figure 1 shows, most of the rise in nonbusiness bankruptcies during the postwar period occurred apart from recessions. Between 1946 and 1967, nonbusiness bankruptcy cases per million adults rose in every year but one (1962). Such bankruptcies displayed no obvious correlation with the economy's business cycle of boom and bust during that period. Between 1985 and 1990, nonbusiness bankruptcies again rose very rapidly during the economic expansion of those years. They also rose sharply during 1995 and 1996, after falling for two years after the 1990-1991 recession.

NONBUSINESS BANKRUPTCY FILINGS MOVE WITH MEASURES OF HOUSEHOLD INDEBTEDNESS

That nonbusiness bankruptcies increase during periods of economic expansion is not really surprising. The incidence of bankruptcy in the adult population closely follows the indebtedness of the household sector, which typically increases during economic expansions (see Figure 2). Comparing the number of nonbusiness bankruptcy cases per million adults with the ratio of household debt to income in the previous year (which compares indebtedness with ability to pay) also shows that the turning points in the debt ratio closely match those in the bankruptcy series. That

Figure 2

Nonbusiness Bankruptcy Cases and Debt



Dotted areas are recessions as defined by the NBER.

suggests that the amount of time between a change in indebtedness and a change in bankruptcies has remained steady since 1962.

The debt ratio shown in Figure 2 is the sum of home mortgage credit (including home-equity loans) and consumer credit divided by after-tax (disposable) personal income. It represents a more comprehensive measure of household indebtedness than the ratio typically used by economists, which compares consumer installment debt with disposable personal income. That narrow ratio is out of date because it does not include home-equity loans, which have grown rapidly since the Tax Reform Act of 1986 phased out the tax-deductibility of consumer interest payments. Consumers have substituted home-equity loans for consumer installment credit because interest payments on home-equity loans are still tax-deductible.

A casual look at Figure 2 raises a question about the relationship between bankruptcies and indebtedness in the early 1990s. Bankruptcy cases appear to have moved more then—both up and down—than the movements in the debt ratio would suggest based on earlier years, although the relationship appears to be back on track by 1996. Some analysts have suggested that the debt ratio overstates the indebtedness of the household sector because it does not recognize that consumers use credit cards as a substitute for cash; that is, some of the measured consumer debt in a given month is not really debt because consumers plan to repay it in full next month. Although such convenience use of credit cards has indeed inflated the debt

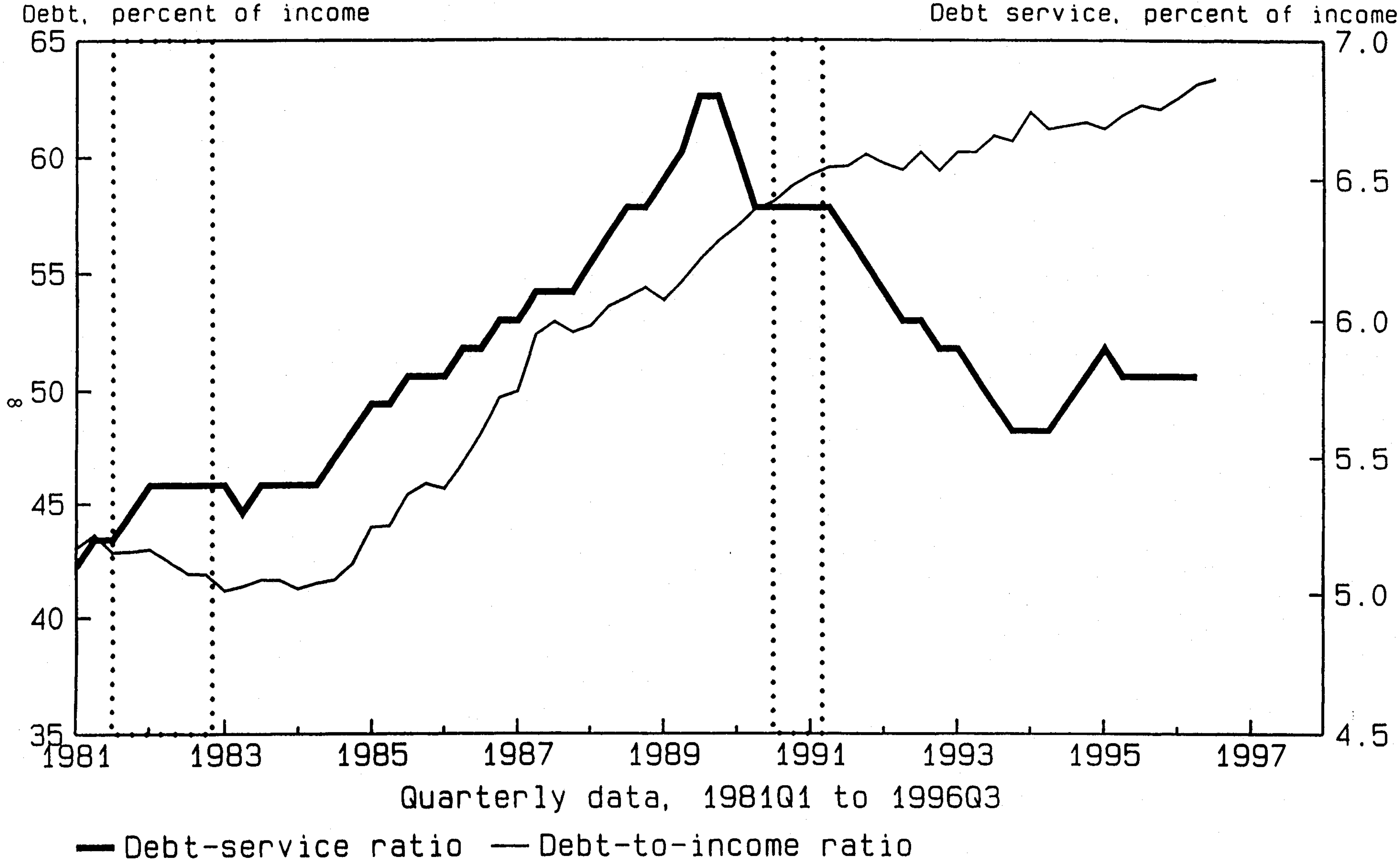
ratio, it has been growing for some time and is not unique to the early 1990s. Moreover, the use of leasing to acquire automobile services rather than outright purchases financed with loans from auto finance companies, banks, and other consumer lenders has lowered the debt ratio. The upward bias of the convenience use of credit cards and the downward bias of auto leasing roughly cancel each other out, leaving the debt ratio about where it is now.

A better explanation for the high level of the debt ratio relative to bankruptcy filings in the early 1990s is the unprecedented amount of mortgage refinancing that occurred then. Figure 3 displays both the debt-to-income ratio and the debt-servicing ratio for home mortgages alone in the 1980s and 1990s. The debt-servicing ratio is principal and interest payments on home mortgages (as estimated by the staff of the Federal Reserve Board) divided by disposable personal income. Notice that the two series moved together fairly closely until the early 1990s, when mortgage interest rates fell to levels not seen for almost 20 years. That drop in mortgage rates spurred many homeowners to refinance their mortgages at lower interest rates, which considerably lowered debt-servicing costs for homeowners but had little effect on the outstanding amount of mortgage debt.

The large role that mortgage refinancing played in temporarily affecting the relationship between nonbusiness bankruptcies and the debt ratio is also apparent in Figure 4, which shows the percentage change in nonbusiness bankruptcy filings per

Figure 3

Home Mortgage Debt Ratios



Dotted areas are recessions as defined by the NBER.

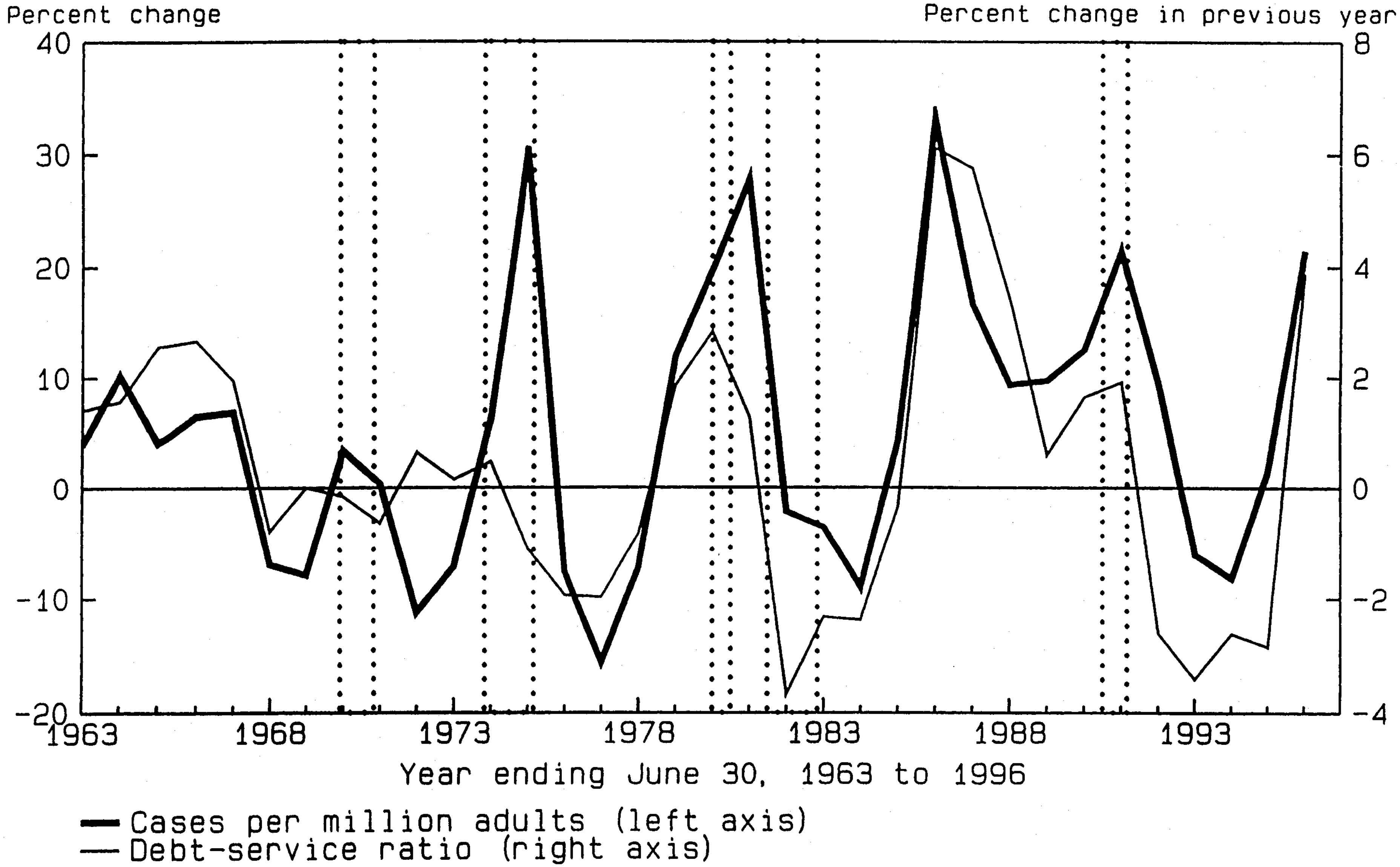
million adults and the percentage change in the household debt-servicing ratio. That debt-servicing ratio is the estimated principal and interest payments on both home mortgage and consumer installment credit divided by disposable personal income. A careful look at Figure 4 does not indicate a shift in the correspondence between nonbusiness bankruptcies and the household debt-service burden in the past 20 years or so, which suggests that the importance of debt for nonbusiness bankruptcies has remained the same.

EXPLANATIONS FOR THE TIME-SERIES BEHAVIOR OF NONBUSINESS BANKRUPTCY FILINGS

Saying that nonbusiness bankruptcy cases follow household indebtedness, however, is a little like saying that obesity follows overeating. It is obvious to everyone that you cannot have bankruptcy without debt. But what explains the indebtedness of the household sector? And what factors affect the decision to file for bankruptcy? In general, the answers relate to the incentives to file for bankruptcy and the factors that determine household decisions about consumption and saving as well as the supply of mortgage and consumer credit. But economists have had limited success in understanding household consumption and saving decisions or how consumer debtors respond to the incentives to file for bankruptcy.

Figure 4

Nonbusiness Bankruptcy Cases and Debt Service



Dotted areas are recessions as defined by the NBER.

One example will serve to indicate the problems of understanding household consumption and saving decisions. The personal saving rate for the nation as a whole fell considerably during the mid-1980s and has remained at a relatively low level since then. At the same time, household indebtedness (and nonbusiness bankruptcies) shot up. But economists are not sure why the personal saving rate fell and, consequently, why household indebtedness rose.

Moreover, very little published research over the past decade has focused on the time-series behavior of total nonbusiness bankruptcies. The research that is available is 10 to 15 years old, and much of it used crude adjustments for economic forces and the incentives to file for bankruptcy.

It seems likely that the shifts in the behavior of nonbusiness bankruptcies and household indebtedness reflect broad trends in the household sector and the supply of credit available to households. The period from 1946 to 1967, when nonbusiness bankruptcy cases rose strongly without regard to the business cycle, encompasses the baby-boom years of 1946 to 1964, when family formation proceeded at a rapid rate. Consumer expectations and sentiment were high, reflecting low unemployment rates, low inflation, strong household balance sheets, and rapid growth of real disposable personal income per capita. Consequently, indebtedness rose rapidly—to finance spending on housing and consumer durable goods—and with it rose nonbusiness bankruptcies.

A marked deterioration in household finances generally occurred from 1968 through 1984. That period was a turbulent one—with food and energy price shocks and rising inflation, two deep recessions on top of a slowdown in the trend growth of real disposable personal income per capita, and postwar highs in short- and long-term interest rates. Consumer expectations and sentiment took nose dives, and consumers became cautious in accumulating debt. They also had less need to make debt-financed purchases of consumer durable goods because the surge in family formation and the baby boom were over. As noted earlier, nonbusiness bankruptcy cases took on a pronounced correlation with the business cycle during that period as external forces dominated changes in family finances.

Household finances have brightened since 1985. A strong economic recovery, a strong stock market, and sharp drops in energy prices, inflation, and interest rates have bolstered the financial health of the household sector. Consumer expectations and sentiment rose to levels not seen since the 1950s and 1960s. The baby-boom generation has been in the midst of its own phase of family formation; spending on housing, furniture, and other consumer durable goods has risen rapidly, as has home mortgage and consumer credit. As the indebtedness of the household sector has increased, so have nonbusiness bankruptcies.

Of course, home mortgage and consumer lenders have played a crucial role in accommodating the household sector's demand for credit. The availability of credit

to households has grown tremendously, particularly in the past 20 years, spurred by technical innovations and competition among lenders, which has made more credit available to households. A simple example from the credit card industry makes the point. The *Wall Street Journal* reported on January 17, 1997, that credit card issuers had mailed 562.8 million credit card solicitations in the third quarter of 1996. That amounts to about three solicitations for every adult in the country. And those figures do not reflect the industry's other main method for signing up customers, telemarketing. The increased availability of credit has undoubtedly made consumers and homeowners better off, but it has also undoubtedly played a role in the increased incidence of nonbusiness bankruptcy.

Apart from those economic factors, some observers have suggested that other factors—such as changes in the bankruptcy code, divorce, a reduction in the stigma of bankruptcy, advertising by lawyers, and fraud and abuse of the bankruptcy code—are responsible for at least some of the rise in nonbusiness bankruptcy cases during the past 20 years. However, divorce is clearly not an important factor in the overall increase: the number of divorces per capita has fallen since reaching a peak in 1981. But because the other factors are difficult, if not impossible, to measure, their importance is harder to evaluate.

Some indirect evidence, however, suggests that those other factors have played at best only a minor role in the rise in nonbusiness bankruptcies. The evidence is

shown in Figure 4: the statistical relationship between percentage changes in nonbusiness bankruptcies and percentage changes in the debt-service ratio appears to have changed very little over the past two decades. If those other factors were important, this statistical relationship should have broken down in recent years; that is, the number of nonbusiness bankruptcies should be greater than the measures of household indebtedness would suggest from historical experience. Such an inference would be incorrect only if those other factors were important and operated solely through the household debt-service ratio. But if they were reflected in the debt-service ratio, home mortgage and consumer creditors would be responsible for allowing those factors to affect household indebtedness and nonbusiness bankruptcies.