When applications for unemployment insurance swamped the system’s administrative capacity, it seemed that bankruptcy applications might do the same. Viewed as giving people a fresh start, personal bankruptcy should be considered an integral part of social insurance—it aims at helping people while correcting for market incompleteness.

In the standard model of economic equilibrium, individuals choose labor supplies and consumption demands that satisfy their lifetime budget constraints. The model has no role for a bankruptcy procedure, because satisfying a lifetime budget constraint implies borrowing only what can be paid back with certainty.

Incomplete markets prevent insuring against all possibilities. An incomplete market equilibrium would be very inefficient if borrowing were limited to what could be repaid with certainty. In practice, people borrow knowing they might not be able to pay back. And people lend knowing that they may not be fully paid back. So, rules are needed to cover failures to pay: good bankruptcy rules help both economic efficiency and income distribution.

Historically, bankruptcy arrangements have included debtors’ prisons and selling debtors into slavery. In the U.S. today, federal bankruptcy law uses two options. A debtor can give up all resources except those exempted, thereby settling debts (Chapter 7); a debtor can propose a repayment plan accepted as sufficient by the court (Chapter 13). What resources to exempt in Chapter 7 and what repayment plans to accept in Chapter 13 are social insurance questions, and can be approached in optimal taxation terms.¹

Viewed as social insurance, it is ironic that the fees paid to the courts and to lawyers are high enough to deter some people from applying for bankruptcy protection; they are referred to as people too poor to go bankrupt. Means-tested subsidization of the cost of bankruptcy would be a natural social-insurance addition. And, temporary rules for bankruptcy in and after a pandemic would recognize that it is harder to fulfill a Chapter 13 payment plan then.

Chapter 13 success could be made more resilient to fluctuations in the debtor’s future income by combining income-contingent debtor payments along with the current rules for creditor receipts. To accomplish this, the federal government could offer the debtor an asset swap. With the swap, the federal government would receive the income-contingent payments from the debtor, while making the standard payments to the creditors. As the creditors already bear the risk of failure of the repayment plan, the government would stop payments to the creditors if the debtor did not make the required payments to the government.²

As an example, the debtor might pay X% of taxable income in excess of $Y. With a stochastic model of debtor incomes and repayment behaviors, the government could equate the expected present discounted values (EPDV) of its receipts and payments. Successful completion of the debtor’s repayment plan

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would then be less sensitive to the state of the economy, an issue of particular importance during and after a pandemic. Such contingent payments offer the debtor better timing of payments (smaller when incomes are smaller). A key element would be the discount rate used in designing the plan. The government could design the plan to break even in expected value over all such swaps, based on the Treasury’s interest rate. For a debtor with a higher discount rate and income that was expected to rise, this would be a smaller EPDV as larger later payments were more likely than with the standard approach. Moreover, explicit subsidization of repayment could be part of a general stimulus program.

Beyond improving bankruptcy for individuals there would be value in doing something similar for small businesses trying to survive in the ongoing pandemic. Indeed, the pandemic challenges us to develop new economic survival strategies. A social-insurance approach to bankruptcy is worthy of further investigation.Indeed, the pandemic challenges us to develop new economic survival strategies. A social-insurance approach to bankruptcy is worthy of further investigation.

ENDNOTES
4. Moreover, recent experience suggests making UI administration federal, as with the Affordable Care Act, thus moving away from the structure that was set in 1935.