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GOING FOR BROKE

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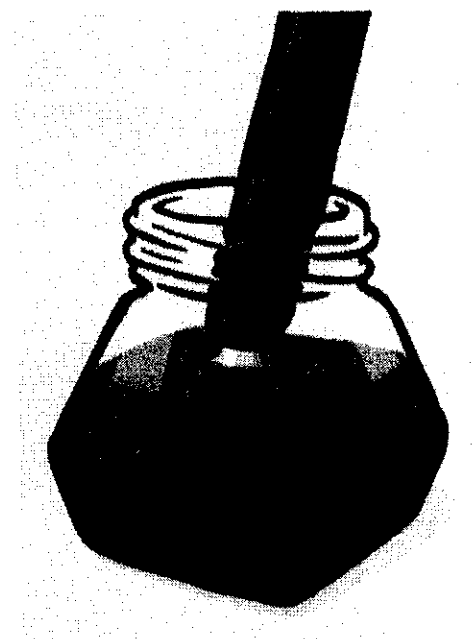

In recent months, a lot of people have been handed financial get-out-of-jail-free cards. C.E.O.s who presided over billions in losses have walked away with tens of millions in compensation. The Federal Reserve has showered cheap money on banks and brokerages. Even Bear Stearns caught a break when, last week, J. P. Morgan agreed to quintuple the price it will pay to take over the firm. But there's one group for whom forgiveness has not been forthcoming: ordinary consumers struggling with piles of credit-card debt. For them, escaping the burden of their bad decisions and their bad luck has become much harder.

That's because of a law that Congress passed in 2005 which has made it more difficult for people to write off their debts. Filing for bankruptcy has become much more expensive. More important, while lower-income people can still declare Chapter 7, which takes away your assets but then discharges your debts, most middle- and higher-income people now have to declare Chapter 13. That means they have to pay their creditors monthly for five years before they're free.

Historically, the U.S. has treated debtors leniently. But the credit-card industry, which was the driving force behind the new law, insisted that tolerance had caused a bankruptcy "crisis": the number of bankruptcies in the U.S. quintupled between 1980 and 2003. Irresponsible debtors, the argument went, were buying plasma TVs and fancy vacations and then declaring bankruptcy to escape their debts. And they were being supported by the rest of us, who had to pay higher interest rates and fees on our credit cards to cover credit-card companies' billions in annual write-offs. Cracking down on those who "abused the bankruptcy laws," President Bush said, would therefore "make credit more affordable." And we'd all be better off.

So are we? That depends on your perspective. The law did slash the number of bankruptcies—they fell by sixty-two per cent between 2004 and 2006. And the credit-card companies should be happy—their profits rose thirty per cent between 2005 and 2007. But the law hasn't done much for anyone else. Interest rates and credit-card fees have not fallen as promised. And for debtors life has become significantly harder: many can't afford bankruptcy—strangely enough, it's possible to be too poor to pay the filing fees—and many others can't qualify. These people will either spend the next five years having their paychecks garnished or simply muddle along, avoiding debt collectors and accumulating huge interest and late fees on their credit cards.

One might say: so what? Even if bankruptcy is sometimes precipitated by bad luck or by an economic downturn, it's always the result of people living beyond their means, and why should they get away scot-free while the rest of us pay our bills? It's a fair question. But there's a reason we did away with debtors' prisons: having millions of people enslaved to their debts is a bad thing for an economy. Putting people into Chapter 13 essentially means they pay a heavy extra tax that goes straight to the credit-card companies. That creates a disincentive for debtors to work, since the more they earn the more they pay. It also takes away spending power—not the best thing during a recession. Making it harder for people to discharge their credit-card debts has other drawbacks as well. Homeowners would once do almost anything to keep up payments on their homes, even if it meant falling behind on other debts. In the past year, though, economists have reported an increase in the number of people who are just walking away from their homes, because it's now often easier to abandon a mortgage than a credit-card bill. (The practice has even been given a name—"jingle mail," because people simply send their keys back in an envelope.) So the new law may very well have exacerbated the housing crisis.

There are long-term disadvantages to tougher bankruptcy laws, too. In the past, America's lenient attitude to bankruptcy encouraged entrepreneurship, by making it easy for people to start over if they failed. (According to one recent study, in fact, more than fifteen per cent of personal bankruptcies are the result of failed business ventures.) A paper by John Armour and Douglas Cumming has found a close correlation between the nature of a country's bankruptcy laws and its rate of self-employment: the more liberal the laws, the more likely people are to start businesses and work for themselves. That's why the U.K. and the E.U. have actually been liberalizing their bankruptcy laws. In toughening our law, we're discouraging people from taking risks, like investing in their own business, or learning a new trade. That will probably mean that we end up fewer business failures, but there'll also be fewer successes.

It's true, of course, that although we want people to get a second chance, we also want them to pay their debts, and a tougher law might have made sense if the U.S. really had been dealing with a crisis. But it wasn't. While the number of bankruptcies soared, the economy as a whole showed no sign of strain; it grew briskly, creating millions of new businesses and new jobs. The credit-card companies themselves were doing fine, too: between 1995 and 2004, as bankruptcies nearly doubled, their profits nearly tripled. In responding to an imaginary threat, we ended up making the economy less dynamic and less flexible. Now that hard times are here, we may find ourselves with a genuine bankruptcy crisis. But it will be one that Congress created. ♦

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