A man in a blue checkered shirt and dark tie is sitting at a wooden desk. His hands are clasped together on the desk. In the foreground, there are several stacks of coins. The background is dark and out of focus.

**A LOOK AT  
BANKRUPTCY  
IN THE TENTH DISTRICT  
AND BEYOND**



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**P**ersonal bankruptcy filing rates have risen dramatically over the past decade. From 1990 to 2003, the national filing rate jumped 103 percent, with a 29 percent increase between 2000 and 2003 alone. The increase was even more marked in the Tenth Federal Reserve District over that period. In 2000, 53 in every 10,000 people over the age of 18 in the Tenth District filed for bankruptcy (see graph on page 21). By 2003, the latest year for which complete data are available, that number had jumped to 75 in every 10,000, a 43 percent increase.

Alarming increases in bankruptcy filing rates over the last decade were largely the impetus for the Bankruptcy Abuse Prevention and Consumer Protection Act, which went into effect in October 2005. The primary goals of the legislation were to steer more petitioners from Chapter 7 (liquidation) to Chapter 13 (reorganization), where more debt would be repaid, and to quash blatant abuses of the bankruptcy system, especially with regard to exemptions.

Congress expressed concerns about the underlying causes of bankruptcy in deliberations over the new law, as effective policy is based on solid research. In an effort to help address these concerns and to inform what will surely be a continuing policy debate, the Community Affairs Department at the Federal Reserve Bank of Kansas City has studied the determinants of nonbusiness bankruptcy filing rates in U.S. counties. An extension of the study investigates regional differences in chapter choice, including the high share of Chapter 7 filings in the Tenth District relative to the nation.

The Community Affairs study evaluates 68 potential determinants of bankruptcy to explore the difference in filing rates across the country. Among the most salient determinants from a policy perspective are state exemption levels and

wage garnishment laws, proximity to gambling establishments, and degree of social stigma associated with bankruptcy filing. The study found that each of these key factors is an important underlying determinant of bankruptcy filing rates.

### **The new bankruptcy law**

Perhaps the most significant change in the new law is the effort to steer more bankruptcy petitioners away from Chapter 7 toward Chapter 13. Chapter 7 requires the liquidation of nonexempt assets, the proceeds of which are distributed to creditors according to a preference system. Exemptions can include personal property and homesteads and are determined by either state or federal statutes. Debts are then immediately discharged, unless they are nondischargeable debts such as court-ordered payments, student loans and certain tax obligations.

Chapter 13 allows debtors to keep their assets, as long as payments are made, while paying creditors—out of future earnings—a portion of what is owed according to a repayment plan developed and administered by a bankruptcy trustee. At the end of the repayment period, which lasts no more than five years, debtors who have fulfilled the requirements of their Chapter

13 reorganization plan will be discharged from the balance of their dischargeable debts. Chapter 7 filings accounted for about 71 percent of all nonbusiness bankruptcies in the United States in fiscal year 2003. In the same year, the proportion in the Tenth District was over 85 percent.

Under the new law, a means test determines, in part, whether or not a petitioner is allowed to proceed under Chapter 7. Specifically, cases in which the debtors have income exceeding the median in their state of residence and, after covering necessary expenses and paying priority debt payments such as alimony, child support, and taxes, are able to contribute a minimal amount toward their debts, will be converted to Chapter 13. The American Bankruptcy Institute estimates that means testing will affect from 3.6 percent to 15 percent of petitioners.

Opinions vary on the likely repercussions of a bankruptcy system tied to a means test. Those who favor the provision believe it will still allow a fresh start for those in need while promoting personal responsibility. Those who oppose means testing believe that standardizing individual situations using median incomes and government-calculated necessary expenses will unfairly hurt many who declare bankruptcy because of “nonstandard” circumstances, such as costly medical conditions or the failure of self-financed startup businesses.

Other provisions included in the new legislation are aimed at curbing abuse. For example, the amount of dischargeable debt attributable to luxury items and cash advances acquired close to the time of filing is reduced as a means of preventing debtors from accumulating large amounts of unsecured debt with the intention of quickly discharging it.

Many of the abuse prevention provisions pertain to exemptions and dischargeability. The most prominent exemption in bankruptcy is the homestead exemption. It allows debtors to exempt either a portion of their home equity or their residence in its entirety. Because non-exempt assets (such as deposit accounts) are easily converted to home equity (i.e., by selling assets and paying off mortgage debt), high homestead exemptions offer protection for all kinds of wealth, not just actual homesteads. Homestead



exemptions vary greatly from state to state. Six states—Florida, Iowa, Kansas, North Dakota, South Dakota, and Texas—have exemptions that are unlimited in value. For other states, the value of the homestead exemption ranges from \$5,000 (Maryland) to \$500,000 (Minnesota), with a mean exemption of \$63,527. Some states allow only their own exemption levels to be used, other states allow debtors to choose either the state or the federal exemption, and a few states have no state exemption, leaving the federal exemption as the only option.

The new bankruptcy legislation requires a longer period of ownership before filing in order to qualify for a homestead exemption, making it harder for debtors to exempt properties purchased immediately before filing for bankruptcy.

Finally, the threshold for dismissal as a result of abuse of the system has been lowered from that of “substantial abuse” to “simple abuse.”

Clearly there is a rising trend in nonbusiness bankruptcy filings, and the new bankruptcy legislation will affect a significant number of future petitioners. The law likely will reduce the proportion of Chapter 7 filings and eliminate some abuses, but tightening bankruptcy law is not an



PHOTOS BY MARIO TAMA/GETTY IMAGES

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**PEOPLE WAIT IN LINE** to enter U.S. Bankruptcy Court Oct. 14. People across the nation filed bankruptcy petitions before the new federal law took effect, setting tougher standards for bankruptcy protection.

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ultimate solution to the alarming increase in bankruptcy filing rates observed across the Tenth District and the rest of the nation.

### **Why so many bankruptcies?**

In the Community Affairs study, three factors stand out as underlying determinants of personal bankruptcies: state exemption levels and wage garnishment laws, proximity to gambling establishments, and the degree of social stigma associated with bankruptcy filing

To examine the effects of homestead exemptions on bankruptcy filing rates, information on homestead exemptions (for a married couple) was collected from a search of the bankruptcy codes for all 50 states and the District of Columbia. A variable was then created for each county to reflect the homestead exemption in its state as a fraction of the median house value in the county. The results indicate that higher

homestead exemption levels are associated with higher bankruptcy filing rates. Specifically, for every percentage point increase in the proportion of the median home price covered by homestead exemption, the bankruptcy filing rate increases by 0.9 filings per 10,000 households. For Missouri, the most populous state in the Tenth District, that would amount to an additional 197 or so bankruptcy filings, or 0.5 percent of annual filings for the year ended June 30, 2005.

When an individual or married couple files for bankruptcy protection, future earnings are protected from garnishment. Federal law protects from garnishment an amount equal to 30 times the federal minimum wage or 75 percent of disposable earnings, whichever is



greater. States are allowed to offer more generous protections, and many do. North Carolina, South Carolina and Texas protect all earnings from garnishment.

The idea behind this exemption is to give bankruptcy filers a “fresh start” and to provide proper work incentives for filers following discharge. Because of this, wage garnishment often spurs bankruptcy filings. Naturally, the greater the amount of an individual’s wages that can be legally garnished, the greater the incentive to file for bankruptcy protection. Hence, bankruptcy filing rates, everything else being equal, are



# The effects of gambling on bankruptcy

Legalized gambling has grown rapidly in the United States over the last two decades, spurred largely by the introduction of gaming on Indian reservations in the 1980s. Commercial gaming expanded shortly thereafter.

Casino gaming in some form—Indian or commercial—is now allowed in 33 states, and gambling of some form, including state lotteries, is allowed in all but two states—Hawaii and Utah. In 2003, the latest date for which complete data are available, consumer gambling losses were \$72.9 billion, suggesting that the total wager in that year was around \$962 billion, which reflects an increase of over 25 percent in four years.

The mechanism whereby gambling would lead to a greater likelihood of filing for bankruptcy is by raising debt levels relative to income. Problem gambling has been shown to increase with the availability of gambling opportunities.

The National Opinion Research Center, in a combined patron and telephone survey, found that the prevalence of “problem and pathological gambling” roughly doubles within 50 miles of a casino. If bankruptcy is associated with problem gambling, therefore, bankruptcy also should be associated with proximity to gambling establishments. The Research Center report revealed that 19.2 percent of “pathological gamblers” have filed for bankruptcy at least once, compared with 5.5 percent for “low-risk gamblers” and 4.2 percent for nongamblers.

The Federal Reserve analysis reveals that the closer a county is to a casino of some type, the higher its bankruptcy filing rate, although the magnitude of the effect is quite small. An additional 100 miles closer to a casino is associated with four additional bankruptcy filings per 10,000 households. Card rooms and race tracks, however, do not appear to have a significant effect on bankruptcy filing rates, and the presence of a state lottery is associated with lower bankruptcy filing rates.

PHOTO ABOVE BY SANTI VISALLI/GETTY IMAGES

expected to be positively related to the proportion of wages that can be legally garnished. The results bear this out, indicating that overall bankruptcy filing rates increase significantly with the proportion of wages subject to garnishment.

The effects of social stigma on bankruptcy filing propensities are impossible to estimate directly because stigma cannot be directly measured. Instead, the effects of stigma must be inferred from other results. To the extent that social stigma varies regionally, geographic variables at least partly will pick up the differences. The idea is that filing for bankruptcy is likely to be less stigmatizing the more that neighbors file for bankruptcy. This is one approach employed here.

Bankruptcy filing rates differ substantially across geographic areas in the United States, but there appear to be patterns that are geographically localized and that cross state boundaries. These patterns suggest that stigma likely plays a role in explaining regional variations in bankruptcy filing rates. Study results indicate that indeed a county’s bankruptcy filing rate is higher if the rate is higher in surrounding counties, and the effect declines as counties get farther away.

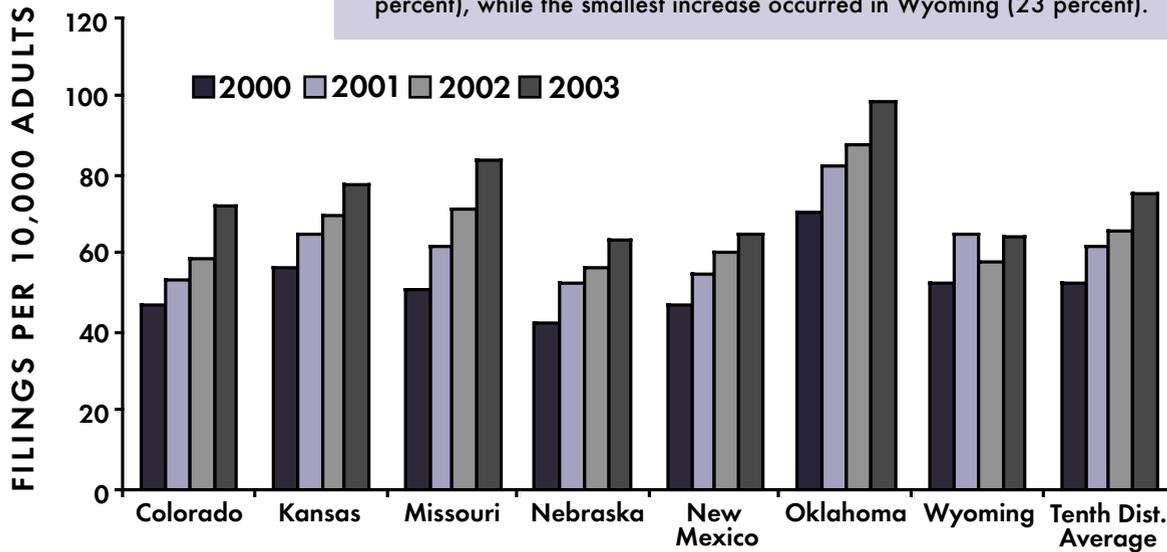
A second way to measure the role of stigma is to include a set of variables representing adherence to various religious groups, with the assumption that different religions have different views on the acceptability of defaulting on debt payments and filing for bankruptcy. The Community Affairs analysis shows that bankruptcy filing rates differ among various religious affiliations, a further indication that social stigma is an important factor in bankruptcy filings.

Numerous other variables were included in the analysis. The proximity of legalized gambling was studied, and is discussed in the sidebar to the left. Demographic variables such as age, race and education level play an important role in explaining differences in bankruptcy filing rates across counties, as does the share of the population that is disabled and the share of the population that is on public assistance. Filing rates also increase with the proportion of the population that does not have health insurance.

Results also indicate that the greater the

## TENTH DISTRICT BANKRUPTCY FILING RATES, 2000 - 2003

AMONG TENTH DISTRICT STATES, Oklahoma consistently had the highest filing rates from 2000 to 2003 while Nebraska had the lowest. The Tenth District portion of Missouri exhibited the greatest increase in the filing rate during the period (61 percent), while the smallest increase occurred in Wyoming (23 percent).



share of the population that is married, and even more so the share that is divorced, is associated with higher bankruptcy filing rates, relative to the share of the population that has never been married. Unsurprisingly, average total debt relative to average income and an index of past due bills for the average person in a county is associated with higher filing rates. Finally, the more vehicles that are owned and the greater the percentage of debt appropriated to autos for the average person, the greater the county bankruptcy filing rate. Greater housing costs also are associated with greater filing rates, but high owner occupancy rates lead to lower filing rates.

### A new era in bankruptcy

The new bankruptcy law likely will have some effect on filing rates by curbing abuses and forcing more petitioners into a reorganization plan that requires them to pay part of their debts. The Community Affairs study suggests that exemption and garnishment laws also should be evaluated to ensure that consumers are offered some protection and a fresh start without being given too much incentive to engage in risky financial behavior that may lead to bankruptcy.

But efforts to change consumer behavior through education likely will have the greatest impact, as many of the factors shown to affect

bankruptcy filing rates, such as gambling, debt composition, home ownership, and prompt payment of bills, are reflections of financial decisions, and good decisions require considerable knowledge.

Congress recognized this in the new law, which also requires that bankruptcy petitioners see a credit counselor before filing for bankruptcy and take a personal finance course before being granted discharge from debts. With this in mind, the Community Affairs Department of the Federal Reserve Bank of Kansas City currently is undertaking a related study designed to evaluate the efficacy of personal finance courses in changing financial behavior.

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## FURTHER RESOURCES

NEW INSIGHTS IN THE DETERMINANTS OF REGIONAL VARIATION IN PERSONAL BANKRUPTCY FILING RATES

[www.KansasCityFed.org/TEN](http://www.KansasCityFed.org/TEN)

**COMMENTS/QUESTIONS** are welcome and should be sent to [teneditors@kc.frb.org](mailto:teneditors@kc.frb.org).