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G. Ray Warner

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BANKRUPTCY REFORM AND ECONOMIC RECOVERY

G. RAY WARNER*

INTRODUCTION

In 2005, following years of intensive lobbying by the consumer credit industry¹, the focus of the consumer bankruptcy law was changed from the liberal debtor-focused “fresh start” approach embodied in the 1978 Bankruptcy Code to a creditor-focused “can pay/must pay” approach. Although the shift to a can pay/must pay system started years earlier to address perceived abuses,² the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005³ (“BAPCPA”) completed that shift by engrafting onto the bankruptcy law a fairly strict and largely objective test for determining a debtor’s ability to repay debt and by setting forth channeling rules designed to force debtors with a perceived ability to repay some debt into a lengthy repayment plan.⁴

The focus of the debate about that change has been on the debtor. Proponents of the change have phrased the reforms in moralist terms. They tend to set forth a narrative of widespread moral failure among those debtors using the bankruptcy system, and they use morally charged terms like “substantial abuse,” rather than more neutral terms like “eligibility” to

* Associate Dean for Bankruptcy Studies and Professor of Law, St. John’s University School of Law. Thanks to my research assistant, Bankruptcy LL.M. candidate, George Klidonas, for his excellent assistance in researching issues addressed in this essay.

¹ See Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 485, 498-99 (2005) (noting role of consumer credit industry in spearheading bankruptcy reform effort).

² A 1984 amendment to the Bankruptcy Code permitted dismissal of chapter 7 cases for “substantial abuse” and imposed a requirement that chapter 13 debtors contribute their “disposable income” to plan payments. See Bankruptcy Amendments and Federal Judgeship Act of 1984, PUB. L. NO. 98-353, 98 Stat. 355 §§ 312, 317, *codified at* 11 U.S.C. § 707(b) (2010); 11 U.S.C. § 1325(b)(1)(B) (2010). These changes were made in response to concerns that non-needy debtors were filing bankruptcy. See *In re Krohn*, 886 F.2d 123, 126 (6th Cir. 1989).

³ Pub. L. No. 109-8, 119 Stat. 23 (2005).

⁴ See 11 U.S.C. § 707(b) (establishing a “means test” based on disposable income as a requirement for relief under chapter 7). See also 11 U.S.C. § 1325(b)(3)-(4) (2010) (incorporating certain § 707(b) living expense limitations for above-medium income debtors and replacing the 3-year plan provision).

describe the debtors determined to have an ability to repay.⁵ Opponents of the change have similarly focused on the debtor, arguing that the indebtedness causing resort to the bankruptcy system does not equate to moral failings by debtors and focusing on the debtors' need for relief from burdensome indebtedness.⁶

Largely missing from the debate is consideration of the possible macroeconomic effects of the 2005 BAPCPA changes to the bankruptcy law. The purpose of this brief essay is to explore the role that the consumer bankruptcy system plays in economic recovery after periods of economic recession like the current "Great Recession." My thesis is that consumer bankruptcy policy plays an important role in economic recovery and that the shift to a can pay/must pay system will both dampen and delay recovery from economic recessions.

Like it or not, at present our economy is driven by consumer spending. During a recession jobs are lost, incomes fall, debt amounts increase and asset values decline. As the recession begins to ease, individuals who have lost jobs or otherwise suffered a decline in income will obtain new jobs or see their incomes begin to rise. As the newly employed consumers begin to spend additional income, that spending has a multiplier effect in the economy, it stimulates additional economic growth and additional jobs and helps to accelerate the recovery.

As previously unemployed or underemployed consumers⁷ begin to see increased income, they will consider bankruptcy as an option to protect their income from creditor collection actions such as garnishment. The prior liberal fresh start policy, by permitting debtors to discharge their debts in chapter 7 liquidation bankruptcies, allowed these newly employed debtors immediately to begin spending their increased incomes on consumption rather than debt repayment. That spending helps accelerate economic recovery.

The BAPCPA amendments, if effective, will instead divert almost all of the newly-employed debtors' discretionary income from consumption to debt repayment, and it will do so for a period of five years. Since debt repayment has a very low multiplier effect, the macroeconomic effect of

⁵ See, e.g., Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 1999 B.Y.U. L. REV. 177 (1999).

⁶ See, e.g., Robert M. Lawless et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349 (2008).

⁷ As of October 2009, the national unemployment rate was more than 10 percent, with the underemployment rate standing at nearly 18 percent. Economic News Release, *Alternative Measures of Labor Underutilization*, Bureau of Labor Statistics (November 6, 2009), available at <http://data.bls.gov/cgi-bin/print.pl/news.release/empsit.t15.htm> (last modified May 07, 2010).

the BAPCPA change to a can pay/must pay bankruptcy system will be to both reduce and greatly delay the economic stimulus effects of the increased income received by deeply indebted consumers. With more than 1.3 million U.S. households filing personal bankruptcy in the past year,⁸ the effect of this change in bankruptcy could be significant.

Additionally, the bankruptcy change likely has a shadow effect that extends well beyond merely those individuals who actually file bankruptcy. The lack of a viable bankruptcy alternative for many debtors provides incentives for creditors to take more aggressive steps to collect debts that otherwise would have been charged off or renegotiated and the likely bankruptcy outcome shapes the private debt restructuring negotiations between consumer debtors and their creditors.⁹ Further, since BAPCPA diverts all additional discretionary income to debt repayment for five years, it reduces the incentives of deeply indebted individuals¹⁰ to seek additional income.

The bankruptcy system has long been an important tool for dealing with economic crises by allowing overly indebted individuals to start fresh as economic actors following periods of depression or recession. A similar credit industry sponsored can pay/must pay approach that also was based on claims of abuse by consumer debtors was rejected during the Great Depression.¹¹ However, with BAPCPA, the consumer credit industry finally got its wish—just in time for the Great Recession. While the idea that the discharge of debt in bankruptcy might be good for the economy seems counter-intuitive, a morally appealing can pay/must pay system may cause far more harm than good.

⁸ Despite the current law's can pay/must pay approach that limits the benefits of bankruptcy relief, the Administrative Office of the U.S. Courts reports that 1,344,095 non-business bankruptcy cases were filed during the fiscal year ending September 30, 2009. James C. Duff, Administrative Office of the United States Courts, Judicial Business of the United States, 2009 Annual Report of the Director 291 tbl. F-2 (2009), available at <http://www.uscourts.gov/Statistics/JudicialBusiness/JudicialBusiness.aspx?doc=/uscourts/Statistics/JudicialBusiness/2009/JudicialBusinesspdfversion.pdf> (last visited May 27, 2010).

⁹ For example, the absence of an ability to force a write down of mortgage debts in bankruptcy has given mortgage lenders no incentive to negotiate realistic mortgage restructuring agreements.

¹⁰ With consumer debt levels at near record highs, a large segment of the consumer population is deeply indebted. Household consumer debt represented 122% of disposable personal income in 2008, down from a high of 128.1% in 2007. In contrast, household consumer debt represented only 76.1% of disposable personal income in 1990. See Mark Jickling, *Consumer Bankruptcy and Household Debt* (Oct. 22, 2008), available at www.Bna.com/webwatch/bankruptcy3.pdf (last visited May 27, 2010).

¹¹ Charles J. Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 27 (1995) (discussing the rejection of a can pay/must pay approach to discharge during the Great Depression).

I. HISTORICAL USES AS A RECOVERY TOOL

For much of our history, there was no federal bankruptcy law. Up until the Bankruptcy Act of 1898, federal bankruptcy laws were passed in response to serious economic crises and were of short duration. As Professor Tabb has explained:

Each instance of federal legislation followed a major financial disaster: the Act of 1800 followed the Panic of 1797; the Act of 1841 followed the Panic of 1837; the 1867 Act followed the Panic of 1857 and the Civil War; and finally the 1898 Act was passed in the wake of the Panic of 1893.¹²

Although these laws generally dealt with business debtors, consumer spending was not a major pillar of the American economy so discharge of business persons was necessary to restart economic activity. For example, although the Panic of 1797 “caused widespread financial ruin and the imprisonment of thousands of debtors,” the Act of 1800 provided an opportunity to discharge those debts and allowed many financiers and speculators to resume their earlier activities.¹³

The practice of using bankruptcy laws to address economic crises continued even after the bankruptcy law became permanent in 1898. During the Great Depression, Congress passed several pro-debtor amendments designed to address the effects of the Great Depression. Although some of these measures were stricken down by the Supreme Court, the effort to reshape bankruptcy law into a tool for financial rehabilitation culminated in the passage of the Chandler Act in 1938.¹⁴ Unlike the BAPCPA amendments, the primary focus of and impetus for the pre-Code bankruptcy laws was to deal with general economic calamity, rather than the relief needed by particular debtors.

The basic structure set forth by the Bankruptcy Act of 1898 and the Chandler Act amendments endured until the 1978 Bankruptcy Code. The Bankruptcy Code was the product of years of study to modernize the bankruptcy laws and represented the first major bankruptcy legislation that was not a response to some economic crisis.

¹² *Id.* at 14.

¹³ *Id.* at 14-15. Among those affected by the Panic were Robert Morris, a principle financier of the revolution who was imprisoned because of \$12 million in debts, and a Supreme Court Justice, who had to flee to avoid imprisonment. *Id.* at 14.

¹⁴ *Id.* at 29 (highlighting the changes brought on by the Chandler Act).

II. EROSION OF THE FRESH START

The Bankruptcy Code represented the high water mark for the liberal consumer debtor fresh start policy. Although the modern liberal discharge and fresh start policy was embodied in the Bankruptcy Act of 1898, the 1978 Bankruptcy Code expanded the scope of relief available to individual debtors. Initially, there were only a few limited types of debts that were excepted from discharge and a consumer debtor could obtain a broad discharge under chapter 7 once every six years in exchange for turning over his or her non-exempt assets.¹⁵ Although a consumer debtor could choose to file a chapter 13 bankruptcy and repay some or all debt through a voluntary repayment plan, the chapter 7 “walk away” discharge allowed consumer debtors to protect all of their future income from creditors, regardless of ability to repay.

A series of amendments over time both limited the scope of the discharge and imposed some restrictions on the ability of debtors to obtain a walk away discharge. The precursor to BAPCPA was a 1984 amendment that allowed the bankruptcy court to dismiss a chapter 7 petition if the granting of chapter 7 relief constituted a “substantial abuse”, and that required chapter 13 debtors to contribute their disposable income to the debt repayment plan under certain circumstances.¹⁶ Although there was a statutory presumption in favor of the debtor’s choice of chapter 7 relief, courts mostly ignored the presumption and eventually focused on the ability to repay debts as a primary factor for determining substantial abuse.¹⁷ This had the effect of adding a mild can pay/must pay feature to consumer bankruptcy because debtors with a substantial ability to repay their debts were forced into a chapter 13 repayment plan or out of bankruptcy altogether. However, the effects of that change on the economic impact of bankruptcy was limited for several reasons: first, the courts generally used a subjective reasonableness test based in part on the debtor’s pre-bankruptcy standard of living to determine the debtor’s reasonable living expense allowance and how much disposable income was available for debt repayment; second, the required duration of the chapter

¹⁵ See 11 U.S.C. § 523(a)(1)-(9) (2010) (listing types of debt excepted from discharge); 11 U.S.C. § 727(a)(8) (2010) (noting that discharge will not be granted if a case was commenced under chapter 7 or 11 within 8 years of the new filing); see also H.R. REP. NO. 95-595, at 363, 384-85 (1977).

¹⁶ See Bankruptcy Amendments and Federal Judgeship Act of 1984, PUB. L. NO. 98-353, 98 Stat. 355 (1984).

¹⁷ See David B. Harrison, *Bankruptcy: When Does Filing of Chapter 7 Petition Constitute “Substantial Abuse” Authorizing Dismissal of Petition Under 11 U.S.C. § 707(b)*, 122 A.L.R. FED. 141 § 2(a) (1994) (noting that courts focus on the ability to repay in determining substantial abuse).

13 plan was only three years, rather than the current five year repayment period; and third, the substantial abuse test generally required a showing that the debtor had the ability to repay a substantial part of his or her debts through a chapter 13 plan and considered a variety of factors in addition to ability to repay debt.¹⁸

In contrast, BAPCPA replaced the mild can pay/must pay approach with a very strict approach. Linguistically, the prior “substantial abuse” standard for dismissing a chapter 7 case was replaced with a mere “abuse” standard. Further, the statutory presumption in favor of the debtor’s choice of chapter 7 relief was removed. More importantly, the bankruptcy court’s subjective determination of disposable income was replaced with a largely objective test based on the relatively frugal living allowances set forth in the IRS Collection Standards. For most categories of expenses, the debtor’s disposable income is determined based on national or local averages, and not on the actual expenses of the debtor or the needs of the debtor’s family. Subtraction of the monthly living allowance from the debtor’s available income produces a figure for “disposable income” that is deemed to be available for debt repayment. The most extreme feature of the new test is that the debtor is deemed to be abusing chapter 7 if that calculation shows disposable income of as little as \$182.5 per month and, in some cases, as little as \$109.58 per month.¹⁹

If the very low threshold of \$182.50 per month in disposable income is reached, then the debtor’s only bankruptcy choice is to enter into a repayment plan under chapter 13.²⁰ That plan must then commit all of the debtor’s “projected disposable income” to debt repayment for a period of the next five years. The combined effect of these provisions is to divert the discretionary income of most middle and upper income debtors from consumption to debt repayment. This removes that income from the consumer economy and deprives the economy of the stimulus effect that such income would otherwise have.²¹ Indeed, since the threshold is

¹⁸ See *id* (discussing some of the limitations of forcing chapter 7 debtors into chapter 13).

¹⁹ See 11 U.S.C. § 707(b)(2)(A)(i)(I)-(II) (2010). Chapter 7 petitions filed by debtors earning less than the median income are not subject to the mechanical test, but can be dismissed under a more subjective abuse standard. See 11 U.S.C. § 707(b)(1), (b)(7A) (2010). The exclusion of these debtors from the mechanical formula should have little impact on the economic effect of the bankruptcy law because they likely have very little discretionary income.

²⁰ A chapter 11 repayment plan is also an option for some debtors, but the disposable income requirements of a chapter 11 plan for a non-business debtor are virtually identical to the chapter 13 plan requirements.

²¹ The test’s exclusion of regularly scheduled secured debt repayments (e.g., monthly mortgage payments and car loan payments) from disposable income will permit many middle and upper class debtors to qualify for chapter 7 relief. See 11 U.S.C. § 707(b)(2)(A)(I), (iii) (2010). However, in those cases the income still is being diverted to debt repayment rather than new consumption. Further, since

determined by objective IRS allowance amounts, which in some cases may not be sufficient to provide the household's reasonable support needs, BAPCPA may in some cases remove income from the system that is not really disposable. Further, the BAPCPA effect will continue for the first five years of economic recovery, delaying the full reentry of these households into the consumer economy during a critical phase of the recovery.

While the present analysis is limited to the economic effects of debt repayment within the bankruptcy system, a complete analysis would include consideration of the shadow effects of the change in bankruptcy law on debtors who do not file bankruptcy. The BAPCPA changes make bankruptcy relief unattractive for most can pay debtors and may make it completely unavailable in those cases where the allowances are too low to meet the needs of the debtor's family. Those can pay debtors who chose not to file bankruptcy will not receive a discharge of their debts and will not be free to fully reengage in the consumer economy. If they attempt to repay their debts either voluntarily or as a response to creditor actions, the diversion of income from consumption to debt repayment will be similar to that accomplished within bankruptcy by the BAPCPA amendments. The economic effect may even be worse for such debtors if the creditors' collection efforts cause additional problems. For example, collection efforts like garnishment may lead to job losses²² and the risk of collection may reduce the debtor's incentives to seek additional income, at least in the legitimate above-ground sectors of the economy.

III. FISCAL MULTIPLIER EFFECTS

While there is vigorous debate in economic circles about the validity and accuracy of analyses based on the Keynesian multiplier model,²³ the

mortgage and automotive debt cannot be adjusted in bankruptcy even when the value of the asset has fallen far below the outstanding debt amount, *see* 11 U.S.C. §§ 1322(b)(2), 1325(a)(9) (2010) (unnumbered "hanging" paragraph), the repayment of the undersecured portion of these debts is comparable to repayment of other unsecured debt. This is not a minor point since at present the principal amount owed on many consumer mortgages exceeds the value of property. *See* Bob Tedeschi, *Mortgages; The Depths of Mortgage Debt*, N.Y. TIMES (Aug. 30, 2009) (*available at* http://www.nytimes.com/2009/08/30/realestate/30mort.html?_r=1) (reporting that more than one-third of all mortgaged homes in the United States were worth less than the mortgage debt amount as of June 2009).

²² While an employer may not discharge an employee because of a garnishment for a single debt, garnishments based on more than one debt may result in firing. *See* 15 U.S.C. § 1674(a) (2010). Further, continued indebtedness may have a negative impact on employment prospects, credit reports, and other opportunities that may be worse or last longer than the impact of a bankruptcy filing.

²³ *See*, PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 638-43 (19th ed. 2010 McGraw-Hill Irwin).

modern mainstream Keynesian approach is “the best way to explain the business cycle in market economies.”²⁴ The multiplier model posits that “each dollar change in exogenous expenditure (such as investment) leads to more than a dollar change (or a multiplied change) in GDP [gross domestic product].”²⁵ The reason for this is that an endless, but ever diminishing chain of secondary consumption spending is set in motion by the primary investment.²⁶ The size of the multiplier (i.e., the amount of resulting change in GDP for each dollar injected) depends on the marginal propensity to consume [MPC].²⁷ The MPC refers to the portion of any new income received that will go to consumption, as opposed to “savings.” For example, if we assume that 75% of each new dollar will be spent on consumption and 25% on savings, then the MPC is .75. If the MPC is .75 and we add \$100 to the system, then GDP will grow by \$400.²⁸ Of course, there is a time lag before the entire effect is felt because of the delay between each successive round of secondary consumption spending. Thus, most estimates of the fiscal multiplier effects of particular stimulus measures predict the effect over a specific time period. Nonetheless, since the multiplier effect is largest in the earliest rounds of secondary consumption spending, most of the impact comes from the early rounds of spending.

However, since the demand created by the increase in overall consumption spending does not by itself increase the available supply of goods and services, the multiplier effect on GDP would not be observed during periods when the economy is already operating at full production capacity, because the economy cannot produce more output regardless of demand.²⁹ But, during periods of recession or depression, when there is a surplus of unused labor and other unused resources, the injection of new dollars to increase consumption spending will stimulate additional production, and thereby increase GDP and aid in the recovery from the recession or depression.

IV. THE FISCAL EFFECT OF DEBT REPAYMENT

So how does the forced repayment of consumer debt affect GDP growth?

²⁴ *Id.* at 638.

²⁵ *Id.* at 437.

²⁶ *Id.* at 441.

²⁷ *Id.* at 440-41.

²⁸ \$100 yields $(1.0)(100) + (.75)(100) + (.75)(75) + (.75)(56.25) + \dots = \400 . See PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 441 (19th ed. 2010 McGraw-Hill Irwin).

²⁹ *Id.*

It does this by diverting part of the debtor's income from consumption to savings. This reduces the percentage of income available for consumption and thus reduces the MPC, which in turn reduces the size of the multiplier. To take the simplest model, a household can devote its personal disposable income to either consumption or savings.³⁰ Consumption, or personal consumption expenditure, is the expenditure by a household on final goods and services. Savings, as used in this sense is not limited to what might be considered savings in the common usage of that term, but rather includes all personal disposable income that is not devoted to consumption.³¹ Viewed from the fiscal multiplier perspective, savings is leakage from the system since it represents that part of income that does not generate a change in GDP (at least in the short term).³²

This simple model shows the dampening effect of forced debt repayment on economic growth. As noted earlier, the BAPCPA standard for abuse will force above-medium income debtors out of the chapter 7 walk away bankruptcy process if they are determined to have as little as \$182.50 a month in discretionary income (called "disposable income" in section 707(b)), with that figure being as low as \$109.58 per month in some cases. The only bankruptcy option for these households is to use chapter 13. However, in chapter 13, they will be required to commit all of their "projected disposable income" to debt repayment for the next five years, unless the debt can be fully repaid earlier. While there are some differences between the "disposable income" used to determine abuse under section 707(b) and the "projected disposable income" that the debtor is required to commit to debt repayment during the five year chapter 13 plan,³³ the intended effect of these combined changes is to divert virtually all discretionary income (i.e., income over the amount necessary for basic support) from consumption to debt repayment.³⁴ Since debt repayment is a form of "savings" and the BAPCPA changes are designed to divert all of the debtor's disposable income to debt repayment, the debtor's MPC for income earned in excess of the BAPCPA expense allowance would be zero. In the simple model, this means that the disposable income received by deeply indebted individuals in bankruptcy will produce no increase to

³⁰ *Id.* at 408.

³¹ *See Id.*

³² *See Id.* at 565.

³³ *See* 7 WILLIAM L. NORTON JR. & WILLIAM L. NORTON III, NORTON'S BANKRUPTCY LAW & PRACTICE § 151:22, p. 151-117 *et seq.* (3d ed. 2009).

³⁴ The extent to which this effect materializes turns on how strictly courts interpret and apply these provisions.

GDP during the first five years of the recovery phase.

Of course, this model is too simple and overstates the anti-recovery effect of the BAPCPA changes. A dollar is a dollar, and one might ask why a dollar devoted to debt repayment has less economic impact than a dollar devoted to consumption. Won't the creditor spend part of the dollar it receives on consumption, just like the producer of the goods or services would have? Or, might the creditor spend part of the dollar on investment that would in turn generate future economic growth? The answers to these questions turn largely on who the creditors are.

For example, if the consumer debtor owes money to another consumer who has the same MPC as the original consumer, then presumably the multiplier effect on GDP will be the same for debt repayment as it would have been for consumption, although that effect may be delayed. However, if the creditor has a different MPC than the consumer debtor, that could result in either a higher or lower multiplier effect on GDP. MPC varies by income level, with wealthier people having a lower MPC than poorer people.³⁵ Thus, if one assumes that the holders of consumer debt are investors with relatively higher incomes than the consumer debtors, then the BAPCPA changes have a depressive effect on GDP growth, even after accounting for the income effect of debt repayment on the recipient.

A few examples of multipliers illustrate this point and suggest that BAPCPA has a negative effect on GDP growth. In February of 2009, the Congressional Budget Office estimated the range of the multipliers for transfers to persons (e.g., unemployment compensation) at a high of 2.2 to a low of 0.8 over several quarters.³⁶ While the disposable income of consumer bankruptcy debtors may not be identical to wage replacements like unemployment compensation, these figures at least provide some idea of the extent of the multiplier effect of that income. In contrast, the multipliers for a one year tax cut for high income persons ranged from a high of only 0.5 to a low of 0.1 over the same period. Again, while tax cuts may not be identical to debt repayment income for higher income creditors, these figures suggest that income from debt repayment has a low

³⁵ Samuelson, *supra* note 24, at 411. See also JOHN M. KEYNES, *The General Theory of Employment, Interest and Money*, 96 (1936) (noting that while aggregate consumption depends on aggregate income, consumption will not increase at the same rate as income).

³⁶ Letter from Douglas W. Elmendorf, Dir., Cong. Budget Office, to Honorable Judd Gregg, Comm. on the Budget, U.S. Senate 9 tbl. 2 (Feb. 4, 2009), available at <http://www.cbo.gov/ftpdocs/96xx/doc9619/Gregg.pdf> (last visited June 6, 2010); see also Statement of Douglas W. Elmendorf, Director, Cong. Budget Office, before the House Comm. on the Budget, *The State of the Economy and Issues in Developing an Effective Policy Response* 27 tbl. 5 (January 27, 2009), available at http://www.cbo.gov/ftpdocs/99xx/doc9967/01-27-StateofEconomy_Testimony.pdf (last visited June 6, 2010).

multiplier. Multiplier estimates by some private economists similarly support the proposition that debt repayment has less stimulative impact than consumption. For example, Mark Zandi, Chief Economist of Moody's Economy.com, estimates that extended unemployment benefits will have a multiplier effect of 1.73 in the first year, compared to a first year multiplier of only .37 for tax cuts on dividends and capital gains,³⁷ income sources of the same type as debt repayment income. These figures suggest that the BAPCPA diversion of disposable income from consumption to debt repayment has a dampening effect on economic recovery, even assuming that the consumer debt is held by individuals who may devote at least some of the repayment income to consumption.

However, the data on consumer debt suggest that only an infinitesimal amount of consumer debt is held directly by other individuals. Instead, institutions or investment pools hold almost all of the U.S. consumer debt.³⁸ Only 1.9% of the outstanding consumer debt is held by non-financial businesses,³⁹ a category that might include a significant portion of high income individuals who might exhibit an MPC similar to the investor MPC discussed above. An additional 25% of outstanding consumer debt is held by pools of securitized assets.⁴⁰ While the investors in such pools may include high income individuals, they likely account for only a small portion of the pool investors and, even then, their investments may be in the form of pension investments or retirement savings that do not correlate to current consumption.

More than two thirds of the outstanding consumer debt is held by financial institutions. Thus, the simple equation needs to be refined further to account for the impact that repayment of debt to these institutions might have on domestic GDP growth. While the transfer of debt repayment income to a commercial bank or other financial institution represents leakage from the system, it may be offset if those dollars are used by that institution for additional investment in the domestic economy. Thus, a somewhat more accurate formula for overall GDP must include both consumption spending and investment spending. In terms of the effect that

³⁷ *Economic Stimulus for Small Business: A Look Back and Assessing Need for Additional Relief Before the H. Comm. on Small Business*, 110th Cong. 5 (July 24, 2008) (written testimony of Mark Zandi, Chief Executive and Co-Founder, Moody's Economy.com).

³⁸ Federal Reserve Statistical Release G.19, *Consumer Credit September 2009* (November 6, 2009), available at <http://www.federalreserve.gov/releases/g19/20091106/> (last visited June 7, 2010).

³⁹ *Id.* \$48.3 billion out of the total of \$2.465 trillion in outstanding consumer credit was held by non-financial businesses.

⁴⁰ *Id.* \$618.3 billion out of the total of \$2.465 trillion in outstanding consumer credit was held by pools of securitized assets.

BAPCPA has on the economic impact of the debtor's "disposable income" as defined by bankruptcy law, the formula would be: disposable income minus debt repayment plus new investment by the creditor. While the additional investment by the creditor will add to GDP eventually, its impact will be delayed and will likely only affect longer term GDP growth rates. Thus, even if one makes the highly improbable assumptions that all of the diverted income will be reinvested by the financial institutions and that the total multiplier effect of the investment is the same as the multiplier effect for consumption, the investment expenditures are unlikely to have much immediate impact on GDP growth or to assist in the recovery from a recessionary period.

In the current economic climate, it is clear that the assumption of reinvestment is not justified. Repayment to pools of securitized assets will not result in any direct additional investment since those pools are not designed to reinvest the income they receive. Further, the Great Recession has caused many financial institutions to fail and left most others in serious financial difficulty with insufficient capital or insufficient reserves. As a result, lending to consumers and businesses by financial institutions has largely dried up. Despite massive infusions of government bailout funds that were designed to encourage these institutions to begin lending again, they have mostly failed to do so.⁴¹ Commercial banks hold 33.7% of outstanding consumer debt, with savings institutions holding an additional 2.9%.⁴² Consumer debt repayment to these institutions will result in virtually no additional investment, and no current GDP growth. Finance companies, which hold an additional 21.2% of the outstanding consumer debt,⁴³ may be more likely than commercial banks to reinvest debt repayment income in new loans, but many are similarly in financial difficulty. Credit unions, which hold 9.8% of the outstanding consumer debt,⁴⁴ appear to be in better financial shape than other financial institutions and may reinvest debt repayment income in additional loans. Even if this is correct, overall only a very small portion of the income diverted from consumption to the repayment of debt held by financial institutions will result in new investment.

The other major holder of U.S. consumer debt is the federal government

⁴¹ Testimony of Til Schuermann, Vice President, Federal Reserve Bank of New York, before the Congressional Oversight Panel for the Troubled Asset Relief Program (May 28, 2009), available at <http://www.newyorkfed.org/newsevents/speeches/2009/sch090528.html> (last visited 1/19/2010).

⁴² See Federal Reserve Statistical Release *supra* note 39

⁴³ *Id.*

⁴⁴ *Id.*

and Sallie Mae, representing 5.4% of the outstanding consumer debt.⁴⁵ Since the federal government, unlike state governments, is not required to balance its budget, there is no direct correlation between income received by the government and government spending. Thus, although government spending does result in an increase in GDP, the BAPCPA diversion of income from consumption to the repayment of debt held by the government does not produce any offsetting increase in GDP.

Finally, the domestic economy is not a closed system. The effect of both foreign investors and foreign debt holders must be considered in calculating the impact BAPCPA has on domestic GDP growth. In an open economy, like ours, the multipliers are lower than in a closed economy because of the leakage caused by transfers to non-U.S. holders of debt.⁴⁶ Debt repayment to non-U.S. holders has no stimulative effect on the domestic economy, except to the extent that the creditor reinvests the debt repayment income in new investments in the U.S. economy or uses those funds to consume U.S. exports. In an open economy, both domestic and foreign holders of U.S. consumer debt are free to invest the additional debt repayment income provided by BAPCPA in foreign economic ventures. In both instances, this would represent leakage and reduce the domestic economic impact of the debtor's disposable income. However, it may be less likely that foreign holders of debt will repatriate the debt repayment income to U.S. investment than that domestic holders will. Thus, the existence of non-U.S. debt holders further reduces the domestic economic impact of the disposable income earned by debtors in bankruptcy.

CONCLUSION

Total domestic economic output, or domestic GDP, is the sum of consumption, investment, government expenditure and net exports.⁴⁷ As discussed above, the BAPCPA can pay/must pay approach to bankruptcy retards the economic stimulus impact of the consumer bankruptcy system. BAPCPA's diversion of disposable income from consumption to debt repayment reduces the debtor's MPC to zero with respect to that income for a five year period. The creditors' receipt of extra debt repayment income does not offset this loss to GDP growth. This is because the repayment will have little offsetting impact on the investment component

⁴⁵ *Id.*

⁴⁶ *Cf.* SAMUELSON, *supra* note 24 at 565 (stating that open economy multipliers are lower than closed economy multipliers).

⁴⁷ SAMUELSON, *supra* note 24, at 443,565.

of GDP, virtually no offsetting impact on the government expenditure component of GDP, and, depending on the extent of consumer debt held by non-U.S. entities, may have a negative impact on the net exports component of domestic GDP. Finally, even to the extent that debt repayment income is returned to U.S. households, the consumption component of domestic GDP will be reduced because the debt holders likely have a much lower MPC than consumer debtors.

While there may be policy reasons to adopt a BAPCPA style can pay/must pay consumer bankruptcy system, those must be weighed against the bankruptcy system's role as an economic recovery tool.