

# Household Bankruptcy Decision: the role of social stigma vs. information sharing

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# Personal Bankruptcy in the US: An overview

- Historically, bankruptcy was seen as anything but an individual choice:
  - Creditors would file and show that the debtor 'committed an act of bankruptcy'—akin to fraud;
  - Associated with truly draconian penalties.

## Example

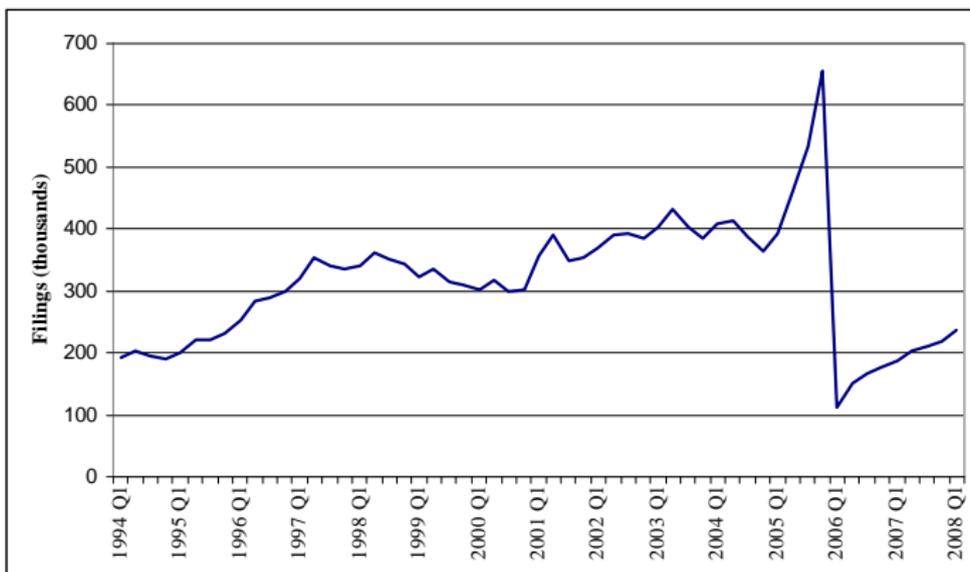
'To disgrace the bankrupt, [his] hair would be cut off..his palm would be branded with the "T" for thief and he would be mandated to stand in a public square for two hours with an ear nailed to the pillory and then cut off.'

- Currently, the US has two different personal bankruptcy procedures, Chapter 7 and 13.
- All unsecured debt, with some exceptions, is discharged, but not secured loans.

# The 2005 Reform: Bankruptcy Abuse Prevention and Consumer Protection Act

- Response to rising bankruptcy rates and lobbying by lenders.
- Intended to restore the stigma associated with bankruptcy.
- Key changes were threefold:
  - No right to choose between Chapter 7 and Chapter 13: replaced by a “means test”;
  - No right to propose repayment plans in Chapter 13;
  - Greatly raised filing costs (actual filing fees, credit counseling, and detailed procedures).

# Figure 1: Bankruptcy Filings



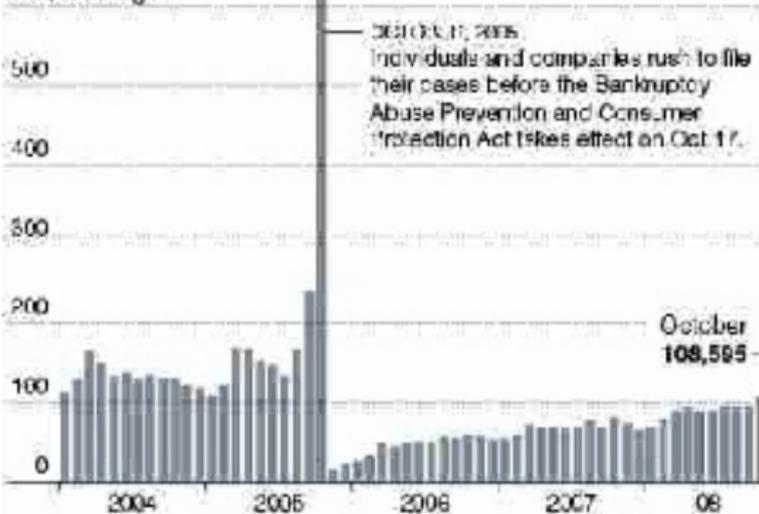
# Figure 1: Bankruptcy Filings

## After a Dip, Filings Climb Again

Bankruptcies are rising, despite a law change in 2005 that made it more difficult, and expensive, for individuals to file.

### BANKRUPTCY FILINGS

000,000 filings



source: NY Times November 19, 2008

## Existing Explanations:

- Commonly discussed explanations for rising bankruptcy rates:
  - Adverse events, such as unemployment, health shocks, and divorce.
  - Changes in the credit market environment:
    - ① Decreased transaction costs, and expansion of credit including to riskier households (supply side);
    - ② Decreased costs of filing for bankruptcy, including legal and information costs, as well as social stigma (demand side).
- Our focus is this last item—the role of social factors.

## Why focus on these social phenomena?

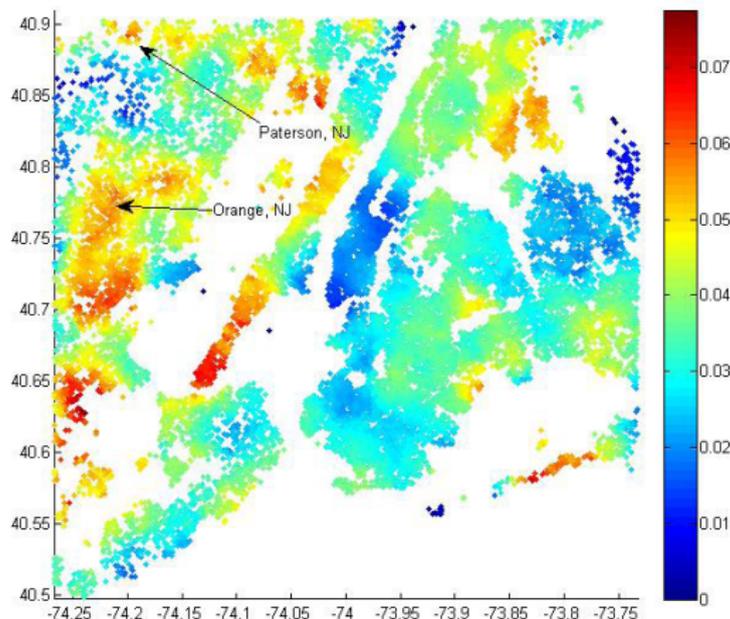
- Much discussion and anecdotal evidence about the role of stigma and changes in social attitudes:
  - A recent Wall Street Journal article: “Now, Even Borrowers With Good Credit Pose Risks.”
  - Bank of America CEO: “There’s been a change in social attitudes toward default.”
  - Sociologists continue to provide quotes showing that stigma is still strong and alive: “I thought of [bankruptcy] as a mark against my name. . . It was too embarrassing. . . I feel like I failed. You know, to go bankrupt, that’s a sign of failure.” w
- And also among economists: Gross and Souleles (2002), Fay et al. (2002), Athreya (2004), Chatterjee et al. (2007), Livshits et al. (2007).

# How do these social factors matter?

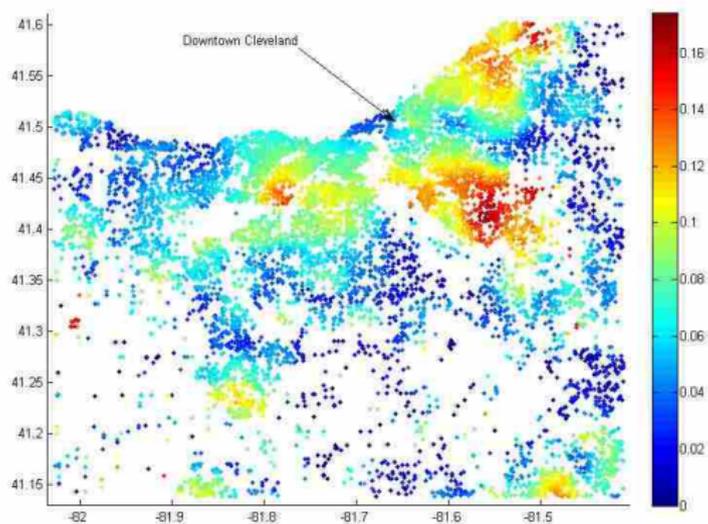
- Interacting with others who have gone bankrupt or are in the process may increase the likelihood of an individual going bankrupt herself, because:
  - The idea that “everybody does it” reduces the associated embarrassment, or social stigma associated with bankruptcy;
  - People share information and learn from one-another about eligibility, application procedures, and other bureaucratic details of filing.

# New York/New Jersey Bankruptcy Rates

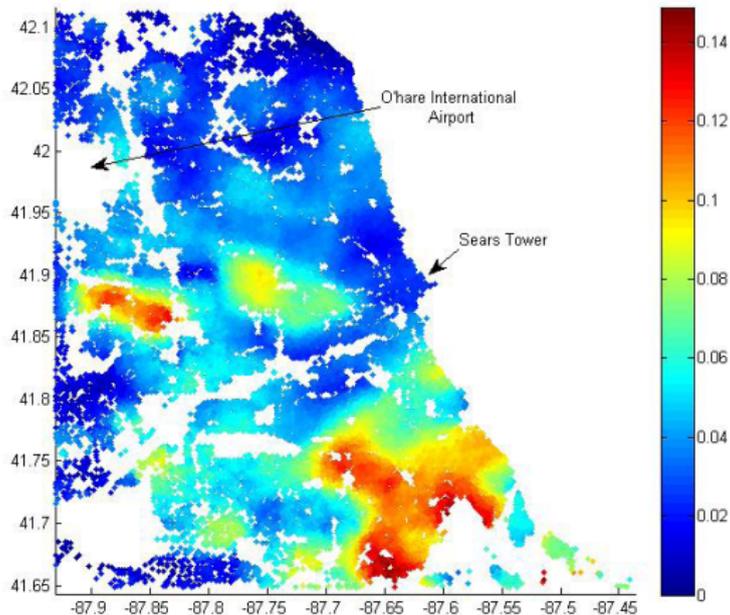
- Bankruptcies appear to 'cluster' - even in rich areas. Evidence that more than prices may play a role.



# Cleveland Bankruptcy Rates



# Chicago Bankruptcy Rates



# This Paper

- Main Questions:
  - To what extent can we explain the trend?
  - To what extent can de-coupling information and stigma effects help us understand the trend and/or the observed clustering?
- Using (a lot of) data from a credit bureau and a new methodology based on the sociology literature, we
  - analyze the empirical relevance of aggregate influences on individual decisions,
  - disentangle the role of separate channels—stigma and informational factors;
  - and comment on their role in explaining the observed bankruptcy trends.

# The sphere of social influence

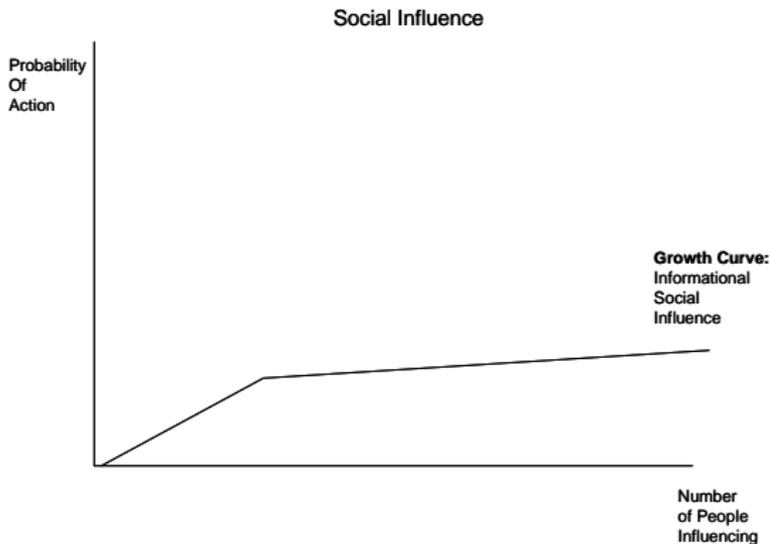
- If individuals condition choices on actions of others, on whom do they base these decisions?
  - Social Interactions studies have used a wide range of criteria from classrooms and schools to local neighborhoods.
  - Social influence can originate in one or more of these.
- We use two levels of influence, both much smaller than a state.
  - Individuals that live within a 1 mile radius: Close neighbors, associates, friends, relatives.
  - Individuals that live 1–4 miles away: Acquaintances, repeat interaction strangers, etc.

# Social Influence, continued

- Recall that we are interested in understanding the social components of the bankruptcy decision.
- For decomposition:
  - Information effect: acquisition of information.
    - If my neighbor went bankrupt, perhaps he can share the institutional details involved.
    - If a stranger who lives 3 miles away did, we are less likely to share information.
  - Stigma: shame associated with bankruptcy.
    - My status on the 'block' will change once it becomes known that I went bankrupt.
    - The perceptions and nature of the shame will depend on how society as a whole views bankruptcy.

# Informational Influence

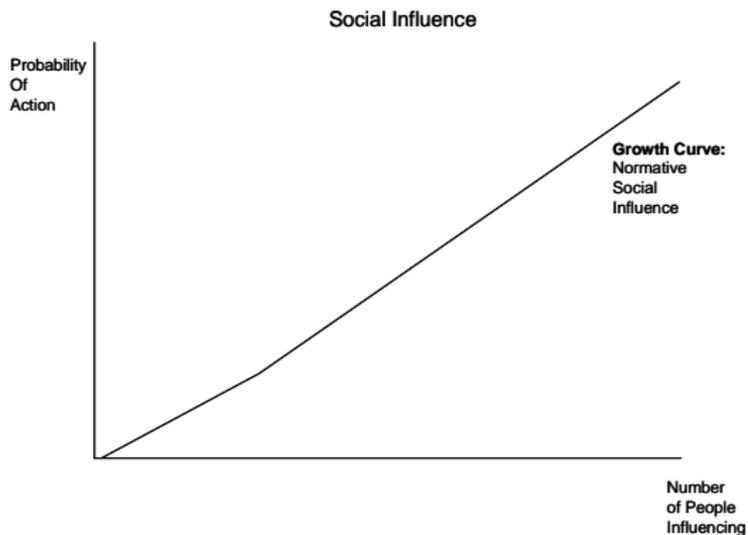
- Informational influence:



- More people providing information does not necessarily increase probability.
- May lead to some resolution of uncertainty, but no change in psychological desire for action

# Social Influence, continued

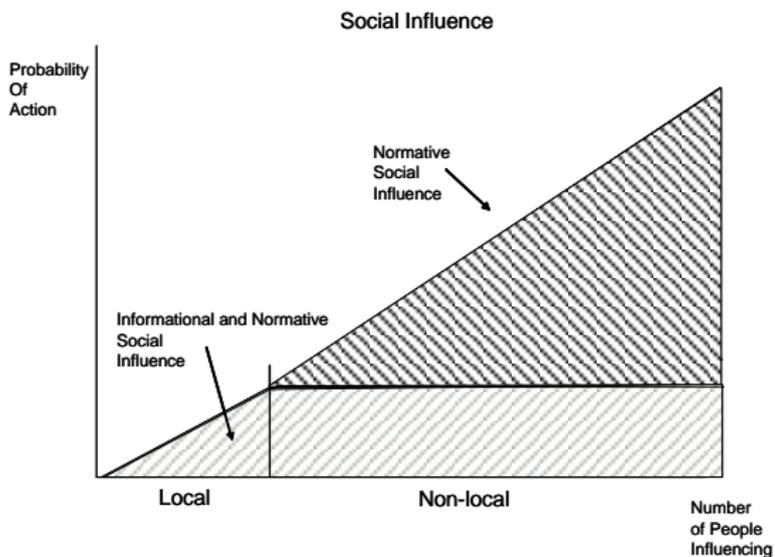
- Normative social influence:



- More people providing pressure does increase probability.

# Social Influence and identification

- Wedge provides identification method



# Credit Bureau Data Plus Census

- US credit bureau
  - 4 national samples: June 2003, December 2004, June 2006, December 2007;
  - First two are large samples of about 285,780 individuals each;
  - Latter two are HUGE samples of 27,000,000 individuals each.
    - 1 in 9 sample of all US households with credit.
- Includes typical information available in a credit history on all open credit accounts.
  - Many advantages w.r.t. measurement error;
  - Detailed geo-code info;
  - No individual level income and employment information.
- Complement with census data on avg. hh. incomes, health insurance coverage, and unemployment rates at county/neighborhood level.

# Summary of Findings

- Social Factors (3-11%) matter more than other controls including risk factors ( $\ll .1\%$ ):
  - On average societal stigma dominates the role of information, especially post 2005;
  - Both information costs and stigma seems to have indeed decreased in this period;
  - But changes in information sharing, not stigma, is the more likely factor behind the observed bankruptcy patterns.
- More interestingly, these aggregate patterns hide a very high degree of heterogeneity.

## Summary of Findings (cont'd)

- Possible link between social context and the strength of social interactions:
  - Do higher income groups share less information?
  - Does bankruptcy stigma differ by education level?

## Summary of Findings (cont'd)

- By subdividing our data into 25 groups (five education and income quintiles) and re-estimating social interactions effects for each, we indeed show that:
  - Stigma is stronger amongst the poorer and less-well educated communities;
  - Information effects are largely constant across groups

## Summary of Findings (cont'd)

- What can we surmise about the patterns?
- As the press has emphasized, stigma has *declined* amongst many groups
- But, stigma has *increased* poorest and least well educated
  - On balance, stigma changes cannot explain the rise in rates

# Conclusions:

- Social effects have impacted bankruptcy rates, but not in way previously expected
- There are important socio-economic drivers of social effects;
- This suggests need for further work on economic risks
  - Cannot explain bankruptcy on their own
  - Seem to influence social effects