Comments on "Borrowing During Unemployment: Unsecured Debt as a Safety Net," by James X. Sullivan, and "Measuring Negative Effects of Bankruptcy Filing for Homeowners: Reduced Credit Access and Lost Option Value," by Cheryl Long

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Let me start with Sullivan's paper, "Borrowing During Unemployment: Unsecured Debt as a Safety Net." Here is a quick summary of the paper. Families face uncertain income flows; some of the fluctuations are permanent and others transitory. Only the transitory uncertainties can be offset by private borrowing or saving as well as public transfer programs without causing a decline in consumption. This is the so-called private versus public insurance. Sullivan observes that unsecured consumer borrowing, or credit card borrowing for ease of language, has surged tremendously since the early 1980s. He then asks in this paper: Are households using unsecured debt to help smooth earnings during periods of temporary declines in income, as identified by temporary unemployment spells in the paper? The answer is not much, especially poor households.

This paper is very well done. I will make only two comments that will perhaps help us understand the results and their policy implications. First, it is important in these types of exercises that the drop in income identified, or the unemployment spell as in the paper, be truly transitory, especially ex ante from the household's point of view. Of course, this is not an easy task. Sullivan has done as many controls as he possibly can. For example, he picked households in a particular year that had temporary unemployment spells but were employed the following year. But these types of controls are typically ex post. At the end of the day, one cannot help noticing that the identified unemployment spells are more severe for poor households: They tend to last longer and are associated with bigger percentages of income drop. This suggests that the unemployment spell identified in the paper is, perhaps, more permanent for poor households. As a result, poor households don't borrow to smooth the associated income drop.

My second comment has to do with the many public policies designed to help households in this type of situation. The first thing that comes to mind is the unemployment insurance program. Sullivan has controlled for state-level unemployment insurance. However, given that the PSID contains information on households' transfer income, it is worth taking a direct look at these households' transfer income, poor households in particular. Are they taking any public money? If so, how much? And if not, why not?

The conclusion of Sullivan's paper is that households are not borrowing credit card debt to help smooth consumption. What are they borrowing for then? Are families increasingly living beyond their means? If so, what is the outcome? These questions lead to the second paper I am discussing today, "Measuring Negative Effects of Bankruptcy Filing for Homeowners: Reduced Credit Access and Lost Option Value," by Cheryl Long.

As the title suggests, Long addresses a very important question in her paper, especially in light of the surging personal bankruptcy filing rate and the surging homeownership rate in recent years. It certainly makes important contributions to the literature by focusing our attention on the longer term cost of filing for personal bankruptcy: the reduced access to future credit and the lost option to file again. I like the main thesis of the paper. However, I do have two main concerns about the execution of the analysis and the interpretation of the results.

First, as already pointed out by many researchers, more homeowners file for personal bankruptcy under Chapter 13. In principle, there is no limit on the frequency of filing for bankruptcy under Chapter 13. A person can file as often as he wants. In practice, there is often a 180-day requirement between two filings, which is far shorter than the six years requirement under Chapter 7 and the assumption in the paper that a person cannot ever file again. In other words, homeowners' lost option value to file again may be far smaller than that calculated in the paper.

My second concern has to do with Long's failure to incorporate in the analysis laws governing mortgage default, such as foreclosure law, and their interaction with bankruptcy law. For example, a bankruptcy filing puts an automatic stay on the foreclosure process and can delay the process for six months to one year, depending on the state the debtor resides in. During this time, the debtor effectively lives rent free in his house. In addition, many states also have a deficiency judgment that allows mortgage lenders to apply the difference between the mortgage and the current house value to the debtor's other assets.

A household in financial difficulty often cannot meet its payments on credit card debt or a mortgage loan, or both. Given the interaction between foreclosure law and bankruptcy law, a debtor may optimally choose his default sequence. Imagine two scenarios. In the first, the household wants to keep the house. So it files for bankruptcy hoping to use the additional income to meet the mortgage payment. However, the income drop that led the household to the situation in the first place turns out to be more permanent than the debtor had thought. The debtor ends up losing the house after filing for bankruptcy. In the second scenario, the debtor knows that he cannot possibly keep the house. Foreclosure is imminent. So he files for personal bankruptcy, and the foreclosure process is automatically stopped. The bankruptcy process lasts one year. As a result, the filer lives in the house rent free for one year. He loses the house after the close of his bankruptcy case. In both scenarios, the debtors lost their houses after bankruptcy filing, but it is not because bankruptcy filing made their access to future credit difficult.

Having said this, I do believe there are costs associated with bankruptcy filing, in terms of both future credit access and lost option to file. Long has taken a useful first step in addressing these issues. Further analysis would require the modeling of the institutional arrangements and more detailed bankruptcy data.