Optimal Bankruptcy Code: A Fresh Start for Some

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Abstract

What is the optimal consumer bankruptcy law? I answer this question using an incomplete markets life-cycle model with a planner who can choose state-contingent bankruptcy costs. I develop two main theoretical characterizations. First, whenever debt discharge is allowed, it should occur without cost. Second, bankruptcy should always be allowed for highly-indebted households. Quantitatively, the optimal policy can generate a welfare gain as large as 11.6%. However, attractive informal default, asymmetric information, and moral hazard can reduce the welfare gain to as little as 0.7%.

JEL Codes: D14, D52, D91, E21, K35

Keywords: Bankruptcy, Life-cycle Models, Incomplete Markets

1 Introduction

Bankruptcy policy varies greatly by time and location. In many European countries, there is little to no debt forgiveness. Bankruptcy laws in the United States, on the other hand, are widely considered pro-debtor. Moreover, views on the proper amount of debt forgiveness have changed dramatically over the last two hundred years. In the U.S., debtors' prisons have been replaced with a relatively swift bankruptcy process, which, until recently, offered a near-complete discharge to almost everyone. In 2005, the Bankruptcy Abuse Prevention

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