

Accepted Manuscript

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PII: S0165-1889(17)30219-1
DOI: [10.1016/j.jedc.2017.10.005](https://doi.org/10.1016/j.jedc.2017.10.005)
Reference: DYNCON 3483

To appear in: *Journal of Economic Dynamics & Control*

Received date: 14 August 2017
Revised date: 9 October 2017
Accepted date: 22 October 2017

Please cite this article as: Grey Gordon, Optimal Bankruptcy Code: A Fresh Start for Some, *Journal of Economic Dynamics & Control* (2017), doi: [10.1016/j.jedc.2017.10.005](https://doi.org/10.1016/j.jedc.2017.10.005)



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Grey Gordon[†]

October 26, 2017

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

*I thank Kartik Athreya, Satyajit Chatterjee, Daphne Chen, Hal Cole, Bulent Guler, Aaron Hedlund, Juan Carlos Hatchondo, Aubhik Khan, Dirk Krueger, Amanda Michaud, Victor Ríos-Rull, Pierre-Daniel Sarte, Michèle Tertilt, Julia Thomas, and Eric Young, as well as anonymous referees. I also thank conference participants from the European Meeting of the Econometric Society 2014, Computing in Economics and Finance 2014, Midwest Macro 2013 and 2014, and a UIUC mini-conference in 2014, as well as seminar participants at Florida State University, the Ohio State University, and Purdue University.

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