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The effect of personal bankruptcy exemptions on investment in home equity ☆

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ABSTRACT

Homestead exemptions to personal bankruptcy allow households to retain their home equity up to a limit determined at the state level. Households that may experience bankruptcy thus have an incentive to bias their portfolios toward home equity. Using US household data for the period 1996–2006, we find that household demand for real estate is relatively high if the marginal investment in home equity is covered by the exemption. The home equity bias is more pronounced for younger and less healthy households that face more financial uncertainty and therefore have a higher ex ante probability of bankruptcy. These results suggest that homestead exemptions have an important bearing on the portfolio allocations of US households and the extent to which they insure against bad shocks.

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1. Introduction

Individuals who file for personal bankruptcy according to Chapter 7 of the US bankruptcy code can generally retain some assets. Specifically, at the state level there tend to be exemptions for certain asset classes up to specific thresholds. The main exemption is the homestead exemption, which enables the filer to retain home equity in his primary residence (‘‘homestead’’) up to the exemption amount.[1] The homestead exemption ranges from $0 in Maryland to an unlimited amount in eight US states, including Florida and Texas, in 2006. Personal bankruptcy is quite common in the US, with about one million Chapter 7 filings in 2009, and homestead exemptions therefore frequently apply.

Limited liability, as implied by the ability to declare personal bankruptcy, provides households with some consumption insurance against possible negative income and wealth shocks. Zame (1993) shows that contingent debt repayment, implicit in the possibility of bankruptcy, can be welfare improving in a world of incomplete contracting, even if it implies a more limited ability to borrow and a reduced ability to smooth consumption over time.[2] Homestead exemptions allow households to emerge from bankruptcy with positive net worth. As shown by White (2011), the effect of exemptions is to further insure household consumption in the face of economic shocks and limit the ability to borrow due to higher interest rates.[3]

The homestead bankruptcy exemption potentially affects household portfolio choice, because a household needs to have home equity to benefit from the implicit consumption insurance. This paper provides an empirical and a theoretical investigation of the impact of the homestead exemption on investment in home equity as part of the household portfolio allocation and on home ownership.

The estimation uses household level data from the Survey of Income and Program Participation (SIPP) of the US Census Bureau. This data source provides information on wealth allocation and a host of personal and household characteristics for approximately 30,000 households. The homestead exemption is found to have an economically significant effect on a household’s investment in home equity. Specifically, the percentage change in home equity as a share of the percentage change in wealth is estimated to be 25% higher if the household’s home equity is below the exemption rather than above it.

The impact of the exemption level on home equity investment is estimated to be stronger for households with relatively young and unhealthy household heads, as these could face heightened income risk and a correspondingly higher probability of personal bankruptcy. A positive impact of the homestead exemption on home equity investment is confirmed by instrumental variables estimation where we use the historical exemption level in 1920 as an instrument for the more recent state-level exemption level. We also estimate a Heckman two-stage selection model, where in the first stage households decide on home ownership. This approach yields a consistent impact of the homestead exemption on home equity investment.

We find only a weak relation between the homestead exemption and home ownership. In probit regressions, in particular, we fail to find a significant impact of the homestead exemption on home ownership, except for households residing in states with unlimited homestead exemptions. This could reflect that households wishing to purchase a home on account of a high risk of personal bankruptcy are thwarted by a lack of mortgage financing necessary to complete the purchase.

[1] Homestead exemption laws generally also include an element of exemption from property taxes but our primary focus is on the bankruptcy protection that they offer.

[2] Livshits et al. (2007) calibrate a heterogeneous life-cycle model with US data to investigate whether the ability to declare personal bankruptcy, followed by a period of exclusion from new borrowing, improves welfare compared to a system where a “fresh start” is not possible. Their calculations suggest that a bankruptcy system that offers a fresh start is welfare improving for the case where expense shocks are explicitly modeled. Athreya (2002) instead finds that the possibility of consumer bankruptcy reduces welfare in a quantitative analysis of the effects of bankruptcy laws in an incomplete market exchange economy.

[3] Li and Sarte (2006) analyze the implications of exemptions for welfare in a general equilibrium model with endogenous capital formation and labor supply. In a model calibrated with US data, they find that lowering the level of exemptions increases output and is welfare improving. Specifically, lower exemptions are found to reduce the incentive to save for borrowers, leading to higher lending rates, which reduces the amount of debt and stimulates capital formation. With higher lending rates, fewer households will opt for a Chapter 13 bankruptcy, thereby increasing the labor supply, output and welfare.

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