

Economic Aspects of Personal Insolvency

Shashank Saksena

The history of debt relief framework for individuals goes back to the past five millennia, but Kilborn (2012)¹ explains that three distinct phases are visible. The rulers in ancient Sumer and Babylon mandated sporadic debt remissions to maintain social stability and military advantage. The Roman and later Islamic law imposed only a limited form of debt forgiveness, encouraging creditors to permit complete remission of distressed debts around the time of Christ. The time up until the late 1900s and the beginning of the twenty-first century witnessed a general criticism of compulsory debt relief when modern democracies re-emphasised mandatory debt remission to maintain social stability and maximise economic competitiveness with foreign countries, rather than maximise comparative advantage militarily.

Therefore, the new personal insolvency laws were designed to maximise the potential to promote efficiency and economic development. However, the design of a personal insolvency law and its impact on efficiency and growth are relatively less explored considering that this law is relatively new and still evolving compared to the law on corporate insolvency. The international standard setting bodies have also not provided clear and comprehensive guidance on an efficient legal framework for personal insolvency. The attempt of this paper is to evaluate the available theoretical and empirical evidence in India and other jurisdictions to provide some policy guidance on strengthening the personal insolvency framework which may be implemented in due course.

OBJECTIVES OF PERSONAL INSOLVENCY AND BANKRUPTCY REGIMES

The objective of any personal debt clemency law has to be based on two important premises of grant of personal relief to economically distressed individuals and achievement of inclusive economic growth. It is argued that the personal insolvency regime is said to reduce the negative externalities of a system which may not appropriately estimate the risk of enforcing uncollectible debt and also designed to force a sharing of losses to entities which are better prepared to deal with such losses (Kilborn, 2009)². Shukla (2016) traces the personal debt and debt relief in India to the legal structure of the colonial period.³ In India, the legal system of debt

¹ Kilborn, Jason J. (2012). The 5000-Year Circle of Debt Clemency: From Sumer and Babylon to America and Europe. *Nederlands Tijdschrift voor Burgerlijk Recht*, pp. 1-7

² Kilborn, Jason J. (2009). Twenty-Five Years of Consumer Bankruptcy in Continental Europe: Internalizing Negative Externalities and Humanizing Justice in Denmark. *International Insolvency Review* 18, no. 3, pp. 155-185.

³ Shukla, Aditi. (2016). The Constitutional Framework Surrounding Debt Relief in India. *International Journal of Law and Legal Jurisprudence Studies*, no. 1, pp.353-365.

relief was intertwined with laws on agricultural credit in view of the fact that a majority of working population was employed in agricultural sector, which faced persistent famines and rural indebtedness. To ameliorate the conditions of farmers, several Acts regulating the agricultural credit and rationalisation of interest on loans such as Land Improvements Loan Act, 1883, the Agriculturists Loans Act, 1884, and the Usurious Loan Act, 1918 have been passed. Post-independence, several State Acts have also been passed to regulate the money lending and to provide debt relief. The efficacy and comprehensiveness of such State Acts in reducing the rural indebtedness has been a matter of debate. A country-wide natural experiment in introducing comprehensive debt relief and debt waiver (a kind of 'fresh start' under the Insolvency and Bankruptcy Code, 2016 (Code)) was conducted in the form of Agricultural Debt Waiver and Debt Relief Scheme, 2008, which holds significant insights into formulation of future policy on debt relief and inclusive economic growth, which theme would be examined later.

According to Feibelman (2018), while rural indebtedness could be used as a ground to argue for formulating a general law on debt clemency, there is no immediate consumer debt crisis in India – a situation which has forced many countries to formulate such laws.⁴ Thus, it is very appropriate that the Code has provided a framework of personal insolvency in the calm period and relatively early stages of consumer credit growth where there is no over-indebtedness or consumer credit crisis impacting financial stability. However, according to Sane (2019), the individual credit has grown in recent times where individuals account for almost 38 per cent of non-food credit and the stress on personal loans is increasing.⁵ Therefore, this is the most appropriate time to learn from the experiences of other countries that have implemented personal insolvency law in the recent period. This may also be conducive to formulate policies to further develop credit markets for individual loans.

LEARNINGS FOR INDIA

According to White (2016), personal bankruptcy law is based on conflicting objectives and these decide the structure of the legal regime, whether it is 'too harsh' (high repayment conditions and /or high punishments for applying) or 'too lenient' (low repayment conditions and/or low punishments).⁶ While on one hand, the personal insolvency law is supposed to provide partial consumption insurance, on the other hand, it should also improve credit supply through a fair distribution of debtor assets between a debtor and a creditor. White (2014) also opines that a larger distribution of debtor assets under a harsh regime may improve credit supply, but it may reduce the consumption of debtors and disincentivise and reduce their work efforts.⁷ Therefore, it may be both welfare-minimising and efficiency-retarding. Since individual debtors cannot be liquidated in modern democracies unlike in medieval times when enslavement and corporal punishment for debt default was common, they would always be reorganised and their personal and other exempt assets protected so that such personal

⁴ Feibelman, Adam (2018). Legal shock or false start? The Uncertain Future of India's New Consumer Insolvency and Bankruptcy Regime. *Tulane Public Law Research Paper*, no.17-16.

⁵ Sane, Renuka (2019). The Way Forward for Personal Insolvency in the Indian Insolvency and Bankruptcy Code. *NIPFP Working Paper 251*, pp. 1-31.

⁶ White, Michelle J. (2016). Economics of Personal Bankruptcy and Insolvency. CESifo DICE Report 4/2015. *CESifo Institute – Journal for Institutional Comparisons* 13, No. 4, pp. 3-7.

⁷ White, Michelle J. (2014). Economics of Corporate and Personal Bankruptcy
Law. <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.497.7830&rep=rep1&type=pdf>

insolvency laws could be not only welfare maximising, but also growth-enhancing. Using the data of 27 countries over the 2005–2010 period, a research study by Fu et.al (2018) found that a personal insolvency regime reducing barriers to failure in terms of World Bank measures of insolvency time, insolvency cost (percentage of estate), and recovery rate had expected impact on individual businesses.⁸ Time and cost are negatively related to entrepreneurship, whereas recovery rate is positively associated with entrepreneurship. Further, the personal insolvency regime provides strong incentive to opportunity-and innovation-oriented entrepreneurship. These findings are corroborated in another study of Japan by Eberhart (2016) which suggests that a lenient insolvency regime is conducive to qualitatively better entrepreneurship.⁹

The empirical evidence produced by Gross et. al.(2018) on personal insolvency regime in US before and after the bankruptcy reforms in the form of the Bankruptcy Abuse Prevention and Consumer Protection Act, 2005 (BAPCPA) provides interesting insights into theoretical debates of 'generous' versus 'harsh' personal insolvency regimes on the insurance and credit supply aspects.¹⁰ BAPCPA can be categorised as a harbinger of a relatively restrictive personal insolvency regime in US which increased the cost of filing and restricted the financial benefits. It applied the 'means test', restricting the high-income individuals to freely use the bankruptcy law and also ensured that defaulted debt may be repaid to the maximum extent which could be afforded by debtors. There were contradictory positions taken by proponents and opponents of the insolvency reform. While the supporters argued that the cost of credit would be reduced as the creditors pass on the benefits of higher recovery rates, the opponents were sceptical about the benefits and apprehended that the insurance value of bankruptcy would decline and the interest of filers affected by medical bills and job-losses would be adversely affected. The results of the one of the most comprehensive studies of personal insolvency regimes (Gross et.al., 2018) indicated that the reduced filings actually helped in passing the benefits of reduced borrowing cost to consumers, however the BAPCPA reduced the insurance value of bankruptcy, as the Act significantly reduced the share of uninsured individuals who accessed bankruptcy as implicit health insurance.¹¹ The other interesting finding of the study is that the 'means test' embedded in the bankruptcy reform was designed with the objective to reduce filing by high income filers, which was not achieved. This brings into sharp focus the optimum trade-off between the 'harsh' and 'generous' personal bankruptcy regimes which may have implications for design of social insurance schemes and regulation of credit markets.

The economic theory of over-indebtedness or financial stress of individuals provides two major channels which negatively impact investment, productivity and the macro economy. The 'poverty trap' models of Banerjee and Newman (1993),¹² Banerjee (2000),¹³ Mookherjee and Ray (2003)¹⁴ explain the constant entrapment of individuals in low-

⁸ Fu, Kun, Wennberg, Karl and Falkenhall, Björn (2018). Productive Entrepreneurship and the Effectiveness of Insolvency Legislation: a Cross-Country Study. *Small Business Economics*, 2018. <https://link.springer.com/article/10.1007/s11187-018-0040-6>.

⁹ Eberhart, Rober N., Eesley, Charles, E., and Eisenhardt, Kathleen M (2017). Failure is an Option. Institutional Change, Entrepreneurial Risk and New Firm Growth. *Organization Science* 28, no. 1, pp. 93-112.

¹⁰ Gross, Tal, Kluender, Raymond, Liu, Feng, Notowidigdo, Matthew, J., and Wang, Jialan (2018). The Economic Consequences of Bankruptcy Reform. <https://economics.mit.edu/files/16255>.

¹¹ Ibid.

¹² Banerjee, Abhijit and Newman, Andrew F (1993). Occupational Choice and the Process of Development. *Journal of Political Economy* 101, no. 2, pp. 274–298.

¹³ Banerjee, Abhijit (2000). The Two Poverities. *Nordic Journal of Political Economy* 26, no. 2, pp. 129–141.

¹⁴ Mookherjee, Dilip and Ray, Debraj (2003). Persistent Inequality. *Review of Economic Studies* 70, no. 2, pp. 369–393.

productivity equilibrium through investment constraints caused by insufficient capital and human investments, which, in turn, are a result of low net income after repayment of debt. The models of 'debt overhang and risk shifting' of Jensen and Meckling (1976)¹⁵ and Myers (1977)¹⁶ focus on concentration of risk (as only creditors have to bear the downside risk) and overlooking of profitable investments by debtors with low net investible surplus in explaining the deleterious impact of debt on productivity and growth. Both the models recognise that debt relief would encourage investment and productivity. The opposing view is that the beneficial effect of the debt relief may have to be weighed against the moral hazard and behavioural response of the borrowers embedded in the possibility of future debt reliefs or bail-outs.

These theories have been examined in the context of a very large debt relief experiment conducted in India through the Agricultural Debt Waiver and Debt Relief Scheme, 2008, which was one of the largest debt relief programmes in the world that accounted for about 1.6 per cent of GDP and affected 45 million farmers. Empirical studies conducted by Kanz (2012¹⁷ and 2016¹⁸) use this natural experiment in the history to obtain evidence on the effectiveness and efficiency aspects of debt relief. The intended objective of the Scheme was to make the collateral (land) free from debt so that the beneficiary farmers get integrated with the formal financial system. The findings indicate that debt relief had a perceptible effect on the level of household debt, but it did not lead to increase in investment and productivity as forecast by theories of debt overhang. Instead, the behavioural expectation of future credit constraints resulted in more dependence on informal financing, lower investment and a decline in productivity among the beneficiary farmers who received debt relief. The findings indicate that a one-time debt settlement may not facilitate new investment, but may have substantial real effects through their impact on borrower expectations. Therefore, it is important to create the long-term credit relationships between borrowers and lenders and supplement the policies to augment formal credit access with 'fresh start' schemes. This brings us back to the lender response behaviour under a personal insolvency regime and what type of personal insolvency regime would improve the supply of credit and cost of credit. This aspect is worth exploring because very little guidance is provided under the Code for discharge from insolvency in the fresh start or earned start.

CONCLUSION

While the Indian personal insolvency regime incorporates many useful features of personal insolvency laws of other countries in allowing both 'fresh start' and 'earned starts' based on the repaying capacity of debtors, applying the means-tested criteria (which may be flexibly determined going forward) and timeliness in resolving insolvency, there are complementary policies to improve credit access like the length of maintenance of credit default record and the role and emphasis on credit counselling as the condition of discharge, which need to be amplified and clarified. What are the costs and benefits of mandatory financial management

¹⁵ Jensen, Michael C. and Meckling, William H (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics* 3, no. 4, pp. 305–360.

¹⁶ Myers, Stewart, C. (1977), Determinants of Corporate Borrowing, *Journal of Financial Economics* 5, no. 2, pp. 147–175.

¹⁷ Kanz, Martin (2012). What Does Debt Relief Do for Development? Evidence from India's Bailout Program for Highly-Indebted Rural Households. *World Bank Policy Research Working Paper* 6258, pp. 1–62.

¹⁸ Kanz, Martin (2016). What Does Debt Relief Do for Development? Evidence from India's Bailout for Rural Households. *American Economic Journal: Applied Economics* 8, no. 4, pp. 66–99

counselling or training and making such training as a prerequisite of debt discharge? It is illustrative to learn from the long-term experience of the countries, like, Canada since 1992 and the United States since 2005, which have mandated that individual debtors are required to receive such counselling or training prior to discharge, even when it is evident, including through evaluation studies that this mandate was not appropriate to achieve the objective of avoidance of insolvency. According to Kilborn (2016), it is prudent to question the effectiveness of such counselling for an applicant who seeks relief from personal financial distress that may have been caused by unanticipated accidents of life and not by the lack of basic financial knowledge or mismanagement of finances or over-borrowing.¹⁹ The final question is if the substantial costs of mandating financial education are justified by its limited and possibly unreal benefits or such requirements cause deadweight loss on a nation that is difficult to justify. Indian studies on financial inclusion also indicate that the recall value of financial inclusion is very low in adult financial literacy programmes. It is appropriate that in the absence of explicit financial management counselling provisions in the Code, any such policy in subordinate legislation may be based on hard evidence, both theoretical and empirical.

While the institutional mechanism of courts, insolvency professionals and information utility has been inbuilt in the insolvency law to deal with personal insolvency, however several policy issues are still open, as mentioned above. The costs of a formal discharge from personal insolvency could be substantial in view of small transaction size of a case. In view of this, efforts may be made to create a personal insolvency regime which is balanced: neither too harsh nor very generous, cost-effective and efficient. The implementation challenges would need to be constantly weighed against the hard evidence on some of the economic policy issues mentioned above. Further, establishment of long-term credit relations between debtors and creditors may be ensured so that the moral hazard and behavioural expectations should not overshadow the beneficial effects of the personal insolvency regime.

¹⁹ Kilborn, Jason J. (2016). Mandatory Financial Education as Prerequisite to Personal Insolvency Relief: The North American Experience. pp. 1-17. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2837287

