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Bankruptcy and the Debt-Unemployment Relationship: Evidence from a Natural Experiment

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This paper examines the effect of a change in bankruptcy law on the relationship between household debt and longer-run unemployment in the United States. In consumer bankruptcy cases, filers can be eligible for two different types of bankruptcies: Chapter 7 and Chapter 13. Chapter 7 frees filers from debt repayment by liquidating their assets and using those proceeds to pay creditors, while Chapter 13 allows filers to enter a debt repayment plan of three to five years rather than discharge debt altogether. In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), which greatly increased the difficulty of filing for Chapter 7 bankruptcy by making eligibility based on income. However, for unemployed households with already low levels of income, this change may have made it easier for them to declare Chapter 7 bankruptcy. Building off the finding in Donaldson et al. (2019) that high levels of household debt lead to high unemployment, I aim to model whether BAPCPA changed the relationship between high levels of debt and longer-run unemployment in the United States. Using OLS regression on state-level panel data from the Bureau of Labor Statistics, the American Bankruptcy Institute, and the Federal Reserve Bank of New York from 2003 to 2019, I find that since BAPCPA was enacted, higher longer-run unemployment has led to more Chapter 7 bankruptcies. I also find that higher household debt has led to more longer-run unemployment since BAPCPA was enacted. However, higher student loan debt, which saw some minor changes in the new bankruptcy law, influences longer-run unemployment more than other types of debt. These findings lead to further questions about the relationship between debt and unemployment, with the possibility that relaxing bankruptcy laws, perhaps through permitting simpler discharge of student debt, would help reduce longer-run unemployment.