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Unemployment Insurance with Consumer Bankruptcy

(Job Market Paper – Abstract)

Adverse labor income shocks such as job loss are a major reason for personal bankruptcy. I study how Chapter 7 consumer bankruptcy affects the welfare implications of different levels of UI. Using county-level bankruptcy rates and cross-state differences in UI generosity, I find that bankruptcy rates are lower in states with more generous UI. Given that the same economic shock can affect both state-level UI and bankruptcy decisions, I compare neighboring counties from different states and exploit policy discontinuities at state borders to identify the effect of UI on bankruptcy. I then construct a lifecycle incomplete market model of heterogeneous agents, extended to include unsecured consumer credit, a frictional labor market, Chapter 7 bankruptcy, and UI as the average US regular UI program. In the model, workers are heterogeneous in terms of their age, stochastic labor productivity, employment status, and UI qualification. Labor frictions are modeled using a Diamond-Mortensen-Pissarides search and matching framework. Competitive financial intermediaries price each loan based on the worker's default risk. Workers make decisions regarding consumption, borrowing or saving, pay their loans, and-if a job offer is available-working. The model is estimated by the simulated method of moments to match key statistics of unsecured credit and labor markets, such as bankruptcy rates, debt-to-income ratios, and employment rates for the overall population and the subpopulations of employed and bankrupts, as well as workers' earning-profiles over the lifecycle.

The model explains the cross-state negative relationship between bankruptcy rates and UI generosity. With bankruptcy, UI implies an additional trade-off: first, higher UI benefits reduce default risk and improve credit access, since they imply higher income during a situation of low-income. Second, higher benefits encourage borrowing, increase unemployment, and require more taxes, so they increase default risk. The model is calibrated to the current average level of UI generosity in terms of replacement rate (50%) and the maximum amount of benefits that can be collected. Below the current levels of UI, the model predicts that the first effect dominates, and higher UI reduces bankruptcy and increases overall debt and ex ante welfare. As UI increases, default risk increases, which leads to higher interest rates on loans, reducing overall debt and bankruptcy as well as welfare. Without bankruptcy, increasing the replacement rate from 50% to 55% would increase welfare by 0.5%, but with a bankruptcy option, it reduces welfare by 1.7%.

Keywords: consumer bankruptcy, unsecured credit, unemployment insurance

JEL Classification Codes: J65, K35, E21, E24, J64