Debt, Drought, and Mobility: How Bankruptcy Institutions Shape Adjustment to Economic Shocks

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Abstract

Understanding how economies adjust to negative shocks is a central question in economics. This paper provides causal evidence on how indebtedness affects occupational and geographic mobility after a negative shock. We focus on U.S. agriculture between 1850 and 1920 and exploit the repeated introduction and repeal of federal bankruptcy laws, granular variation in drought exposure, and rich county-level and individual-level data. We find that bankruptcy protection facilitates reallocation by reducing indebtedness: farmers affected by droughts are more likely to exit agriculture and migrate to manufacturing jobs in urban counties. In contrast, in the absence of bankruptcy protection, farmers remain in agriculture and sell portions of their land to other locals. These effects are reinforced by homestead exemptions, which shield certain assets from creditors; bankruptcy law transforms such assets from illiquid to liquid ones. Our findings underscore the role of institutions in enabling individual mobility and structural change following adverse economic shocks.