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Personal bankruptcy law, debt portfolios, and entrepreneurship

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ABSTRACT

Bankruptcy provides entrepreneurs with insurance against the financial consequences of failure at the cost of worsened credit conditions. Using a quantitative general equilibrium model of entrepreneurship, we show that the presence of secured credit in addition to unsecured credit substantially alters this trade-off. If secured credit is not available the optimal bankruptcy law is harsh since the negative effect dominates. If secured credit is available the optimal law is lenient since entrepreneurs rationed out of the unsecured credit market can still obtain secured credit, lowering the costs of worse credit conditions. We find significant welfare gains from reforming the law.
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1. Introduction

In recent years, many countries have changed their personal bankruptcy laws. In Europe, where the bankruptcy law is much harsher than in the U.S., many countries, for example Germany, the Netherlands, and the UK, have made the bankruptcy law more lenient with the explicit aim of fostering entrepreneurship. The U.S. moved in the opposite direction. The "Bankruptcy Abuse Prevention and Consumer Protection Act" (BAPCPA) of 2005 made it more costly to declare bankruptcy. We contribute to this debate on two levels. First, we examine the role of the personal bankruptcy law for entrepreneurs and its macroeconomic implications. Personal bankruptcy law affects entrepreneurs because if an entrepreneur's firm is not incorporated, the entrepreneur is personally liable for all the unsecured debts of the firm. However, despite the fact that entrepreneurs can default on unsecured debt, they overwhelmingly borrow secured. Thus our second, and most important, contribution is to show that the presence of secured credit in a model of unsecured credit and default alters all positive and normative implications dramatically. In a version of the model without secured credit, the optimal bankruptcy law is very harsh. The opposite happens when secured credit is available.

The possibility of filing for bankruptcy introduces some contingency in a world of incomplete credit markets where only simple debt contracts are available. This contingency provides insurance against entrepreneurial failure at the cost of worsening credit conditions. If the bankruptcy law is very generous to defaulters, borrowers are insured against bad outcomes. But in order to compensate for the default risk, banks have to charge high interest rates or ration credit altogether. Allowing for secured credit modifies this trade-off by allowing agents to obtain cheap credit even under a very generous bankruptcy law. Poor agents are rationed out of the unsecured credit market, independently of the availability of secured

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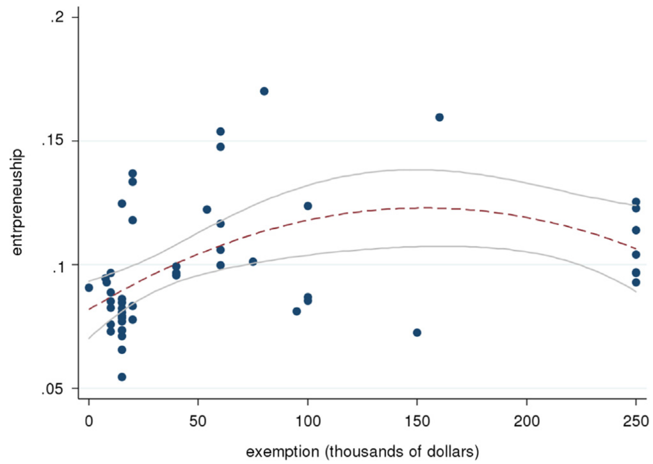

Fig. 1. Entrepreneurship and bankruptcy exemption across U.S. states. *Notes*: The figure shows the relationship between exemption levels, which differ across U.S. states and the entrepreneurship rate (self-employment rate). The data are from the Kauffman foundation for 1996–1998.

credit. But if secured credit is not allowed, these agents will have to self-finance, and therefore will have only very small firms. In contrast, if secured credit is available, these agents can obtain secured credit and therefore are able to have bigger firms. Thus, secured credit weakens the negative effect of a generous bankruptcy law.

We build an infinite horizon heterogeneous agents model with occupational choice to quantify this trade-off. Each period, an agent decides whether to become an entrepreneur or a worker. An entrepreneur can obtain both secured and unsecured credit. As in Kiyotaki and Moore (1997), an entrepreneur can borrow secured by pledging his future output and the capital of his firm as collateral. Credit is provided by perfectly competitive financial intermediaries. Conditions for unsecured credit reflect the risk profile of each individual entrepreneur. After uncertainty in production has realized each entrepreneur can decide whether to file for bankruptcy. The bankruptcy law is modeled on U.S. Chapter 7: debt is immediately discharged and after repaying secured debt, all assets in excess of an exemption level are liquidated. The proceeds are used to (partially) repay the unsecured creditors. The most important feature of secured credit for bankruptcy proceedings is that it has priority over unsecured debt and it is not subject to bankruptcy exemptions.

We solve for two versions of the model which are identical in all respects with the only exception being the availability of secured credit. Both models are calibrated independently to replicate the same macroeconomic facts—the fraction of entrepreneurs, their exit rate and bankruptcy filings, and the wealth distribution—of the U.S. economy. With both models the same policy experiment is conducted: we change the severity of bankruptcy law, using wealth exemptions as a proxy. The main result of the paper is that the presence of secured credit is critical for all positive and normative results. On the one hand, if secured credit is not available, a very harsh law would induce high entrepreneurship and maximize welfare. On the other hand, if secured credit is available, a very lenient law would be optimal and would increase entrepreneurship. This result is general and, most likely, carries over to other models of default with unsecured credit.

In our model with secured credit there are significant welfare gains from increasing the current exemption level to the optimal one: entrepreneurship would increase from 7.3% of the population to 7.6%. This is due to the increased insurance effect, which mainly works through a *fresh start* effect: if the exemption level is high, entrepreneurs who have defaulted can keep a significant amount of wealth which enables them to start another entrepreneurial project soon afterward. Thus, they enjoy a fresh start. We also show that the optimal exemption level is only slightly lower when we include the transition period in our welfare calculations.

The available empirical evidence (Fan and White, 2003) show that entrepreneurship is higher in states with a more lenient bankruptcy law. Data from the Kauffman Foundation for 1996–1998, suggests an hump-shaped relationship between bankruptcy exemptions and average self employment rate across US-states (Fig. 1). Our model is the only one consistent with existing empirical evidence on the relationship between bankruptcy exemptions and entrepreneurship.

Livshits et al. (2007) and Chatterjee et al. (2007) among many others investigate the consequences of the personal bankruptcy law on consumer credit. These papers abstract entirely from secured credit, thereby overstating the negative effects of a generous bankruptcy law. Hintermaier and Koeniger (2011), and Pavan (2008) analyze models with a durable good which can be used as collateral for secured credit. Li and Sarte (2006) allow for both debt and assets in a general equilibrium model but they abstract from secured debt and find that the bankruptcy law should be harsher. Athreya (2006), like us, abstracts from durable goods but allows households to borrow secured up to an exogenous limit. Athreya (2006) and Hintermaier and Koeniger (2011) also find that a lenient bankruptcy law is optimal.

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