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How do bankruptcy laws affect entrepreneurship development around the world?

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ABSTRACT

How do bankruptcy laws as formal institutions affect entrepreneurship development around the world? Do entrepreneur-friendly bankruptcy laws encourage more entrepreneurship development at a societal level? We posit that if bankrupt entrepreneurs are excessively punished for failure, they may give up potentially high-return but inherently high-risk opportunities to start new businesses. Amassing a cross-country database from 29 countries spanning 19 years (1990–2008), we find that lenient, entrepreneur-friendly bankruptcy laws are significantly correlated with the level of entrepreneurship development as measured by the rate of new firm entry.

1. Executive summary

Corporate bankruptcies are common. While all entrepreneurs are interested in success, unfortunately a majority of their ventures fail and many end up in bankruptcy. A challenge confronting policymakers around the world is: How to facilitate more entrepreneurship development in the face of such odds against entrepreneurial success?

How formal institutions of a society, such as bankruptcy laws, govern bankrupt entrepreneurs and firms is an important component of the institutional framework within which entrepreneurs and firms operate. The legal procedures associated with bankruptcy vary significantly across countries. Some countries provide only limited protection for entrepreneurs and managers of bankrupt firms, while others have more entrepreneur-friendly bankruptcy laws.

A well-known proposition in the literature is that institutions matter—more specifically, entrepreneurs and firms strategically respond to the institutional incentives and disincentives. Given the "institutions matter" proposition, more work is needed to help us understand: How do institutions matter? Thus, two important but unexplored questions we investigate in this study are: How do bankruptcy laws affect entrepreneurship development around the world? Do entrepreneur-friendly bankruptcy laws encourage more entrepreneurship development at a societal level?

Amassing a longitudinal, cross-country database covering 29 countries and spanning 19 years (1990–2008, inclusive), we focus on whether differences in bankruptcy laws are systematically related to the different levels of entrepreneurship development as measured by the rate of new firm entry. Components of entrepreneur-friendly bankruptcy laws include: (1) the time spent on bankruptcy procedure, (2) the cost of bankruptcy procedure, (3) the opportunity to have a fresh start in liquidation bankruptcy,

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(4) the opportunity to have an automatic stay of assets, and (5) the opportunity for managers to remain on the job after filing for bankruptcy. By examining the relationship between bankruptcy laws and the value creating activities in a society associated with new firm formation, we predict that entrepreneur-friendly bankruptcy laws may increase the rate of new firm entry, which may be indicative of vibrant entrepreneurial activities in an economy.

Contributing to an institution-based view of entrepreneurship, our research has clear implications for policymakers interested in entrepreneurship development in an economy and for entrepreneurs assessing their risk when starting up new firms. For policymakers, we suggest that making bankruptcy laws more entrepreneur-friendly will positively affect entrepreneurship development by lowering exit barriers and entry barriers. For entrepreneurs starting up new firms, we suggest that they pay attention to the nuances of bankruptcy laws in their jurisdiction and that if possible they set up firms in a jurisdiction that has entrepreneur-friendly bankruptcy laws.

2. Introduction

Corporate bankruptcies are common. While all entrepreneurs are interested in success, unfortunately a majority of their ventures fail and many end up in bankruptcy. A challenge confronting policymakers around the world is: How to facilitate more entrepreneurship development in the face of such odds against entrepreneurial success?

Entrepreneurship is widely seen as one of the most important drivers of economic growth (Schumpeter, 1942). The level of entrepreneurship in a particular country is not independent of the broader institutional context that has evolved in that country (Baumol, 1996; North, 1990). Countries that are characterized by institutions that support entrepreneurial activity will, other things equal, have higher levels of entrepreneurship than countries characterized by institutions that do not support entrepreneurship (Acs and Laszlo, 2007; Busenitz et al., 2000; Peng et al., 2009; Peng et al., 2008).

Of course, the institutional context of entrepreneurship in a particular country can have many different elements—ranging from cultural values concerning risk to beliefs about the stigma associated with entrepreneurial failure (Shepherd, 2003; Yamakawa, 2009). Research has shown that many of these elements are, in fact, related to the rate of entrepreneurship in a country (Shane, 1996). Because many of these institutional elements reflect the evolution of values and beliefs in a country over long periods of time, they are both relatively stable (Hofstede, 2007) and difficult to alter with changes in public policy (North, 1990). However, there are some elements of the institutional context of entrepreneurship within a country that are somewhat more susceptible to policy manipulations. One of these may be a country's bankruptcy laws—a form of formal institutions (Gamboa-Cavazos and Schneider, 2007).

Indeed, Lee et al. (2007) have argued that a country's corporate bankruptcy laws (hereafter “bankruptcy laws”) can have an important impact on the level of entrepreneurship in a country.[4] Lee et al. (2007) posit that bankruptcy laws that reduce the cost of entrepreneurial exit may increase the level of entrepreneurship in a country, while bankruptcy laws that increase the cost of such exit may reduce the level of entrepreneurship in a country. Peng et al. (2010) show systematic differences in terms of bankruptcy laws' entrepreneur-friendliness around the world. It follows from this logic that countries seeking to increase the level of entrepreneurship can, among other things, adjust their bankruptcy laws to reduce the cost of bankruptcy (Armour and Cumming, 2008; Halliday and Carruthers, 2007).

Of course, a country's bankruptcy laws are not independent of other elements of its broader institutional framework, especially those elements of its culture that are relevant to entrepreneurial activity. Thus, for example, a country that has a culture that is risk adverse is more likely to have bankruptcy laws that raise the cost of entrepreneurial failure, while a country with a less risk adverse culture is likely to have bankruptcy laws that impose lower costs of such failures (Lee et al., 2007; Tezuka, 1999). If, as a matter of public policy, a country is to use changes in its bankruptcy laws to facilitate more entrepreneurship, the impact of those changes on the propensity of individuals to become entrepreneurs must be greater than those elements in the institutional context that continue to be anti-entrepreneurial in nature.

In a nutshell, we address two important yet underexplored questions: How do countries' bankruptcy laws affect the level of entrepreneurship development as measured by the rate of new firm entry? Do entrepreneur-friendly bankruptcy laws encourage more entrepreneurship development at a societal level? We endeavor to contribute to theory building and empirical substantiation with a focus on diverse entrepreneurship phenomena around the world (Zahra, 2007). We begin by more fully developing the logic that links bankruptcy laws with the level of entrepreneurship in a country. Then we develop hypotheses linking the specific elements of these laws with entrepreneurial behavior and test them with a sample of 29 countries over a 19-year time period.

While our paper builds on the most relevant earlier work by Lee et al. (2007), Peng et al. (2010), and Armour and Cumming (2008), ours goes beyond these three papers in at least five significant ways. First, Lee et al. (2007) is a theory paper with no empirical data. Peng et al. (2010) show qualitative data without empirical testing. Ours is the first paper to deepen and broaden their theoretical ideas, transform them into testable hypotheses, and empirically test them with worldwide data. While Lee et al. (2007) and Peng et al. (2010) emphasize the benefit side of bankruptcy and pay less attention to the important component of the cost of bankruptcy (Bris et al., 2006; Djankov et al., 2008; White, 1984), we have added the estimation of the direct and overall cost of the bankruptcy proceedings (e.g., cost of petitioning for insolvency, court fees, fees of practitioners, independent assessors, lawyers, and accountants). The positive externality discussed in Lee et al. (2007) is also complemented by the negative externality in our research. Second, Armour and Cumming (2008) is an empirical paper that shares the same basic thrust of our paper—with

[4] Although a country's personal bankruptcy laws may also affect entrepreneurship development (Armour and Cumming, 2008; Efrat, 2002; Fan and White, 2003; Mankart and Rodano, 2007), we do not deal with personal bankruptcy laws in this article.