6-11-2011

BEYOND BANKRUPTCY: DOES THE BANKRUPTCY CODE PROVIDE A FRESH START TO ENTREPRENEURS? (INTERACTIVE PAPER)

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Recommended Citation
Available at: http://digitalknowledge.babson.edu/fer/vol31/iss15/17

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Principal Topic

There is a surprising dearth of literature on how business owners actually fare post-bankruptcy. What impact does the filing have on access to credit and interest rates? What happens to wages and employment? Our paper focuses on the effects of bankruptcy on firm performance.

Method

The analysis makes use of data from the National Survey of Small Business Finances (NSSBF). The Survey collects information on small businesses (those with fewer than 500 employees) for the United States. We use data from the years 1993, 1998 and 2003. The 1993 survey contain 4,637 firms with less than 500 employees. These represent (appropriately weighted) about 4.99 million small businesses. The 1998 survey contains 3,561 firms that were in operation in December 1998, representing 5.3 million businesses. The 2003 survey, which sampled 4,240 firms (representing 6.3 million small businesses nationwide), improved further by asking questions relating to the relationship between the firm and the lending institution.

Results and Implications

On the positive side, previously bankrupt firms are not any more burdened than the average small firm by problems relating to profitability, cash flow, health insurance costs, or taxes—all considered to be major problems facing all small businesses. There is little to distinguish these firms in terms of firm size, as measured by employment. The most interesting results, and those which pertain directly to the notion of a “fresh start”, deal with access to credit issues. If the bankruptcy system really did wipe the slate clean, then in principle, there should be little to distinguish between firms with and without a prior bankruptcy filing. However, we find that access to credit is a significant constraint for businesses with a bankruptcy filing on their record. Not only are they charged interest rates that are more than 1 percentage point higher than for businesses without a bankruptcy history, but they are also significantly more likely to be denied loans. In fact, it appears that firms with a bankruptcy record are rationed out of the market, with all types of loans being denied at significantly higher rates than other firms. This fits in with the predictions of the Stiglitz and Weiss (1981) credit rationing model. This is true even of trade credit, which is an informal credit system within businesses wherein one firm allows another to make purchases without immediate cash payment. Further, it appears that bankruptcy leads to a class of discouraged borrowers who are significantly less likely to even apply for a loan.

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