Bankruptcy Delay and Firms' Dynamics

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Abstract

Institutions Matter! A vast literature has explored the impact of the institutional framework on economic activity. Regulatory regimes shape the environment in which entrepreneurs might conduct their transactions and thus might substantially affect the propensity to enter markets. This is particularly true for bankruptcy law, since it regulates a very crucial moment in firms' life: however, from this painful event, might still yield beneficial returns on the societal level. Previous works have shown how entrepreneurship-friendly bankruptcy regimes might have a positive impact on markets' dynamics by encouraging firms to engage risks and entry markets. At the same time such regulation, by fostering more competition, pushes unproductive firms out of the markets more smoothly, thus allowing a more efficient allocation of their assets. However, even the most well designed regulation, without a proper enforcement, might turn out to be ineffective. Accordingly, by sharing from previous works dealing with judicial performance, we focus on the issue of how judges enforce bankruptcy regulation, using Italy as a case study. The idea to be tested is the following: a "faster" court-system will help make the bankruptcy regulation more "entrepreneurship-friendly" and thus make the markets more dynamic (higher firms' entry and exit rates). In particular, we hypothesize that the entry of prospective entrepreneurs will be hindered by the increasing "indirect" costs related to bankruptcy procedures' length. On the individual level, as the time needed to undergo bankruptcy increases, the moment of a "fresh start" will be postponed and, equally, all the negative consequences that relate to failed entrepreneurs will persist. On the societal level, lengthy procedures will determine the delay of a more efficient allocation of resources. However, if bankruptcy indirect costs are positively linked with

judicial delay, one might equally hypothesize that, when such costs are too high, firms might be reluctant to bear them and prefer to operate at financial loss: thus, bankruptcy delay should have a negative impact also on firms' exit rate.

This issue is particularly binding in the case of Italy: when considering European developed economies, Italy is by far the worst performing country when it comes to judicial delay and markets' dynamism. In order to test the aforementioned hypotheses we are going to exploit the fact that both bankruptcy substantial regulation and procedures are the same across Italy. Accordingly, any difference in the bankruptcy system that firms are going to deal with will ultimately depend on how effectively courts will enforce this regulation. In order to disentangle this mechanism we employ a unique dataset accounting for bankruptcy delays in the 165 Italian Tribunal Districts between 2005 and 2011. This dataset has been merged with firms' dynamics figures and other control variables accounting for markets' characteristics. From the empirical analysis conducted, we found evidence of the impact exerted by a firm-friendly bankruptcy system might differently affect firms' entry and exit rates across Italy. Interesting results emerge from our empirical analysis, suggesting that bankruptcy delay might have a different role in incentivizing risk between limited liability companies and entrepreneurs personally liable.