Will reform harm small business growth?

Bankruptcy and Small Business

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Each of the past three years, Congress has passed a bankruptcy reform bill that was later vetoed by Bill Clinton. This year, the same bill — now titled "Bankruptcy Abuse Prevention and Consumer Protection Act of 2001" (H.R. 333/S. 420) — is making its way through Congress and could be signed by President Bush. The main purpose of the bill is to reduce the number of personal bankruptcy filings by making bankruptcy less favorable for households whose incomes are above the median level.

Reforming personal bankruptcy law would do more than change the attractiveness of bankruptcy to households; it would also alter the economic environment for small business. Under current law, the debtor-friendly personal bankruptcy procedure makes it more attractive for potential entrepreneurs to go into business. Changing the law to make bankruptcy less favorable for debtors would discourage many would-be entrepreneurs from going into business. And because small business is one of the primary sources of new jobs in the U.S. economy, the change could have important negative effects.

SMALL BUSINESS DEBT

How does the U.S. personal bankruptcy procedure affect small businesses? Because most small businesses are unincorporated, debts are personal liabilities of the business owner. Lending to those small businesses is legally equivalent to lending to their owners. If the business fails, the owner is likely to have large business debts that legally are personal debts.

The Chapter 7 procedure of current U.S. bankruptcy law provides two important protections for small business owners who are faced with business debt:

Future earnings First, owners of failed businesses can file for personal bankruptcy, in which their unsecured personal and business debts are discharged. Their future earnings are exempt from the obligation to repay debt, so they can start new businesses or take jobs working for others without having their future earnings taxed to repay their pre-bankruptcy debt. The future earnings provision — referred to as the "fresh start" — applies uniformly throughout the United States.

Current assets Second, business owners (like other bankrupt debtors) must surrender current assets that are above an exemption level set by the state in which they live. The non-exempt assets, in turn, are used to repay debt. Because the exemptions vary by state, states with higher bankruptcy exemptions are more attractive to entrepreneurs.

Most states have several bankruptcy exemptions for different types of assets, but the most important is the exemption for equity in an owner-occupied home (the "homestead" exemption). Seven states have unlimited homestead exemptions: Arkansas, Florida, Iowa, Kansas, Minnesota, Oklahoma, and Texas. Unlimited exemptions allow individuals or couples who file for bankruptcy to shelter millions of dollars of assets from creditors, as long as the assets are converted into equity in an owner-occupied home before the bankruptcy filing occurs.

Several other states have homestead exemptions of $100,000 or more. At the other end of the spectrum, Maryland and Delaware have no homestead exemption at all and seven other states have homestead exemptions of $5,000 or less. Besides the homestead exemption, most states also exempt clothing, furniture, and cooking utensils, and have small exemptions for other types of personal property and some retirement accounts.

In states with the highest exemptions, owners of failed businesses can shelter assets worth millions of dollars. That encourages even risk-averse individuals to go into business. In states with low exemptions, owners of failed busi-

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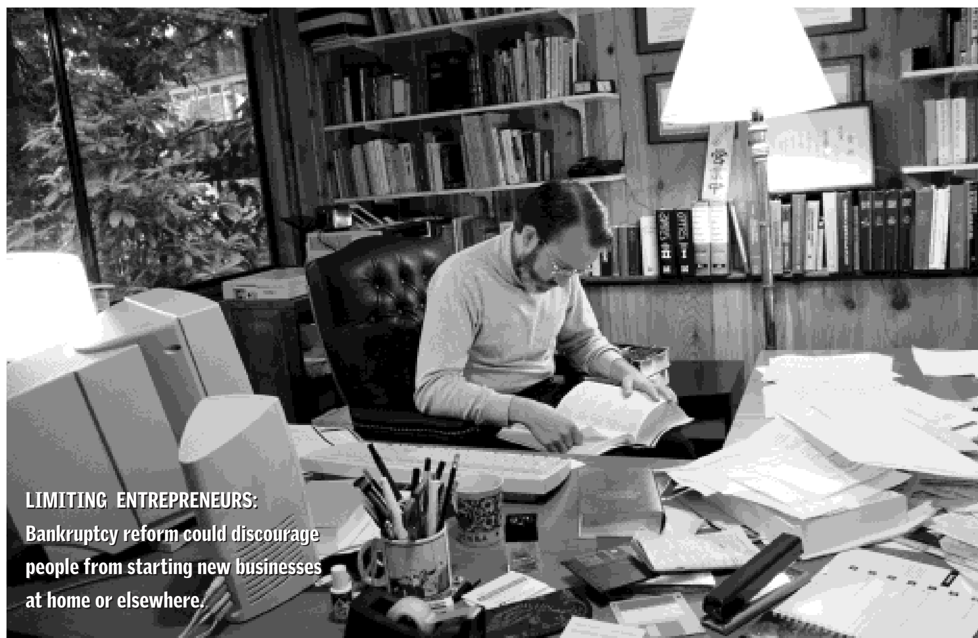
nesses can shelter their clothes, furniture and cooking utensils, but little else. That discourages risk-averse individuals from going into business.

THE EXEMPTIONS' EFFECTS

How does the variation in bankruptcy exemption levels affect small business? We can hypothesize that, in states with high exemption levels, individuals would be more likely to own businesses because the more generous exemptions cushion entrepreneurs against the consequences of business failure. We can also hypothesize that lenders would be more likely to deny applications for credit from small businesses in high exemption states because entrepreneurs in those states would be more likely to file for bankruptcy and would repay less when they file.

To test the hypotheses, two fellow researchers and I examined the entrepreneurship and lending patterns in states with different exemption levels. Specifically, we used the homestead exemption as the basis for comparison because it is the largest exemption in nearly all states and it is also the most variable. As we made the comparisons between states, we kept in mind that renters cannot make use of homestead exemptions and, therefore, they cannot shelter as many assets when they file for bankruptcy. Bankruptcy therefore provides a much more generous "insurance policy" for homeowners who go into business than for renters.



LIMITING ENTREPRENEURS: Bankruptcy reform could discourage people from starting new businesses at home or elsewhere.

CORBIS

Entrepreneurship effects University of Michigan researcher Wei Fan and I used the *Survey of Income and Program Participation*, a large government dataset, to examine how variations in bankruptcy exemptions across states affect individuals' decisions to choose self-employment versus working for an employer. We estimated a model explaining whether one or more workers in a sample of households choose self-employment as a function of the bankruptcy exemption level in the households' state of residence and other variables.

Holding other factors constant, we found that the predicted probability of owning a business was 35 percent higher for homeowners in states with unlimited homestead exemptions as compared to states with low exemptions. What is more, renter households in states with unlimited exemptions were 29 percent more likely to own a business as compared to renters in low exemption states. Both increases are statistically significant.

The average business owned by a self-employed person is small. We therefore re-estimated the model for large businesses, defined as those having business income greater than $2,000 per month. We found that the probability of homeowning households owning big businesses was 28 percent higher in states with unlimited homestead exemptions as compared to states with low exemptions. Again, that difference was statistically significant.

We also examined whether entrepreneurs behave differently depending on whether their businesses are incorporated. We predicted that owners of non-corporate businesses would respond more strongly to changes in the homestead exemption than owners of corporate businesses, because owners of corporate businesses are not personally responsible for their businesses' debts. They therefore would not be affected by whether the exemption levels in their states are high or low. However, exemption levels could still affect the creation of incorporated businesses because lenders know that owners of small corporations can easily transfer assets from the corporation to themselves and, as a result, lenders often require that owners of small corporate businesses sign for personal liability for business loans. That abolishes the legal distinction between the corporation and its owner for purposes of the loan.

Our results show that the probability of homeowning households owning non-corporate businesses was 37 percent higher in states with unlimited exemptions as compared to states with low exemptions. What is more, the probability of homeowning households owning corporate businesses was 14 percent higher in unlimited exemption states as compared to low exemption states. Both increases are statistically significant.

Finally, we examined whether homeowners are more likely to start (as opposed to own) businesses if they live in states with high homestead exemptions. We found that the probability of starting a business was 23 percent higher in states with unlimited exemptions as compared to states with low exemptions. All of the figures, taken together, indicate that bankruptcy law has a strong effect on the

number of people who choose self-employment.

Lending In the second study, University of California, Irvine, researcher Jeremy Berkowitz and I examined how bankruptcy law affects the availability of small business credit. We used data from the *National Survey of Small Business Finance*, produced by Federal Reserve and the Small Business Administration, to test whether small businesses are more likely to be turned down for business loans if they are located in states with higher bankruptcy exemptions.

Holding other factors constant, we found that the probability of a typical non-corporate firm being turned down for credit was 40 percent higher in states with unlimited exemptions as compared to states with low exemptions. For corporate firms, the rejection rate was 30 percent higher. Both increases are statistically significant.

The similar results for non-corporate and corporate firms suggest that lenders ignore the legal distinction between non-corporate and corporate small businesses when deciding whether to lend. We also found that lenders are approximately three times as likely to turn down applications for credit if the owner of the business (corporate or non-corporate) has previously filed for bankruptcy.

NEW LEGISLATION

How would the current bankruptcy reform bill change the small business environment? The most significant change would be that debtors who earn more than the median income level would no longer be allowed to file for Chapter 7 bankruptcy and take advantage of the "fresh start." Instead, they would have to file under a new version of Chapter 13 of the U.S. Bankruptcy Code.

Under the proposed new Chapter 13, debtors would keep all of their assets but would be obliged to use all of their future earnings beyond a not-very-generous Internal Revenue Service formula to repay debt. That obligation would continue for five years. That differs from the current Chapter 13 bankruptcy procedure, which is voluntary rather than mandatory for all bankruptcy filers. Under the current Chapter 13, debtors propose their own repayment plans, which usually involve using only a small proportion of their future earnings over a three-year period to repay debt. Only the bankruptcy judge must approve the repayment plan.

Impact The proposed bankruptcy reform would have a chilling effect on incentives to start or own small businesses. Instead of entrepreneurs being able to shelter all of their future earnings and some or all of their current assets from creditors if their businesses fail, they would be required to use most of their future earnings for five years after the bankruptcy filing to repay debts from the failed business. Owners of failed businesses who have filed for bankruptcy under Chapter 13 would not find it attractive to start new businesses because any future income would be heavily taxed to repay debts of the old businesses. Owners of failed businesses would also be discouraged from taking well-paying jobs, because taking a job that pays more than the median income level would prevent them from filing for bankruptcy under the more favorable Chapter 7 procedure. And lenders would be loath to lend to once-failed business owners who try to start new businesses, because the owners would be discouraged from working hard by the bankruptcy tax on their earnings from the new business.

Our research suggests that potential entrepreneurs are very responsive to the terms of the bankruptcy insurance policy. Because the new bankruptcy policy would be much less favorable to small business owners, all but the most risk-loving potential entrepreneurs would find it much less appealing to go into business.

CONCLUSION

At the macro level, the reform is likely to have mixed effects on the U.S. economy. On the positive side, some entrepreneurial activity in the United States is essentially disguised unemployment and wiping it out would have little effect on U.S. output. Also, business owners who have not previously failed and filed for bankruptcy are likely to find credit easier to obtain, because business loans would be less risky and creditors would be more willing to extend loans.

But the reform will discourage many potential entrepreneurs from going into business and some of the discouraged businesses would inevitably involve innovative new ideas that would have generated jobs and economic growth. That should make us worry that the proposed legislation would make the U.S. small business environment more like that of Germany, where bankruptcy law has never included a "fresh start," risk-taking is frowned upon, there are many fewer entrepreneurs, unemployment is higher, and economic growth is slower. R

READINGS

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