Insolvency Regulations and Economic Recession: An Austro-Libertarian Point of View*

Valerio Tavormina
The Università Cattolica di Milano, Milan, Italy
Email: valerio.tavormina@tavormina-balbis.it

Received 23 February 2014; revised 21 March 2014; accepted 28 April 2014

Copyright © 2014 by author and Scientific Research Publishing Inc.
This work is licensed under the Creative Commons Attribution International License (CC BY).
http://creativecommons.org/licenses/by/4.0/

Abstract
Economic recovery after a crisis requires above all capital to support the most efficient investments. It is therefore counterproductive to delay selling off the assets of insolvent debtors through lengthy insolvency proceedings instead of letting the creditors free to enforce their claims in the speediest way.

Keywords
Economic Recovery, Malinvestments, Insolvency Regulations, Discharge from Debt

1. Institutions Hinder Economic Recovery

The decisive factor in the delay of an economic recovery after the end of a boom, even by many years, is not, like the “animal spirits” of Keynes’s investors (12, VII) raised to be the subject of not-always-useful qualitative and quantitative investigations (behavioural economics in the first case, confidence indices in the second)\(^1\), a psychological attitude on the part of entrepreneurs and consumers.

Within the framework of the Austro-Libertarian model, which is the only one that describes economic activity rationally, rather than with an authoritarian prescription of related behaviours (with results that always deviate from the stated goals, even though they may appear consistent with those actually pursued), Colombatto (22 et seq.) warned us in 2005 that while an important role is indeed played by the costs of dismantling malinvestments brought about by the economic boom, which have tied up capital that now needs to be converted into more pro-

---

\(^1\) I am indebted to Prof. Colombatto both for the origin of these reflections and for his subsequent observations; any deficiencies in making use of them, are obviously my responsibility only.

\(^1\) On the limits of the use of psychology and behavioural models in economic theory, see Rizzo (2012) and Long (2008).

productive uses, these costs alone cannot by themselves explain the intensity and duration of the resulting recession, which are rather to be attributed to the institutional factor (on the role of the institutions see also Colombatto, 2011, 53 et seq. and passim).

It is the interference of the government at all levels (local, state and supranational) that hinders the recovery. In order to maintain electoral consensus—considered to be essential—the government yields to the pressures exercised by those who have benefited during the boom from remunerations which are no longer compatible with the current production of wealth. The latter category comprises: employees who demand that activities which are operating at a loss are kept alive (among these we can find those State-owned activities that are a merely substitute for unemployment benefits, as well as those private activities that are no longer profitable), thus perpetuating and worsening the entry-barriers to the labor market; self-employed workers (such as taxi drivers or chemists) entrenched behind those barriers which refrain from economic competition; and also entrepreneurs who have become submarginal and who demand credit and protection against their creditors, in the search for unearned income based on the coerced consumption of others’ capital².

With respect to this last point it should be mentioned that, from the great crisis of 1929 onwards, a regulatory apparatus that supports and protects insolvent enterprises has been developed at various levels, the economic rationality of which has yet to be demonstrated.

This is not to say that legislation concerning bankruptcy (since this as well, as I will note, seems to represent an obstacle to the conversion of investments into more productive uses) and composition did not exist beforehand [it was in fact present for a number of centuries in Italy, then exported throughout Europe: Rossi, 4 et seq.]; but it is certainly no coincidence that the precursor to the renowned Chapter 11 of the US bankruptcy law [i.e. the instrument that allows the insolvent debtor to continue his activity with the assent of merely the majority of his creditors (and since 1978, only of those who vote), even allowing the interruption of a bankruptcy procedure already underway, relieving him from large percentages of his debts] was introduced for individuals in 1933 during the Hoover presidency and then extended to companies by the Chandler Act of 1938, under the Roosevelt presidency (Rothbard, 1963, 318 et seq.) that is to say “under the manifest immediate influence” of the largest among the “recurring economic crises that have left direct traces in the evolution” of bankruptcy law (Rotondi in the preface to Rossi, XII; Rossi, 190).

2. Insolvency Procedures Relating to Entrepreneurs Who May Go Bankrupt

1) Not even Keynes (to quote a distillate of non-original truths and non-truthful originalities: Hazlitt, 1959, 6, 9, who thus solved the evaluation-by-posterity option imagined by Keynes himself in his preface; but also Rothbard, 1963, 60 et seq.) doubted that exit from a recession passes through the expansion of investments⁴; on the contrary, he even achieved the miracle of the multiplier, according to which if 9/10 of the income is consumed and the residual 1/10 is invested, this means that only 1 needs to be invested in order to achieve an income of 10 (Keynes, 10, II) and therefore (following the same logical reasoning) even not investing anything at all (i.e. consuming everything) leads to an infinite income (Hazlitt, 135 et seq.)³.

This implies that, to accelerate economic recovery, it is decisive that creditors recover as soon as possible their financial means, which are instead stuck with the insolvent entrepreneur, and that the latter’s fixed assets are productively reinvested, insofar as possible. These goals can be pursued simultaneously only through a liquidation of the business’s assets that takes place as quickly as possible, at the highest price obtainable, among those offered for each asset or for the business as a whole.

³It is appropriate to warn that the forced consumption of others’ capital also takes place in the case of capital obtained with an additional bank (fiduciary) credit, that inflates the money supply by subtracting real purchasing power from all of those who are not subsidized (von Mises, 433 et seq.).

²Instead it seems entirely inappropriate to speak of bankruptcy in the case dealt with by a document from the 6th Century B.C., of the Second Babylonian Empire, reported by Kohler et al. (24 et seq.) and commented on by Johns (preface xvii), since that document rather concerns a case of several creditors seeking enforcement.

⁴Except that he thought it possible only if driven by the forced expansion of consumption (Keynes, 3, II; 10, VI; etc.), that has however the crucial deficiency of having effect in an excessively long time (for example, Skousen, 33) and the additional deficiency of distorting the related prices and thus impeding an allocation of resources consistent with the wishes of the consumers (for example, von Mises, 555 et seq.).

⁵And after more than 50 years, Paul Krugman, a Nobel Prize winner (like Dario Fo), insists on the Samuelson cross in the Cartesian diagram of spending and income (Krugman, 2011: Figure 1), as if it were sufficient to draw those lines to define cause and effect (Rothbard, 1962, 775 et seq.).

There are always plenty of krank economists, like (now) the MMT’s theorists who “demonstrate” that government deficit raises private (net of investment) saving: Murphy, The upside-down world of MMT, Mises daily, 9.5.2011, at www.mises.org.
There are essentially two recurring objections to this theory (even though they are linked to prescriptive elements of various types, i.e. solidarity and welfare, which are not the object of the present dissertation) and they concern the safeguarding of employment (and other productive factors) as a source of consumption capacity and thus a driver for investment, and the safeguarding of a businesses’ technological assets, the potential dispersion of which (in the case of a liquidation that dismantles the whole organization) is assumed to depress the productivity of the respective factors.

This second objection does not hold though, because the best value of the union of a number of productive factors can only be revealed (and thus not be lost) in the clearance price. As far as the consumption capacity is concerned, this is prejudiced not even in the short term, except to an irrelevant degree, when compared with the consequent recovery not only of the tied-up capital which is put to its best use, but also of the greater and more efficient production by the competitors which is itself made possible by the (total or partial, depending on the case) reclamation of the market share previously occupied by the agonising enterprise—provided, however, that this recovery is not hindered by some kind of interference in the determination of the productive factors’ prices, i.e. provided that it is left to the market (rather than to the institutions) to determine salary levels, rental fees, raw material prices, etc.6

Hence, contrary to what is constantly being repeated (Rossi, 36 et seq., 190; Forste, 266 et seq.), within the context of a recession not only are all the composition or reorganization procedures, which inevitably entail deferments in the liquidation of the insolvent party’s debts and investments—deferments which in the declared intentions of the regulator are to be reduced to the minimum, but which in reality are successfully pursued as the principal goal by a series of actors—wholly inappropriate but so is the bankruptcy procedure itself, due to the time which is necessary for the reconstruction of liabilities and the liquidation of assets, in an highly unrealistic framework of par condicio creditorum7.

As more efficient alternatives, we could consider a free individual form of enforcement, which does not however exclude other agreements, even with just some of the creditors, to be subordinated to other agreements reached with the remaining creditors, and save for the individual assessment of the usefulness of said agreements by each creditor; or at the very least, we could consider an immediate liquidation of all of the insolvent party’s remaining assets followed by a provisional distribution of the revenues among the preferred creditors and the unsecured ones who have already so requested; all of this while awaiting (most probably for a notoriously long time) the outcome of the pursuit of possible criminal liabilities, the invalidation of fraudulent acts, and a correction of the provisional division based on some efficient criteria for the allocation of losses among the various creditors8.

After all, ours was the only legal system which continued to do without bankruptcy procedures for the insolvency of agricultural entrepreneurs (and also of small commercial enterprises: no more than 300,000 Euros in total assets, 200,000 Euros in revenues, and 500,000 Euros of debt).

Only recently were agricultural entrepreneurs also granted the possibility to make use of debt restructuring agreements as per Art. 182bis of the Italian bankruptcy law (Art. 23.43 of Law Decree No. 98/2011), which, while allowing a moratorium on payments of more than 7 months, binding for all creditors, requires on the other hand both an agreement representing at least 60% of the total credits (and the prospect of) full repayment of the others. At the end of 2012 however, with the changes made to the newly enacted Law No. 3/2012, a bankruptcy procedure was devised for all those individuals not covered by the existing bankruptcy law (agricultural or small entrepreneurs, non-entrepreneurs and consumers), which can potentially lead to a liquidation and can be triggered only on the debtor’s request, although it can then proceed by any creditor’s request (Art. 14quater).

With this latest regulatory intervention, there has essentially been a generalization of that recent aberration for non-small entrepreneurs, represented by the introduction—seen as an “urgent measure for the country’s growth”, “for economic growth”, and “to facilitate the management of business crises”, (respectively the headings of Law

---

6 On the fallacy of the Keynesian argument that full occupation cannot be reached without external stimulus (via deficit, inflation, etc.) of aggregate demand (the so-called “IS-LM” analysis) see Reisman, 879 et seq.
7 Naturally what has been noted for example by Caloia (226) is true, i.e. that the hypothesis of “complete flexibility of prices and salaries are in actual reality (massive presence of oligopolies and labor unions) heroic to say the least;” but this only highlights additional elements of interference by the institutions, respectively represented by artificial barriers to entry and by coercion to minimum nominal salaries, which in turn give rise to unemployment, production displacement and so on: see Electrolux, Peugeot and other current cases.

8 As noted by Voltaire (31-32), “la Justice... s’empare des biens des banqueroutiers pour en frustrer les créanciers”.

---

6For example, to repeat observations already made by Muratori (137 et seq.), why par condicio creditorum, rather than prior in tempore posterior in iure (bar further examination for debts resulting from torts)? The second solution would certainly act as a brake on the creation of excessive debt.
The termination of the composition procedure with ensuing bankruptcy (Art. 186) requires the approval of the creditors, to payment of the creditors (although this payment may again be deferred by a year: Art. 186). The bankruptcy of an entrepreneur is the incapacity resulting from the declaration of bankruptcy and allows creditors to vote (Arts. 161.6, 168, and 178 of bankruptcy law); and finally, after court approval, to payment of the creditors (although this payment may again be deferred by a year: Art. 186 bis.2c) or termination of the composition procedure with ensuing bankruptcy (Art. 186).

Of course we have not yet attained the 18 - 20 months which an insolvent entrepreneur in the United States can take under § 1121 of that bankruptcy law to present a plan, but almost all that which should have been avoided has been done.

2) Another problem is represented by the consequences of the insolvency on the subsequent economic activity by the party and/or his representatives (if it is a company). The international regulatory trend is to exclude any limitations on the activity, at least for the period following the closing of the procedure [see the abolition in 2006 of Articles 50 and 142 et seq. of bankruptcy law, on the public register of bankrupts and the discharge of incapacity resulting from the declaration of bankruptcy respectively, that have also been declared unconstitutional] and to discharge from debt an individual entrepreneur who is not guilty of fraud to the prejudice of his creditors (§ 523, 727 and 1141 of US law; §§ 286 et seq. of German law concerning insolvency; Art. 142 et seq. of our bankruptcy law); however that treatment is excluded in case of crimes by the insolvent party and/or his representatives (Arts. 142.1.6 and 216.4 of bankruptcy law, etc.).

A survey and analysis of the data relating to the trend and reasons for insolvencies could certainly provide some arguments, in one direction or another, on the usefulness of said device, though still questionable from a counterfactual standpoint (what if?). Undoubtedly however, a better knowledge of such data would be of great interest to an economic actor, and directly related to this, any obstacles which the European Court of Human Rights implausibly imposes via the right to the respect of privacy according to Art. 8 of the Convention, result in a distortion of all related choices.

As concerns in particular the discharge from debts, temporarily setting aside its univocal condemnation for causing harm to the property rights of creditors, which in the context of Austro-Libertarian Natural Law (Rothbard, 1982, 143 et seq.) operates on the different level of the “ought”, it is necessary to consider:

- the deterrent effect to productive activity in general, implied by the practical limitation of liability to the entrepreneur’s current assets, such that by now, for an entrepreneur subject to bankruptcy, the formulation of Art. 2740 of Italian Civil Code which states that he answers for the breach of obligations contracted “with all of his present and future assets”, is vacuous. It is true on the other hand that the limitation of liability characterizes the entire current institutional context, in which said limitation can always be obtained through certain corporate instruments (Arts. 2362 and 2462.2 of the Italian Civil Code); however only via the counterbalance of greater costs, and, more importantly, greater transparency through the obligation to file financial statements, etc.;
- the forced transfer of resources from the insolvent party’s original creditors to the party and his subsequent creditors;
- the likely incentive for the productive activity of the formerly insolvent party;
- the potential perpetuation of disruptive effects for the productive activities of others, when the insolvency was the effect of structural inadequacy on the part of the entrepreneur.

---

9Throughthe Law of 7 Dec. 2011, in force since 1° March 2012, the Germans, in addition to the normal continuation of operations by the bankrupt under the supervision of an expert, also provided for the possibility of requesting a deadline for the presentation of a plan (§ 270b InsO): but it must be an impending (and not yet actual) insolvency, the time limit is only 3 months, and in the meantime, only enforcement of moveable property can (and must) be suspended by the judge (Foerste, 278 et seq.).


11It is the judgment referenced in the previous note, that unfortunately cannot be used as a shield against tax espionage, since such a use would certainly be branded as contrary to (rather than promoting) the “economic well-being of the country” pursuant to Art. 8, § 2.

12As stressed by the German Constitutional Court, III Div., 22.12.2005, 1 BvL 9/05, Nr. 23, to uphold the discharge rule introduced as per 1.1.1999. The judgment rests besides largely on social contents which the German Grundgesetz shares with other European constitutions and which hinder the European recovery (see Kowsmann, Constitutions Stall Efforts to Shed Workers in Europe, WSJ, 27.9.2013, A13).
On the whole, it seems that the disadvantages exceed the advantages.

3. Insolvency Procedures Relating to Subjects Who Cannot Go Bankrupt

The institutional context has not yet shifted in the same shown above direction in all of the so-called advanced economies for situations of insolvency of subjects who cannot go bankrupt. For example, this has happened in the United States and in Germany, where the treatment of insolvency has substantially been unified for all debtors, with procedural differences that do not affect the essential characteristics: free access (and possibility of compulsion) to collective procedures for liquidation or “restructuring” of debt and ensuing discharge from debt; even in Russia the Parliament is expected to give the go-ahead to a law on bankruptcy for every individual. Discharge has been excluded in Spain, unless at least 25% of the unsecured claims have been paid (Art. 178 of bankruptcy law). In France it has been limited to consumers, with the peculiar addition of individuals who act as guarantors for an entrepreneur (Art. L.330-1 of the consumer code), leaving professionals outside of the umbrella of protection. In Italy, as mentioned in point 2) above, a procedure that is substantially analogous to bankruptcy (liquidation of assets) was recently introduced with amendments to Law No. 3/2012 for all parties not subject to bankruptcy, on a generally voluntary basis (except in cases of annulment or termination of the composition, which also gives creditors the right to request the liquidation of assets: Art. 14 quater).

It does not interest us here to establish if the prospect of a future purging of debt stimulates the recourse to debt for consumption (as stated by White (1977)) and if that can (contribute to) generating the launch of an expansion-recession cycle: Rothbard denied this with reference to bank credit for consumption (1963, 93) and was probably right as regards immediate consumption, while the American and Spanish real estate booms that triggered the subprime mortgage crisis in which we are still immersed, provide evidence in support of the opposite for the consumption of durable goods (Huerta de Soto, 406 et seq.).

The issue is rather that of recovery from recession, and from this viewpoint, while there is obviously not the problem of guaranteeing the best possible allocation of the insolvent party’s productive factors (supra, § 2a), that do not exist for the consumer and play a very modest role for the other persons affected, except for the agricultural entrepreneur, the time needed for the realization of claims does however represent a hindrance.

As regards the remaining points dealt with in section 2), it is certainly to be hoped that the insolvent party performs some productive activity, but at the same time, the collection and circulation of all of the data relating to the insolvency should not be impeded, in order to allow the producers (and not only the banks and other lenders) to minimize the risks of their activities by allowing them to make an informed choice. Thus the provision of Art. L.334-4 of the French consumer code appears to represent a harmful interference, as it prohibits any such activity except in favour of the professional lenders, while an appropriate measure is the establishment of the Spanish Registro público concursal (Art. 198 bankruptcy law) and the British “individual insolvency register”, made available to the public, even if, as noted above, sooner or later those governments will have to deal with the privacy watchdogs [privacy that naturally doesn’t come into play in the case of state robbery, i.e. of taxation: (Cf. Art. 13, § 1, lett. e), of Directive 95/46/EC on personal data].

Finally, as concerns discharge from debt, leaving aside considerations regarding perpetuation of a productive activity by the non-entrepreneur insolvent party (which is always to be hoped for, as already stated), on one plate the scale holds the lack of confidence generated by the knowledge of the possibility for the insolvent party to escape its responsibilities with ensuing definitive loss of the value equivalent to one’s services, and on the other, the probable greater productivity of the formerly insolvent party.

This aspect takes on a varying significance though, depending on the portion of individual income that, based on a widespread rule, would in any event be exempted from any attempt at enforcement, weighted against the level of unemployment subsidies available in the different contexts.

Here too, therefore, an overall assessment leads to conclude that discharge from debt is not advantageous.

References

Agarwal, S., Benmelech, E., Bergman, N., & Seru, A. (2012). Did the Community Reinvestment Act (CRA) Lead to Risky

13This was reported on 12 July 2013 by the Russian legal information agency RAPSI, highlighting the raising of the threshold for access, that nevertheless remains quite low (slightly higher than $ 9000).

14On the role played by the Community Reinvestment Act of 1977 in that crisis, with its instruments to “convince” the banking system to expand real estate credit for those who are less well-off, see the irrelevant considerations of Krugman (2010) on the securitization of those mortgages (that only touch the issue of the disposal and not the creation of the junk) and on the other hand the study by Agarwal et al., 2012.
Scientific Research Publishing (SCIRP) is one of the largest Open Access journal publishers. It is currently publishing more than 200 open access, online, peer-reviewed journals covering a wide range of academic disciplines. SCIRP serves the worldwide academic communities and contributes to the progress and application of science with its publication.

Other selected journals from SCIRP are listed as below. Submit your manuscript to us via either submit@scirp.org or Online Submission Portal.