Ten very good things 2: Bankruptcy [1]

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For the second of the very good things that tend to receive a bad press, I highlight bankruptcy.

2. Bankruptcy

When an individual or firm goes bankrupt, a legal process is instigated to discharge debts that cannot be repaid. In former times such debtors might have been put into a debtors' prison and languished there for years. The process weighs assets against liabilities and allows the debts to be discharged at some fraction of their nominal value, leaving the debtor free of the burden, albeit subject to rules of financial behaviour and with a blemish on their credit record which can last for years.

While bankruptcy undoubtedly involves some social stigma that most people would seek to avoid, it does have advantages to society as well as to the individuals it releases from debt. A discharged bankrupt is no longer burdened by the debt, and is free to work again and to earn money without it all being consumed in repayments. If he or she went bankrupt as a result of a failed business enterprise, they become free, after the passage of time, to try again. Some highly successful business people have failed to get it right the first time, and have experienced bankruptcy on the road to eventual success.

Most lenders who extend loans to business know that risks are higher among 'subprime' candidates, and set their repayment terms sufficiently high to cover the losses from those who go bankrupt. While failure might be devastating and distressing for the individual, however, it has economic and social benefits. Failure enables capital and assets to be redeployed from businesses that have not worked towards new ventures that show more promise. It is the financial equivalent of clearing out the less hardy plants and animals and leaving their ecosphere available for the hardier strains.

The economist Joseph Schumpeter spoke of the "creative destruction" wrought by innovative ideas and businesses that led to the demise of established ones. Bankruptcy is part of the process by which failing firms close down and are replaced by newer and more successful ones. Although governments might try to reduce bankruptcies and failures by propping up firms in trouble, they do the economy and the prospects for future growth no favours by doing so. The failure of some is an important ingredient in the success of others.

Links:
[1] http://www.adamsmith.org/blog/economics/ten-very-good-things-2-bankruptcy

[2] http://www.adamsmith.org/taxonomy/term/5779
[3] http://disqus.com/?ref_noscript
[4] http://disqus.com