

Research Report: Estimated insolvency backlog and projected increase in the number of firms with long-term negative equity after COVID-19

English Summary

International developments and national measures to contain the COVID-19 pandemic have had significant impacts on the Austrian economy. The Gross Domestic Product fell by 6,6 percent in 2020. To combat the recession, the Austrian government enacted a wide range of fiscal and other measures, aiming to dampen financial losses of private households and firms as well as to secure their liquidity. Moreover, the obligation to declare insolvency has been suspended at least until June 2021.

In consequence, the number of insolvencies fell by 40 percent in 2020. Also in the first quarter of 2021, the number of insolvencies is significantly below pre-crisis levels. Considering the recession, a considerable increase in insolvencies would be expected. This gives rise to concerns that a catch-up effect sets in and the insolvency backlog is partly realized, once the policy measures end or are phased out.

This study aims to estimate the insolvency backlog on the basis of an empirical regression model using granular industry-level data from KSV1870. The results show that the GDP decrease in 2020 would be associated with an increase in declared insolvencies of 34,4 percent compared to 2019. In absolute terms, this would imply 6.839 insolvencies in 2020, while only 3.048 have been filed according to KSV1870. Hence, the estimated insolvency backlog due to the recession in 2020, taking the government support measures into account, is around 3.800 insolvencies.

It can be observed that the industries, which have been hit the hardest by the crisis, also exhibit large increases in insolvency cases in 2020. Taking the actually filed declarations in 2020 into account, also a relevant insolvency backlog is expected for these. Specifically, these are accommodation and food service activities, wholesale and retail trade, transportation and storage, administrative and support service activities as well as manufacturing.

A considerable insolvency backlog can also have an impact on firms' viability and increase the share of non-viable firms. In this study, we approximate the share of non-viable firms using the share of firms with long-term negative equity (more than 3 years). The emergence of such firms can be explained by distorted incentives in the banking sector, which result in a prolongation or restructuring of loans to non-viable firms instead of the bank accepting the loan as a loss ("evergreening"). An expansive monetary policy also contributes to these incentives. A further factor is the insolvency regime. If an insolvency regime is efficient and ensures the most productive use of economic resources, firms with long-term negative equity are less prevalent. However, a large share of firms with long-term negative equity has direct and indirect negative economic effects: They invest less, they are less productive and distort the competitive environment by tying up resources.

For 11,7 percent of all corporations, which are active more than 8 years, negative equity in the least three years in 2019 can be observed. In absolute terms this amounts to 10.210 corporations.

Due to the considerable insolvency backlog in 2020, the structural preservation by the imposed policy measures, and the unchanged factors that enable the formation of firms with long-term negative equity, it is likely that the number of firms with long-term negative equity will increase over the next years. The results of the empirical regression model imply that the recession in 2020 would be associated with an increase in the number of firms with long-term negative equity to 12.300 corporations in 2023. This is equivalent to an increase by 20 percent compared to 2019.

In the short term, it is crucial to stabilise and improve expectations for consumers and entrepreneurs as well as to flatten the development of insolvency declarations. A too rapid increase of insolvencies after phasing out economic support measures has the potential to entail a further negative macroeconomic shock. However, the prolongation of economic support measures should – if in accordance with EU state aid law – take the specific situation of individual industries into account and be limited in time. Prolonging economic support measures for too long would preserve the pre-crisis economic structure and prohibit necessary structural change, which can lead to an increase in the number of firms with long-term negative equity. Ensuring structural change and improving business dynamics are essential for a sustainable recovery after a recession.

In the medium to long term, it is important to improve firms' equity ratios, since this can contribute to reduce the increase of firms with long-term negative equity after the crisis and enable a fast economic recovery. Furthermore, an improved equity ratio can increase the resilience for future crises. In this study, a number of policy options have been discussed, which can contribute to an improved equity ratio, e.g. the introduction of an allowance for corporate equity. In addition, it is important to stabilize or increase the investment dynamics in the economy. This can be done indirectly by lowering taxes for enterprises or directly by granting investment premia such as the COVID-19 investment premium. These have a positive impact on the firms' productivity and increase the profitability of Austrian companies, which affects the Austrian GDP positively. Thus, in the short term, the insolvency backlog can be reduced, while in the medium term the share of firms with long-term negative equity decreases.

Moreover, the efficient design of an insolvency regime plays a crucial role, since it can enable the efficient use of economic resources. The shortcomings of the Austrian insolvency regime, according to the literature, are partly addressed in the recent legislative proposal, which implements the EU's directive. However, an early warning system for SMEs is still lacking and the stringent employment protection regulation in the insolvency process is not addressed.