The 1978-83 Increase in U.S. Business Failures

By Dale N. Allman

Since 1978 there has been a dramatic increase in the number of business failures in the United States. Some of these failures have been highly publicized as press accounts have focused attention on problems faced by individual firms such as Wilson Foods, Braniff Airlines, and the Manville Corporation.[1] While useful in drawing attention to the problem of business failures, this narrow emphasis on the problems of individual companies may be misleading because it gives the impression that business failures are isolated phenomena impacting a small number of large firms and that the causes of business failures—and possible remedies—are specific to individual firms.

This article examines the recent surge in business failures from a broader perspective. The increase in business failures is found to be widespread across the spectrum of U.S. industry, affecting small, medium, and large firms alike. The pervasiveness of the problem suggests that the increase in business failures has been caused by such broad factors as the state of the economy, the level of interest rates, and changes in the legal and regulatory environment affecting industry generally.

The article is divided into three sections. The first section describes the behavior of business failures in the postwar period from 1952 through 1983. The second section discusses possible explanations for the recent sharp rise in failures. The final section examines whether the recent rise in failures is a temporary phenomenon or a longer term structural problem that may require new policy initiatives.

Dimensions of the problem

Some might wonder why business failures should be a cause for concern. After all, in a

Dale N. Allman was an associate economist with the Economic Research Department of the Federal Reserve Bank of Kansas City when this article was written. Glenn H. Miller, Jr., vice president and economic adviser, and Gordon H. Sellon, Jr., research officer and economist, assisted with the preparation of the article.

[1] For example, see R. Winter, "Up in Smoke?" *The Wall Street Journal*, November 17, 1982; "Bankers' Bedside Manners," *The Economist*, August 7, 1982; Peter Trenholm, "The Four Horsemen: Three Good Prospects and a Puzzlement," *Bank Administration*, August 1982; and Anna Cifelli, "Management by Bankruptcy," *Fortune*, October 31, 1983.

dynamic, growing economy, some business failures are to be expected and may simply reflect the normal reallocation of resources in a market economy. Business failures are costly, however, both to the companies directly involved and to other firms whose operations depend upon businesses that fail. Business failures may also be concentrated in certain geographic areas, creating or worsening problems of structural unemployment and adversely affecting the tax base and revenue structure of particular regions. Thus, legitimate concern can be expressed when business failures deviate from their long-run trend.

As shown in Chart 1, there has been a sharp increase in business failures since 1978, an increase that represents a dramatic deviation from earlier U.S. postwar experience.[2] After rising in the 1950s and gradually declining during the 1960s and 1970s, the number of business failures reached a postwar low of 6,619 in 1978. This downward trend was reversed after 1978, however, and failures rose sharply to a level of 31,334 in 1983.

The increase in the number of business failures is mirrored in Chart 2 by a sharp rise in the failure rate for U.S. businesses. The failure rate measures the number of failures relative to the number of businesses in existence.[3] For example, if the number of failures were to increase but the number of businesses in existence were to increase at the same pace, the failure rate would be unchanged. In this situation, the increase in the number of failures might not be a cause for concern. Chart 2 clearly shows, however, that business formation has not kept pace with the rise in business failures. Thus, the sharp increase in business failures since 1978 deserves further study.[4]

An understanding of the recent business failure experience is enhanced by disaggregating the data by size of firm and by business sector. When the failure data are examined in this way, several patterns emerge.

First, the increase in failures has not been entirely concentrated in large firms but has been widespread across different size categories. Thus, small business failures increased from 3,712 in 1978 to 10,480 in 1982, medium-sized business failures rose from 2,593 in 1978 to 10,452 in 1982, and large-sized business failures expanded from 314 in 1978 to 1,387 in 1982.[5]

Second, the pattern of failures for different size firms shows distinct contrasts in the postwar period. From 1952 to 1978, as shown in Chart 3, failures of medium and large-sized firms trended upward slightly. In contrast, from the early 1960s to 1978, failures of small businesses showed a pronounced downward trend. Thus, while failures in all three size categories increased sharply after 1978, the pattern of small business failures is sufficiently distinct to suggest that disaggregation

[2] A firm that either files for bankruptcy in U.S. courts or voluntarily suspends operations without paying creditors is counted as a business failure. Annual failure data are published in *The Dun and Bradstreet Business Failure Record* and monthly data are published in *News from Dun and Bradstreet, Monthly Failures.*

[3] This information is available in Dun and Bradstreet, *Reference Book.* The book includes data for mining, manufacturing, retail, wholesale, construction, and commercial service firms. The types of companies not included are financial, insurance, real estate, railroad, amusement, professional, and farm.

[4] It is interesting to note that despite the moderate increase in the number of firms in existence, the number of new business incorporations (as reported by Dun and Bradstreet) has increased dramatically since 1974. Since historically about half of business failures has been among firms in business five years or less, such growth in incorporations suggests increased business vulnerability to adverse economic and financial conditions.

[5] Small businesses are defined here as having less than $100,000 in current liabilities at the time of failure, medium-sized firms have between $100,000 and $1 million in liabilities, and large firms have more than $1 million in liabilities. At the time that this article was prepared, a detailed breakdown of the 1983 data by size of firm was not available.

CHART 1
Business failures annually, 1952-83

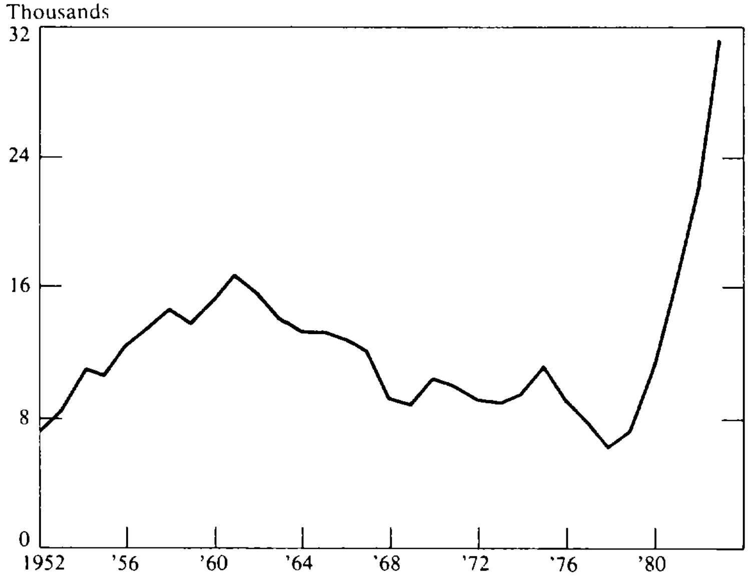


CHART 2
Business failure rate annually, 1952-83

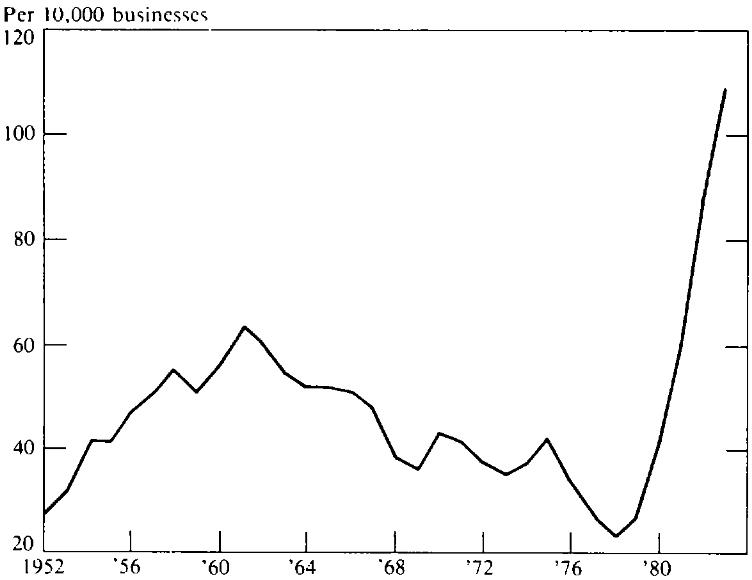
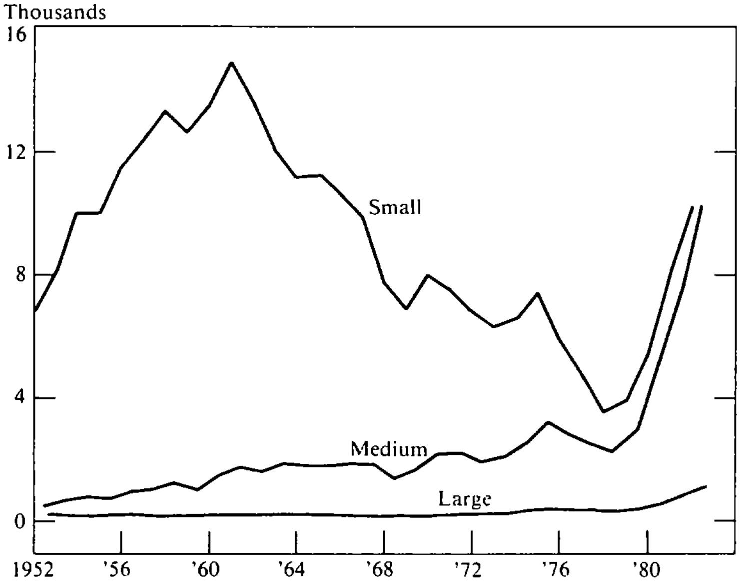


CHART 3
Failures by size of business annually, 1952-82



is important in understanding the recent failure experience.

Third, failures in all business sectors for which data are available increased sharply between 1978 and 1983. As shown in Table 1, the growth in failures was especially pronounced in the commercial service sector, which includes such businesses as passenger and freight transportation, hotels, laundries, funeral homes, and other service firms. Failures in this sector increased at a 54.6 percent annual rate from 1978 to 1983, far above the 36.5 percent rate of increase for all businesses included in Table 1.

Examination of the failure data by size of firm and by business sector thus confirms the casual impression that the problem of business failures has worsened dramatically in the 1978-83 period. The pervasiveness of the problem, however, suggests that a number of economywide causal factors may be at work. The following section identifies some of the more important factors that might be relevant in explaining the recent rise in failures.

Possible explanations for increasing failures

Explanations for the recent increase in business failures can be divided into three broad categories: the influence of the business cycle, changes in interest rates and other financial market conditions, and the reform of the bankruptcy laws. While these explanations do not constitute an exhaustive list, they do represent some of the more significant factors that might account for the increase in business failures.

Part of the recent rise in U.S. business failures no doubt reflects variation due to changes in economic activity associated with the busi-

TABLE 1
Business failures by sector, 1978 and 1983

	1978	1983	Average Annual Percentage Increase
Retail trade	2,889	11,076	30.8
Wholesale trade	740	3,525	36.6
Mining and manufacturing	1,013	4,632	35.5
Construction	1,204	5,262	34.3
Commercial services	773	6,839	54.6
Total	6,619	31,334	36.5

ness cycle. Failures tend to increase during recession and decrease during expansion phases of the cycle.[6] For example, during the 1970s, the number of business failures peaked at 11,432 in the midst of the 1974-75 recession and then fell steadily until 1978 in the subsequent recovery. There have been two recessions since 1978, one in 1980 and another in 1981-82. The postwar behavior of failures in recessionary periods suggests that failures would be expected to increase during both of those recent contractions in economic activity.

Business failures in recent years could also be expected to increase more than the postwar average because of the severity of the 1981-82 recession. For example, from 1981 to 1982 the U.S. industrial production index fell by 8.2 percent, the largest decline since the 1974-75 recession. By December 1982, the unemployment rate had risen to 10.7 percent and the rate of capacity utilization in manufacturing had fallen to 67 percent, setting new postwar records. Thus, the severity of that recent recession period suggests that more firms were susceptible to failure than in previous postwar recessions.

The 1981-82 recession also followed a short and weak recovery period, which lasted from mid-1980 to mid-1981 and came after a prolonged period of economic weakness beginning in 1978.[7] Over the period from 1978 through 1982, there was practically no real economic growth. With U.S. businesses having to deal with declining sales due to lackluster output growth, more marginal firms were susceptible to failure than during earlier postwar years.

A second major factor contributing to the rise in business failures was the changes that occurred in U.S. credit market conditions and interest rates. Both nominal and real interest rates rose to unusual heights between 1978

[6] See Victor Zarnowitz and Lionel Lerner, "Cyclical Changes in Business Failures and Corporate Profits," in *Business Cycle Indicators*, Vol. 1, by Geoffrey Moore, ed., National Bureau of Economic Research, New York, 1961; Edward Altman, *Corporate Bankruptcy in America*, Heath Lexington, Lexington, Mass., 1971; and Edward Altman, *Corporate Financial Distress*, John Wiley & Sons, New York, 1983, for discussions of the influence of U.S. business cycles on failures.

[7] See Glenn H. Miller, Jr., "Inflation and Recession, 1979-82: Supply Shocks and Economic Policy," *Economic Review*, Federal Reserve Bank of Kansas City, June 1983, for a characterization of U.S. economic activity in the 1978-82 period.

and 1983.[8] For example, the prime lending rate of U.S. commercial banks rose to almost 19 percent in 1981. The prime rate was still at a relatively high level of almost 15 percent in 1982. Other indicators confirm the greater vulnerability of businesses to high interest rates over the 1978-83 period.[9] Increasing failures since 1978 may reflect the fact that U.S. businesses had to contend with these higher rates and the greater debt burden that resulted from those higher rates.

The process of deregulation of financial markets also may have played a role in explaining increased business failures. With the deregulation of deposit rates, financial institutions have faced increasing pressure to ensure the profitability of loans. Thus, lending institutions may have been less willing to make loans to marginal firms, those most susceptible to failure. In addition, with the widespread use of variable-rate loans, firms without adequate cash flow may have found themselves in a liquidity bind when interest rates rose sharply.

Finally, some of the increase in business failures is no doubt linked to changes in the legal environment in which businesses operate. The reform and liberalization of bankruptcy laws in 1978 made bankruptcy filing, and hence failure, easier for U.S. businesses.[10] In fact, a recent analysis suggests that bankruptcy may be used by U.S. businesses as part of their management strategy.[11] The introduction of future potential liabilities into consideration of business solvency is a direct result of the 1978 change in bankruptcy laws. Until then, in order to file for bankruptcy, a business had to prove that current liabilities exceeded the value of assets. The reform in bankruptcy laws removed that insolvency test and allowed businesses to file for bankruptcy before they were actually insolvent. Thus, the Bankruptcy Act of 1978 made it easier for firms to continue to operate while in bankruptcy proceedings.[12] These changes in legal attitudes toward business failures have undoubtedly played a role in explaining the recent rise in failures.

Summary and conclusions

This article has examined several dimensions of the recent increase in business failures in the United States. The article shows that the problem of business failures is not localized in a few large firms but rather affects small, medium, and large firms across the spectrum of U.S. industry. The broad nature of the problem suggests that economywide influences such as the business cycle, interest rates, and bankruptcy laws are important causal factors behind this phenomenon.

The extent to which policymakers should be concerned with the problem depends upon whether the recent surge in failures is viewed as temporary or permanent in nature. If the

[8] Raymond E. Lombra, "The Changing Role of Real and Nominal Interest Rates," *Economic Review*, Federal Reserve Bank of Kansas City, February 1984.

[9] Edward Altman, *Corporate Financial Distress*, John Wiley & Sons, New York, 1983, pp. 42-45, and Karlyn Mitchell, "Trends in Corporation Finance," *Economic Review*, Federal Reserve Bank of Kansas City, March 1983.

[10] See Edward Altman, *Corporate Financial Distress*, pp. 13-27, for a detailed description of the changes in bankruptcy laws enacted in the Bankruptcy Reform Act of 1978.

[11] Anna Cifelli, "Management by Bankruptcy," *Fortune*, October 31, 1983.

[12] In response to some of the problems created by the 1978 Bankruptcy Act, recent legislation modifies some of the act's provisions. In particular, the Bankruptcy Amendments of 1984 limit the ability of businesses to unilaterally terminate labor contracts as part of bankruptcy proceedings. In 1983, the Supreme Court had ruled that such actions were permissible under provisions of the 1978 act.

increase in failures is a result of the chance occurrence of a number of temporary factors, failures might be expected to decline to normal levels in the near future. However, if there has been a permanent increase in the number of failures, policymakers might need to consider legislative or macroeconomic policy remedies.

Examination of the three types of factors identified as contributing to the increase in failures suggests that both temporary and permanent factors are at work. On the one hand, the effect of the business cycle on the number of failures should prove to be temporary in nature. The strong economic recovery that began in 1983 should help to alleviate the failure problem over time by improving the sales and cash-flow prospects of U.S. business. On the other hand, financial developments may continue to keep failures abnormally high. Financial markets are clouded by uncertainty and interest rates remain relatively high due mainly to the spectre of large structural deficits in the federal budget for years to come. In addition, the overhang of problem loans in the banking system and ongoing financial deregulation may continue to limit the access of small and marginal firms to adequate financing. Finally, to the extent that liberalized bankruptcy laws have contributed to the problem, business failures in the United States may remain at historically high levels for the foreseeable future.

Consideration of the three major factors affecting business failures suggests that business failures may remain permanently higher unless policymakers undertake macroeconomic and legislative initiatives. In the Bankruptcy Amendments of 1984, Congress has already taken legislative action to remedy some of the weaknesses in the 1978 bankruptcy law. Thus, the most useful initiative for policymakers to take would be to reduce the large structural deficits in the federal budget. Such action would contribute to an improvement in the outlook for financial markets and, thereby, augment the beneficial effects of the economic recovery in reducing business failures.

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