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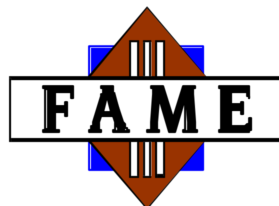

Research Paper Number 81

Does Poor Legal Enforcement Make Households Credit-Constrained?

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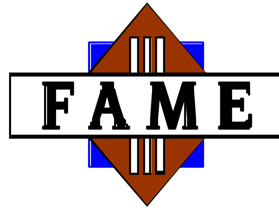
Daniela Fabbri, Mario Padula, "Journal of Banking and Finance", 2004, n°28, pp. 2369-2397.

Abstract:
This paper analyzes the relation between the quality of the legal enforcement of loan contracts and the allocation of credit to households, both theoretically and empirically. We use a model of household credit market with secured debt contracts, where the judicial system affects the cost incurred by banks to actually repossess the collateral. The model shows that the working of the judicial system affects both the probability of being credit-constrained and the equilibrium amount of debt. In the empirical part, we test our predictions using data on Italian households and on the performance of Italian judicial districts. Controlling for household characteristics, unobserved heterogeneity at judicial district level and aggregate shocks, we document that an increment in the backlog of trials pending has a statistically and economically significant positive effect on the household probability of being turned down from the credit. Endowing the households living in high-cost judicial districts like Campobasso or Caltanissetta (in southern Italy) with the best enforcement in the sample would reduce the probability of their being credit-constrained by 70% and 63%, respectively. This effect is stronger for poorer than for wealthier households. Moreover, we document that an increment in the backlog of trials pending reduces the availability of credit for poorer households but, surprisingly, has the opposite effect on wealthy households, whose debt volume increases. Again, this effect is found to be significant both statistically and economically.



Executive Summary
In the last few years a new line of research has begun to investigate the economic implications of different legal systems. Most of this literature focuses on corporate credit and identifies two channels by which legal institutions may affect financial markets: the content of the law and the quality of its enforcement.

Only a few papers examine the household credit market, all offering empirical evidence on how different legal bankruptcy arrangements affect this market and all focusing exclusively on the United States.

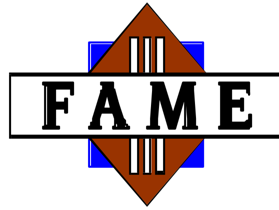
The objective of this paper is to measure the effect of the degree of enforcement of laws which regulate credit contracts. More precisely, we test whether the behavior of courts in enforcing credit contracts is able to explain differences in the household credit market. To this end, we use data on Italian households drawn from the Survey of Household Income and Wealth and we combine them with data on Italian judicial districts. This data set is particularly well suited for our problem, since in Italy the rules on credit relations are the same nationwide, but enforcement differs considerably across judicial districts. Italy thus offers a useful if not unique natural experiment that can disentangle the enforcement effect from the legislative effect. Our focus on the quality of the enforcement of credit contracts distinguishes us from Gropp, Sholz and White (1997). They investigate how differences in the content of bankruptcy laws affect household credit market, without controlling for possible differences in the enforcement of laws.

In the first part of the paper we provide a theoretical model, which is suitable to describe an economic mechanism through which courts may affect the credit market.

We consider the household credit market with secured debt contracts and strategic default, where the judicial system affects the costs paid by creditors to enforce their right to repossess the collateral, by determining when the transfer of the as sets takes place. The model identifies two main effects of weak judicial enforcement.

First, households are more likely to be credit-constrained when judicial costs are high, i.e. the quality of enforcement is poor, because when contracts are weakly enforced the household's incentive to repay decreases and banks respond by rationing credit.

Second, the higher the judicial costs, the smaller the amount of credit provided to households in equilibrium, because banks compensate for the lower net revenues from the liquidation of the



collateral asset by charging higher interest rates.

In the second part of the paper, we test the validity of these theoretical predictions by proxying the amount of legal costs (i.e. the degree of enforcement) with measures based on the backlog of civil trials. First, we investigate whether the probability of a given household's being credit-constrained depends on judicial costs. Second, we test whether the level of the household's debt is also sensitive to judicial costs.

Controlling for household characteristics, unobserved heterogeneity at judicial district level and aggregate shocks, we document that a poorly functioning legal system does cause Italian households to be credit-constrained: households living in judicial districts where the quality of legal enforcement is poorer have a higher probability of being denied loans. To quantify this distortion, we compute how much the prob-ability of being credit-constrained would change on average, if we endowed all the households with the same degree of enforcement. Other things being equal, endowing the households living in high-cost judicial districts like Campobasso or Caltanissetta (in southern Italy) with the best enforcement in the sample would reduce the prob-ability of their being credit-constrained by 70% and 63%, respectively. This effect is found to be much stronger for low asset households. The probability that a household in the first quartile of the asset distribution is credit-constrained ranges from 60% in the worst judicial district to 18% in the best judicial district. This jump is strongly reduced if we consider households in the last quartile, where the probability ranges from 23% in the worst judicial district to 12% in the best judicial district. We also document a second welfare implication of poor legal enforcement: the amount of debt decreases as the quality of enforcement worsens. The elasticity of household debt with respect to the quality of enforcement is about 34%, meaning that a 1% increase of the legal costs (corresponding to a 1,500 units increase of trials pending) corresponds with a reduction of € 300 in the debt. This second effect is also found to vary across wealth quartiles: we find that a worsening in the legal enforcement reduces the amount of debt of households in the first and second quartile, but it increases the availability of credit for households in the upper half of the asset distribution. This effect is significant not only statistically but also economically.

Computing the elasticity of the household debt with respect to the legal variable, we find that a 1% increase of the legal costs is associated to a reduction of €9000 in the debt volume of low asset households and an increment of €4000 in the debt volume of high asset households. This evidence seems to suggest that an ill-functioning legal system may have both allocative and redistributes effects in the credit allocation to households.

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