Freedom to Exit

The Insolvency and Bankruptcy Code, 2016 builds the third pillar of economic freedom

It is well established that economic freedom and economic performance have very high positive correlation. Countries having high level of economic freedom generally out-perform the countries with not-so-high level of economic freedom. The index of economic freedom, which measures the degree to which the policies and institutions of an economy are supportive of economic freedom, has substantially improved for India since the 1990s. The outcome has been astounding; the growth rate in the 1990s onwards has almost doubled as compared to the *Hindu rate of growth* in the preceding period.

An economy has either of the two broad types of institutions, namely, inclusive institutions and extractive institutions. The inclusive institutions allow everybody to participate in the economy, while extractive institutions restrain them. Inclusive institutions allow every person to undertake any economic activity(ies) (business) of his choice in the manner and the scale he is comfortable with. These unleash and realise the full potential of a person to innovate, invest and contribute to the economy. On the other hand, extractive institutions concentrate power and opportunity in the hands of a few or use energy and creativity of a small set of persons. Obviously, economies with inclusive institutions develop faster as the contribution of all exceeds the contribution of some.

One of the primary duties of the State is to provide the right institutional milieu to bring out the best from her people. It is, therefore, not surprising that the thrust of the reforms over the years has been provision of economic freedom, inclusive institutions to protect freedom and regulation of such economic freedom only to address market failure(s). Accordingly, India made a paradigm shift from State providing goods and services to State regulating the market for provision of goods and services. It granted freedom by repealing enactments such as the Capital Issues (Control) Act, 1947 and the Import and Export (Control) Act, 1947. It came up with a different genre of economic laws, which expanded the 'who, what and how to do' list. These expanded the contours of economic freedom and consequently the frontiers of development.

Markets need freedom broadly at three stages of a business - to start a business (free entry), to continue the business (free competition) and to discontinue the business (free exit). This enables

▲ Secretary, Ministry of Corporate Affairs, Shri Tapan Ray addressing an event on 28th November, 2016, where certificates of registration were handed over to Insolvency Professional Agencies new firms to emerge continuously; and they do business when they remain efficient, and vacate the space when they are no more efficient. This ensures free flow of resources from inefficient uses to efficient uses - the first stage ensures allocation of resources to the most efficient use, the second stage ensures efficient use of resources allocated, and the third stage ensures release of resources from inefficient uses - and consequently the highest possible growth.

The reforms initially focused on freedom of entry by dismantling the license-permit-quota Raj. This phase witnessed laws such as the Securities and Exchange Board of India Act, 1992, when license gave way to registration. Anybody who meets the eligibility requirements is entitled to registration. If registration is to be denied, it has to be communicated by a reasoned order and that order is appealable. Further, entry requires many facilitators. For instance, one can enter into a business only if he has resources. Accordingly, the securities laws allowed him, subject to meeting the eligibility requirements, to access the securities markets without requiring any approval from any authority.

The reforms then shifted focus to freedom of doing business. It came up with laws such as the Competition Act, 2002 to protect freedom of firms. One has freedom to do business, but not to refrain the freedom of others to do so. One restrains freedom of others by taking control of either price and or quantity. For instance, if a business adopts predatory pricing and has the financial muscle to sustain it, it effectively thwarts the competitors' freedom to do business. So predatory pricing was proscribed. Further, freedom of business requires strengthening supporting institutions such as level playing field. Accordingly, a state owned firm was treated at par with a private firm under the competition law.

A firm may fail to deliver as planned for a variety of reasons. It could be because of faulty conceptualisation of business, inefficient execution of business, change of business environment, or even malafide design in some cases. Regardless of the reason, the failure impacts macro economy in multitudes of ways and needs to be addressed expeditiously. Such failure usually manifests in default in repayment obligations. Default arises also from mismatches between cash inflows and outflows. Default is a state of insolvency and is often a legitimate outcome of business operations. It does not necessarily warrant the closure of a business, which destroys organisational capital. It is necessary to have a mechanism to resolve insolvency in an orderly manner. The absence of such a mechanism hitherto denied effective recourse to lenders to recover their debt and thereby discouraged them from lending. This reduced availability of finance for even genuinely viable projects. Further, low and delayed recovery pushed up the cost of lending, and consequently, fewer projects became viable.

Further, it may not be possible to resolve insolvency of firms in all cases. It is mostly because efficient firms drive out inefficient firms continuously from the market. It is necessary to have a mechanism whereby the inefficient or defunct firms vacate the space and release the idle resources for efficient uses in an orderly manner. In the absence of a mechanism hitherto, there are quite a few firms stuck in unsustainable business or with no business and idle assets. The Economic Survey 2015-16 compares this situation to the '*Chakravyuaha'* of the *Mahabharata,* and has documented the cost of such impended exit, thereby illustrating the opportunity cost of not allowing *'creative destruction'* in an otherwise dynamic economy.

It has been a paradox that an economy which allowed free entry and free competition did not permit free exit and in the process suffered the inefficiencies of several zombie entities in the system for so long. The third pillar has now been erected in the form of the Insolvency and Bankruptcy Code, 2016. This Code offers a market directed, time bound mechanism for resolution of insolvency, wherever possible, or exit, wherever required, and thereby ensures freedom to exit.

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