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When will India celebrate failure? Insolvency key to small business growth

Entrepreneurs, fearful of social judgement, often hesitate to seek help, allowing their struggles to fester until it is too late

M S Sahoo | Ashish Makhija |

The executive and legislature work in unison to enact laws to address pressing socio-economic issues. Historically, laws would include a clause stating that they would come into effect on a date appointed by the executive. However, recent enactments include a proviso to that clause, allowing different provisions of the same law to come into force on different dates.

While this flexibility helps the executive align the implementation with the readiness of the required machinery, it also provides a convenient excuse to delay the implementation indefinitely. This happens even when there is no political or public opposition to its implementation, highlighting a disconnect between the legislative intent and executive action, which undermines the intended purpose.

The Insolvency and Bankruptcy Code, 2016, (Code) is a notable example. This was enacted to provide a comprehensive framework for the stress resolution of corporate entities, proprietorships, partnerships, and individuals. India has an estimated 1.7 million companies, 170 million proprietorships and partnerships (100 million agricultural and 70 million non-agricultural), and 1,400 million individuals. However, the IBC is currently available only for corporate entities, covering a mere 0.1 per cent of potential beneficiaries. Nearly a decade after its enactment, proprietorships, partnerships, and individuals, representing 99.99 per cent of those who could benefit, still lack access to the Code. The executive has restricted the availability of the Code to a tiny fraction of those who need it, thereby denying a key benefit: The promotion of entrepreneurship.

A firm requires freedom at three stages of its lifecycle — to enter the market (freedom of entry), to compete and grow (freedom to grow), and to exit the market (freedom of exit). This mirrors the metaphors of creation, preservation, and destruction in Hindu mythology, where the balance of the universe is disrupted if any one element is missing. A well-functioning market economy offers this complete spectrum of freedom. New firms emerge all the time, they do business while they are efficient, and vacate the space when they are no longer efficient. This cycle ensures that resources are continually allocated to the most efficient firms, promoting the optimal use of limited resources.

Economic freedom unleashes and realises the full potential of every firm and every resource, fostering an inclusive economy. Such economies grow faster, as the contributions of many far surpass the contributions of a few, which is often the case in economies with extractive institutions. Theoretical and empirical studies have established that nations with higher levels of economic freedom consistently outperform those with lower levels. For instance, the Fraser Institute's 2023 Annual Economic Freedom of the World report notes that nations in the top quartile of economic freedom had an average per capita gross domestic product of $48,569 in 2021, compared to just $6,324 in the bottom quartile.

India's business reforms in the 1990s centred on freedom of entry, moving from a system where most industries required a licence to one where only a few did. In the 2000s, reforms focused on freedom to grow, lifting restrictions on business size, and removing barriers to international trade.

As a result, India's index of economic freedom saw a significant improvement, leading to markedly better economic outcomes. Before Independence, India's annual growth rate lingered below 1 per cent. With civil liberties after 1947, this improved to 3.5 per cent, a rate famously dubbed the "Hindu rate of growth". However, following the economic reforms of the 1990s, growth rates almost doubled, driven by the newfound entrepreneurial freedoms that ignited competition and innovation.

Competition forced less efficient firms out of business as they struggled to match the prices of more agile competitors. Innovation rendered many industries obsolete, making firms in those industries unviable. The greater the intensity of competition and innovation, the higher the likelihood of business failures. As a result, countless entrepreneurs found themselves trapped in a chakravyuha of failed businesses. With no clear exit, their resources idled, and their dreams shattered. This discouraged new entrepreneurs from taking risks, knowing they had no way out if they failed. This stifled entrepreneurship, limiting the gains from competition and innovation, and held back economic growth.

Thomas Alva Edison is said to have invented the light bulb after 1,000 attempts. When asked if he had failed 1000 times, he reportedly replied, "I haven't failed, I've just found 1,000 ways not to make a light bulb." This sentiment captures the essence of entrepreneurship: Failure is part of the learning process. In well-functioning economies, entrepreneurs are not punished for honest failures. Instead, they are given a dignified exit, enabling them to recover and start afresh with renewed insights. When entrepreneurs know that they can fail and yet not be trapped, they are more likely to pursue bold ideas, fuelling economic progress. Recognising this, India enacted the Code to provide freedom from failure, the ultimate economic freedom, to allow entrepreneurs to exit gracefully and begin anew with renewed vigour.

This freedom from failure is especially critical for small ventures: 170 million proprietorships and partnerships that serve as breeding grounds for entrepreneurship. Operating with razor-thin margins, they are highly susceptible to failure. Studies indicate that nearly 90 per cent of startups fail within their first five years. The deep-rooted stigma surrounding failure in Indian society compounds their challenges. Entrepreneurs, fearful of social judgement, often hesitate to seek help, allowing their struggles to fester until it is too late. In the worst cases, this pressure has led to tragic outcomes, including suicide.

Extending the safety net available in the Code to small ventures would empower them to restructure viable businesses and close unviable ones, thereby optimising resource allocation. This will rescue entrepreneurs from failure, unlocking the full potential of the entrepreneurial spirit. Just as the use of the Code for corporate entities has transformed the credit culture for the better and for good, its extension to proprietorships and partnerships will shift the narrative from a hopeless end to endless hope. Only then can India truly celebrate honest business failures, elevating the country to a higher growth trajectory on its path to becoming a $10 trillion economy.

The authors are legal practitioners

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