Inefficient insolvency regimes: a barrier to creative destruction?

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Productivity is the ultimate engine of growth in the global economy, but there has been an increasing concern about weak productivity growth in recent years. A key recent OECD work, the Future of Productivity implies that inefficient firms increasingly linger as opposed to exit the market, despite their inability to adopt new technologies. Joseph Schumpeter (1942) introduced the idea that economic progress can be partly attributed to the principle of "creative destruction", the replacement of old and obsolete technologies, products, methods of production and markets with new ones; and the exit of existing firms that are unable to adopt new innovations.

The productivity costs of barriers to entry and competition are well known, but policy-induced barriers to exit of low productivity firms can also affect aggregate productivity. For example, personal insolvency regimes lacking a "fresh start" provision – i.e. the exemption of future earnings from obligations to repay past debt due to liquidation – increase the costs and the stigma of failure associated with insolvency: this can not only delay exit of failing firms, but also lower incentives for experimentation and entrepreneurs' ability to start new businesses in the future. To better understand this kind of link between productivity and exit policies, Adalet McGowan and Andrews (2016) has developed an analytical framework to identify the channels through which exit policies affect aggregate productivity growth. Two main insights emerge from it (Figure 1):

- Exit policies can directly affect aggregate productivity by: *i*) shaping the strength of market selection, which enables the exit of non-viable firms and the restructuring of viable ones (e.g. judicial efficiency); and *ii*) shaping the reallocation of resources from failing firms to more productive uses (e.g. via policies facilitating worker mobility).
- Product market reforms that raise competitive pressures and efficient insolvency regimes will strengthen the contribution of exit to aggregate productivity via both tighter market selection and more effective reallocation, ultimately boosting the effects of other exit policies (e.g. regulations affecting product, labour and financial markets) on aggregate productivity growth.

Figure 1. A stylised depiction of how policies can shape productivity growth along the exit margin

The OECD, which has been a leader in developing indicators on product market regulations, is currently building new cross-country indicators on insolvency regimes, which will be released in early 2017. This will make it possible to estimate the effects of these regimes on productivity and make relevant and specific policy recommendations on how to improve their different design features so as to boost productivity growth.

References:

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