



REPORT ON 2nd SPEAKING TOUR

**EVALUATION OF
COMPETITIVENESS AMONG
NORTH INDIAN STATES**

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This report summarises the key takeaways from the speaking tour organised by the US Embassy, New Delhi and Consumer Unity Trust Society (CUTS International) in Jaipur, Rajasthan and Dehradun, Uttarakhand, between July 23 and 29, 2017. I participated in two focus group meetings in Jaipur, two in Dehradun, and several one-on-one meetings. My remarks based on each focus group from the various sessions have been summarised in the following sections:

Competitiveness and Cooperation among US States

My observations focussed on the experience of US states in competing with each other to attract businesses and talent. I began by noting that like India, the US has a federal structure, and states frequently compete with each other to offer financial incentives to certain firms to locate there. In general, research suggests that while states with overall low tax burdens and low costs of doing business do have higher growth, other factors are often more important.

When establishing a new factory or considering moving headquarters, firms usually follow a two-stage procedure. In the first stage, while determining what state or region to locate in, firm management will consider factors, such as infrastructure, availability of skilled labour, proximity to customers and suppliers, and labour regulations. Once an area has been selected, localised considerations like availability of appropriate sites, and financial incentives offered by counties (akin to districts in India) become more important.

Financing

Financial incentives can make a difference in firm location decisions, especially at the local level. However, in the long run, the evidence is mixed as to whether the potentially large costs to the state or county granting the incentive –often in the form of lost tax revenues – lead to a level of sustainable benefits that are sufficient to justify the costs. In fact, as more and more states or counties compete to offer benefits, the benefits to any individual area are diminished, yet the costs often escalate.

For Micro, Small and Medium Enterprises (MSME), financial considerations can be particularly important. However, tax breaks are often not as useful to these firms, as many of them are either start-ups, and pay low taxes or no taxes at all if their products are not yet commercialised. Instead, availability of finances to tide them through the ‘valley of death’ – the period between when they are funded by ‘friends, family and fools’ and when they manage to get funding from venture capital funds or through sales – might be more important.

Recent research suggests that promoting competition can be particularly important in this regard, in two ways: First, areas with more competition in private banking have more firms, and particularly more small firms, suggesting that competition among banks is a potentially important method to increase the finance available to small firms. Second, government programmes that finance young firms at early stages are generally more successful when they require a competitive application process that is judged by technical experts, thus helping to channel government funds for the most promising start-ups.

Ease of Doing Business

Overall, the US experience suggests that policies that promote ‘Ease of Doing Business’ (EoDB) can influence firm location and growth. A critical role of government – one that is difficult to replace with private sector investments – is to ensure the availability of high-quality, basic infrastructure, such as roads and ports. For areas with concentrated numbers of firms in specific industries (for example, pharmaceuticals), public laboratory space or equipment that can be rented by MSMEs might also be helpful.

Labour Mobility

Another business condition that is important to business location and growth in the US context is labour mobility – from two perspectives. First, it is important for firms to be able to easily hire and fire workers. This is especially true for MSMEs, which need to rapidly grow and contract in response to changing technological or marketing realities. Second, it is important that workers should be able to move between firms. Research suggests that one of the reasons for Silicon Valley’s success is the fact that ‘non-compete’ clauses are not enforceable in the state of California – thus allowing workers

to take their human capital with them from one firm to another, and improving the flow of ideas in the region, as a whole.

Nonetheless, the US experience also suggests that EoDB alone is not a sufficient condition for attracting firms and encouraging their growth. Key factors that do not directly fall under the EoDB category but are perhaps more important are availability of a qualified workforce, access to customers and access to suppliers and natural resources. In addition, specifically for MSMEs, availability of an 'ecosystem' i.e. firms that provide support through legal, marketing, and accounting services – can be important.

Workforce Skills

Policy can influence some of these factors – perhaps most importantly by providing good education and training to the local labour force. In addition, vocational training programmes that involve partnerships between local firms and community colleges can help to provide a variety of qualified workers to the firms seeking good manpower. Business incubators can also contribute in terms of providing relatively inexpensive office or laboratory for MSMEs as well as access to support networks of successful entrepreneurs and other service firms. In general, business incubators tend to be more successful if they foster competition and support the private sector rather than trying to provide government services that replace private firms.

The two key takeaways from the US experience are as follows:

- A package of policies that promotes a broad array of good business conditions, coupled with financial incentives that promote competition and entrepreneurship instead of narrowly targeting a few sectors or firms, is most likely to be successful in attracting businesses and promoting growth.
- States that want to support MSMEs should ensure provision of critical public goods and services, allow flexibility in labour markets, and work with the private sector to design the right programmes to ease financial constraints on small firms.

Focus Groups in Jaipur

First Focus Group

The first focus group in Jaipur largely consisted of business owners. Overall, the participants were fairly optimistic about business conditions in Rajasthan. The participants observed one specific area of improvement: infrastructure. For example, frequent blackouts were reported to be no longer the norm. Improvement in roads, air travel and other areas was also noted.

However, participants also identified a number of remaining challenges. A key challenge noted was the availability of financing. Several participants indicated that even though there are a number of government schemes to finance small firms, small firm owners are often turned down for loans when they apply. This is because bank officials are not willing to take the risk that the firm may default on its repayments. Participants indicated that this was a particular challenge for female entrepreneurs; there is a special scheme to provide them with financing, but the perception was that bank managers are even less willing to provide financing to women.

The second challenge identified was that despite the new single window clearance system (SWCS) in Rajasthan, there are still 'multiple windows' behind the single window. This means owners still need to interact with various departments. In addition, banks do not take 'deemed approval' seriously so when an owner does not get response from the government regarding a permit, he/ she cannot take out a loan.

Although the session was aimed at analyzing overall business conditions rather tax policy in particular, participants in this focus group – and indeed, throughout the tour – frequently brought up issues associated with the recently introduced Goods and Services Tax (GST). Generally, there was uncertainty about how the GST would be implemented. Participants also mentioned an issue related to EoDB – namely, that the GST might make it difficult for Rajasthan to offer tax breaks to firms, as the tax would be uniform across the country. However, there was some confusion regarding what exactly the GST would entail for firms and state governments.

Second Focus Group

The second focus group was at the Malaviya National Institute of Technology (MNIT), Jaipur and included students, faculty members, administrators and participants in MNIT's incubator. The incubator houses a number of start-ups, and has a number of support services in place. These include offering interactions with successful entrepreneurs, and providing access to service providers, such as legal and accounting support. Given the setting, the focus of this group was on the incubator's structure and the experiences of its tenants.

The incubator is fairly new, but appears to have garnered quite a bit of interest and participation to date. The tenants were at a much earlier stage than the business owners from the first focus group – still in the stage of conceptualizing their business ideas. The tenants who participated commended the support they received from the incubator, especially the guidance they were provided as they refined their ideas. Despite being in an early stage, though, the entrepreneurs and the administrators of the incubator echoed the theme of difficulty in receiving finance that occurred in the first focus group.

One surprising aspect of the MNIT incubator is that it does not currently have strict screening criteria for the participants. Although there was substantial discussion about 'innovation', the incubator included many entrepreneurs initiating businesses in retail or food services, with little or no evidence of innovation. The incubator administrators did not view this as an impediment, but rather wanted to encourage young people to initiate their own businesses, no matter what areas they were working in.

As the incubator progresses, and the demand for space outstrips supply, there may be a need for a more formal, competitive process to select tenants. To the extent that any such process can be judged by previously successful entrepreneurs associated with the incubator, or by an independent technical committee, this may increase the chances of selecting businesses more likely to succeed.

Focus Groups in Dehradun

First Focus Group

The two focus groups in Dehradun presented two very different aspects on the success of the State performing in business policies. The first included a number of state civil servants including the Chief Secretary, as well as members of the Industries Association of Uttarakhand (IAU).

The overall consensus was that Uttarakhand's recent reforms have been helpful. The IAU attendees generally seemed satisfied with the new SWCS. However, they asked for the system to be extended to permit renewals as well as initial permits. The Chief Secretary urged other civil servants present to process renewals through the online system after dealing with the initial permit applications.

The Chief Secretary and other civil servants indicated a specific challenge that Uttarakhand has been facing: at present, the financial incentives offered by the state to pharmaceutical companies are ending, and a number of companies that moved to Uttarakhand to take advantage of these incentives are leaving, given the State's geographic disadvantages. The group discussed various suggestions to improve Uttarakhand's appeal, drawing on the US experience of areas that are not close to major customer bases.

Overall, the takeaways of the discussion from the first group were that Uttarakhand faces a number of challenges due to its geographical conditions, but that government officials and local business owners are working together to help address them.

Second Focus Group

The views of the second focus group were quite different from the first. The second group was hosted by the World Integrity Center, and largely included small business owners and aspiring entrepreneurs. The participants in this focus group reported that they did not feel that any progress had been made on EoDB in Uttarakhand.

One major issue that emerged was that persistent corruption undermined any efforts at reform. For example, one participant recollected that when they endeavoured to comply

with a regulation, the government inspector asked for a bribe instead. The participants reported that the SWCS had made little difference to the ease of starting a business in Uttarakhand.

Like the first focus group in Jaipur, participants in this group also spent a substantial amount of time talking about the GST. In this case, a number of participants were particularly concerned about how the GST would affect the informal (unregistered) firms or individual craftspeople they purchased goods from. They expressed the concern that GST would be too burdensome for their businesses and for the livelihoods of the craftspeople. An accountant provided some information on how purchases from these individuals and firms could be accommodated under the GST regime. Overall, though, as in Jaipur, there was a substantial amount of confusion about how the GST will affect businesses, particularly informal business relationships.

Other Meetings

The other meetings in Jaipur and Dehradun covered a variety of themes. Below, I summarize two key issues that emerged:

The first is the persistent challenge of corruption. In contrast with discussions of improvements in areas such as infrastructure and labour regulations, no one mentioned any improvement in the need to pay bribes in order to get business done. Some participants indicated that the level of corruption they faced in doing business was increasing. This was not seen as a problem confined to Jaipur, Dehradun, or northern India, but was rather observed as a challenge across in the country. The second major issue that arose in several instances was how the civil service in India is structured and incentivised. In several cases, discussants noted that making it easier to do business does not help civil servants to get promoted, as the Indian civil service system promotes individuals automatically, regardless of performance. Hence, there is no incentive for bureaucrats to help firms to start or expand businesses.

While states do seem to have responded to the recent doing business reforms proposed by the Department of Industry Policy & Promotion (DIPP), under the Ministry of Commerce & Industry, for the most part, the participants in meetings as well as focus

groups felt that these responses were only on paper and had make little difference to the realities of running a business.

Key Themes of Speaking Tour

Key themes that emerged during the speaking tour are as follows:

Deemed approved

First, the 'deemed approved' title is not useful. Not only business owners but even government officials indicated that if a business is 'deemed approved' the owner cannot actually start the business fully. Most critically, banks do not accept deemed approval, and thus do not provide financing to the affected firms. Thus, any progress in terms of the speed of processing business permit applications should carefully distinguish between what share of permits are 'deemed approved' versus actually approved.

De jure versus de facto regulations

Broadly, there is a large disconnect between *de jure* and *de facto* EoDB. In many cases, discussants drew a stark distinction between the way things were supposed to work and the way they actually work. Whether applying for a business license, passing an inspection or getting a loan, many noted that despite the new, *de jure* online process or simple form, the business actually proceeds through one-on-one interactions, which can be complex and lengthy, and at times require bribes.

Impact of the GST

Interestingly, although the new GST can be seen as improving the EoDB by harmonising the tax system throughout India, many discussants regarded it as a potential impediment. One reason for this concern is simply uncertainty about how the specific provisions of the GST will be implemented; to some extent, this is to be expected to go with any new tax regime.

Another issue raised was that since GST will be implemented equally across states, some policymakers felt that they would no longer be able to offer financial incentives to firms to locate in their states, although there was some disagreement about whether this was in fact the case. Participants in Uttarakhand were particularly concerned about

competing with states that have other competitive advantages, such as proximity to customers.

A third concern was how the informal sector will be treated under the GST, and whether the imposition of GST on goods and services purchased from the informal sector will lead to regulatory or tax burdens that drive informal firms out of business.

Issues beyond EoDB in northern India

Although the discussions started by considering ease of doing business specifically, many of the challenges and concerns that participants and entrepreneurs spoke of were much broader, pertaining to issues such as corruption and financing for small businesses. Likewise, although individuals in Jaipur and Dehradun raised some issues specific to their states, such as Uttarakhand's remote location, most of the factors that emerged from the discussions were common across India. These included not only challenges like lack of appropriate reforms in the permitting system but also areas of improvement.

One area that was seen to be much improved was infrastructure – especially electricity availability and roads. Many business owners noted that blackouts were no longer a daily concern, as used to be the case 10-20 years ago. However, the discussants also acknowledged that the availability and quality of infrastructure in India is still not on par with that of many regional competitors – most notably China.

Seeking government support versus non-interference

On one hand, many discussants expressed a strong desire that the government reduce its burden on business owners, and simply get out of the way. On the other hand, many discussants (sometimes the same discussants) proposed government schemes to support businesses in multiple areas, such as providing financing to small firms, encouraging workforce training, and starting business incubators. These two concepts are not mutually exclusive.

However, it is important to note that even in cases where policymakers might wish to encourage the provision of specific services, actually implementing those services

through the private sector can be more effective, and can mitigate conflict with the competing goal of getting the government out of business concerns. For example, an incubator may be government-funded, but could be run by successful private sector managers, with legal and accounting services provided by local firms.

Corruption

While not a major theme in most focus groups or meetings, corruption was an underlying concern that emerged in most discussions. This concern did not appear to be confined to Jaipur, Dehradun or the northern states, but rather individuals spoke of it as being a countrywide problem.

Incentives to move to a new system

The question of corruption often led to a related issue of whether the incentives of government officials are properly structured to encourage growth. A number of individuals noted that government officials are not promoted based on local growth outcomes, and so have no incentives to actually improve *de facto* business conditions. However, some discussants also opined that business owners are not eager to move away from a manual system of permitting to an online system.

For example, in Jaipur, it was reported that only 2 percent of new business applications come through the online system. It was not clear whether this is because individuals are simply unaware of the system or are unable to access it; because 'deemed approval' is not considered helpful; or because individuals also find it more efficient to talk to bureaucrats personally either to pay bribes or simply because they prefer one-on-one interactions.

Overall, the general impression is that it will take a substantial amount of time and perhaps a change in attitudes – on the part of both civil servants and business owners – to move to a completely arms'-length system.