Doing Business in India
What has Changed and What has Not
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Agenda

The Central Government matters less than we think; States matter more
- A vast and diverse country, difficult to manage centrally; Social and infrastructure needs vary
- The Constitution is designed appropriately: citizens and businesses mostly interact with local governments
- Surge of the states: they spent 65% more than the centre in FY16 (almost half of the increase self-funded)
- States resetting ambitions; easing business rules helping drive the surge in FDI

Re-assessing “State Capacity”, and the slow pace of change
- High informality creates a vicious cycle impeding productivity improvement and growth
- It also keeps India in a “low equilibrium” of low taxes ➔ small government ➔ low productivity ➔ low taxes
- Both these vicious cycles should turn into virtuous ones with technology and some reforms like GST

The Challenges
- Business cycle yet to turn: the demand problem probably got intensified
- The government can in theory step in, but appears to be hitting capacity bottlenecks
- Many of the historical bottlenecks continue: Judicial timelines, logistical costs, etc.
The central government matters less than we think
A vast and diverse country, difficult to administer centrally
Surge of the states: federalism finally working, unlocking potential
India more than just a country: home for 1/6\(^{th}\) of humanity

States house large populations

With wide income disparity/level of development

GSDP per capita for states (INR ‘000 p.a.)

Nearest comparable country in population for every state

Source: Census of India, IMF World Economic Outlook, Planning Commission, CSO, Credit Suisse research
Significant diversity, like in demographics

Fertility Rates too vary widely across the country

Some states need kindergartens, others old age homes

Some states need to spend on primary education, childcare and infant/maternal mortality whereas others need to spend on old age homes, and shut down nursery schools

Source: Census of India, Credit Suisse research
Governance mainly provided by state governments

Ex-Railways and Defence, central govt. is small

States provide most of government services

- Of the 3.1 mn employees of the central government, nearly 90% are in the Railways
- State government employment focused on essential services in the economy
  - Education, police, urban administration (including traffic police), healthcare services, utilities, public works

Source: Brochure on Pay and Allowances (2012), MOSPI, Credit Suisse research
State expenditure growing faster than that at Centre

- Unprecedented sharp divergence in the pace of spending of states and Centre
- State governments together spent 65% more than the Centre in FY16
  - This is substantially higher than the level seen 5 years back
- Internal generation as well as central transfers work

Source: RBI, Budget Documents, Credit Suisse research
Causality is from employees to productivity

Do richer states have more employees because they can afford/need them or are they rich because they have more employees?

- It seems to be the latter

Law & order a must for private sector capex

Source: MOSPI, UNODC, IMF, Credit Suisse research
State governments resetting ambitions

- Competition among states in easing rules of doing business
  - Number of days to get clearances, number of steps to register companies falling sharply
  - Land banks being made available to companies for speedy translation of plans into action: jobs and growth
  - Land acquisition: states easing rules, Rajasthan has transitioned from presumptive to conclusive titling of land
  - Even Left-ruled Kerala has committed to supporting land acquisition drives

- Pickup in Metro Rail projects demonstrating the need to show commitment
  - UP conducting feasibility studies in five new cities: Agra, Meerut, Kanpur, Allahabad and Varanasi
  - MP likely to complete metro rail projects in its two largest cities Bhopal and Indore by 2019; 80% JICA funded

- Electrification: from connecting wires to reducing losses to improving service quality
  - Under-electrified states focusing on laying new lines to new villages and then to un-electrified households
  - Number of hours of power availability improving sharply, e.g. UP to grow demand 60% starting Oct-16
  - UDAY Sign-ups and implementation much better than expected, e.g. Rajasthan’s steps to improve collections

- Novel funding sources being explored
  - States improving sales tax collection by broadening the base; using lotteries and land sales to gather funds
  - To be accelerated by GST whenever it is implemented
FDI surge owes a lot to state governments taking the lead

Greenfield announcements: sharp jump

- State governments are making land banks, soliciting investments directly (earlier MEA)
- FDI related cash inflow improved sharply as well, rising to all time high
  - This capital goes directly into investments/jobs, unlike FPI the impact of which is more diffused

Source: FDI Intelligence, CMIE, Credit Suisse research
Vicious cycles turning into Virtuous Cycles

Small enterprises ➔ Costly Capital ➔ Low Growth
Informality ➔ Low Productivity ➔ Low Taxes ➔ Small Government
Both these vicious cycle likely to inflect in the coming few years
Informality seems to mean very low productivity, small size

- Informal sector, though 83% of workers, accounts for only 45% of GVA
  - The value added per worker is very low at Rs 93k vs Rs 1mn per worker in formal sector
- Of the 59mn non-farm enterprises in India, only 0.8mn had 10 or more employees, and 79% of non-crop workforce works in enterprises smaller than 10 employees

Source: NSSO, CSO, Credit Suisse research
Vicious cycle: small ⇒ costly capital ⇒ low growth

Trouble is in accessing capital

- Institutional Sources 5%
- Non-Institutional Sources 2%
- No Finance/Self-Finance 93%

Percentage Split of MSMEs by Sources of Finance

- Given the low productivity there aren't any savings to invest back in the business, and availability of external capital is also constrained
  - 93% of MSMEs as per 2007 census were self-financed

- The cost of capital for smaller firms in India is also much higher than it is for larger firms

As well as its cost

Source: 6th Economic Census, IFC, MSME Census 2007, Credit Suisse Estimates
Low equilibrium: low tax $\Rightarrow$ small govt $\Rightarrow$ low GDP (1)

**Constrains the ability of the government to raise tax**

- **The Indian government can’t spend as much as a result**

  - India's headline tax to GDP at 17% is among the lowest in the world
  - However, that for the formal sector is nearly 30%, among the highest in the world
    - Limited scope for squeezing more tax from the formal economy

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Source: OECD, IMF, Credit Suisse Estimates
Low equilibrium: low tax ⇒ small govt ⇒ low GDP (2)

The Indian government is too small

- The size of Indian government is actually smaller than most other governments
- India in 2013 had only 1.38 police personnel per 1000 population, among the lowest in the world

Source: IMF, UNODC, Credit Suisse Estimates
Financial Inclusion: Technology helping (‘Sachetization’)  

100% of households now have banking facility

- PMJDY success is “sachetization” of the banking system enabled by technology
  - Change in KYC norms and mobile banking bring down cost of starting/maintaining bank accounts

Usage of accounts picking up: cumulative account balance Rs348bn
  - As per SBI’s standards of two transactions a month, 20% of accounts now “active”

Source: PMJDY, RBI, Credit Suisse research
Financial Inclusion: Enabling Environment is Ready

Credit Bureau Coverage can be significantly expanded

- Credit Bureau coverage up sharply, particularly for MFIs
  - Several new start-ups targeting exciting applications on the JAM platform
- Remittances, POS Terminals, MFs, and possibly even deposit accounts are at risk
- Significant opportunity emerging in HH sector

Source: PMJDY, RBI, Credit Suisse research
The Challenges
A stubborn business cycle downturn
Government has limited capacity to generate demand
Judicial and regulatory delays
Overall capex revival not imminent, but pockets of strength

Most large capital intensive sectors seeing low utilization

Private sector capex weak not just because of utilization but also broken balance sheets

Sectors where India needs capacity are under government control

Source: CMIE, Credit Suisse research
Building government capacity to spend a challenge

- Slowing growth in roads ordering shows slowing capacity to spend
- Similar challenges appearing in Railways and in Urban infrastructure

Source: PPAC, NHAI, MoRTH, Credit Suisse research
The Formal Banking System under stress

Banking credit growth is at multi-decade lows

Banking system credit growth is at 50 year lows, mainly because corporate credit, which is more than half of all banking system credit, is seeing near zero growth

Significant under-reporting of problem loans: now a well known problem

More stresses possible after and due to the demonetization exercise

Bad loans under-provisioned/unrecognised

Source: RBI, Credit Suisse research
Judicial timelines, infrastructural costs still too high

- Insolvency resolution in India takes very long – in my districts it can test peoples’ patience
- Recovery rate on cents per dollar is also low
- The Bankruptcy Code being notified on 1-Dec-16 is a step forward, but a long way to go

Source: RBI, Credit Suisse research
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*Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock’s total return relative to the analyst’s coverage universe which consists of all companies covered by the analyst within the relevant sector. Outperform represents the most attractive, Neutral the less attractive, and Underperform the least attractive investment opportunities. As of 2nd October 2012, U.S. and Canadian as well as European ratings are based on a stock’s total return relative to the analyst’s coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperform representing the most attractive, Neutral the less attractive, and Underperform the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock’s total return relative to the average total return of the relevant country or regional benchmark; prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock’s absolute total return potential to its current share price and (2) the relative attractiveness of a stock’s total return potential within an analyst’s coverage universe. For Australian and New Zealand stocks, the expected total return (ETR) calculation includes 12-month rolling dividend yield. An Outperform rating is assigned where an ETR is greater than or equal to 7.5%; Underperform where an ETR less than or equal to 5%. A Neutral may be assigned where the ETR is between 5% and 15%. The overlapping rating range allows analysts to assign a rating that puts ETR in the context of associated risks. Prior to 16 May 2015, ETR ranges for Outperform and Underperform ratings did not overlap with Neutral thresholds between 15% and 7.5%, which was in operation from 7 July 2011.*

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<th>Of which banking clients (%)</th>
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