

# 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.

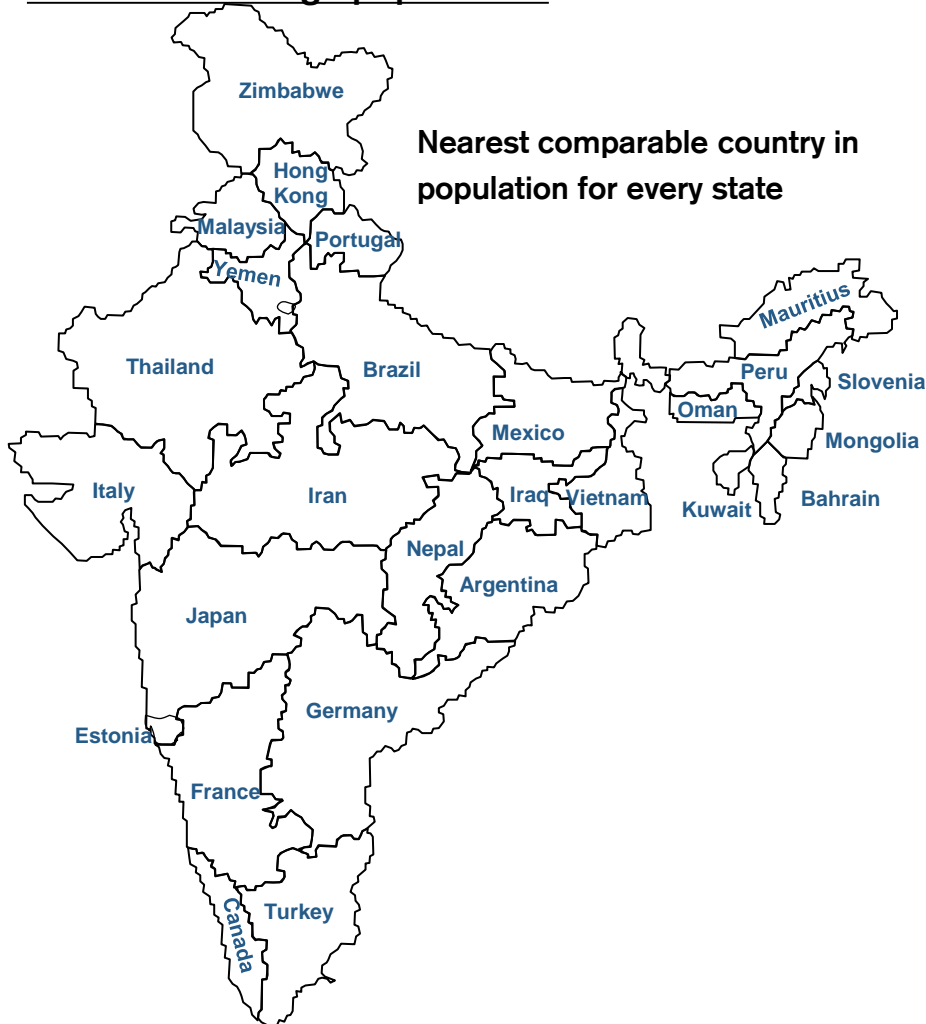
## **The central government matters less than we think**

A vast and diverse country, difficult to administer centrally

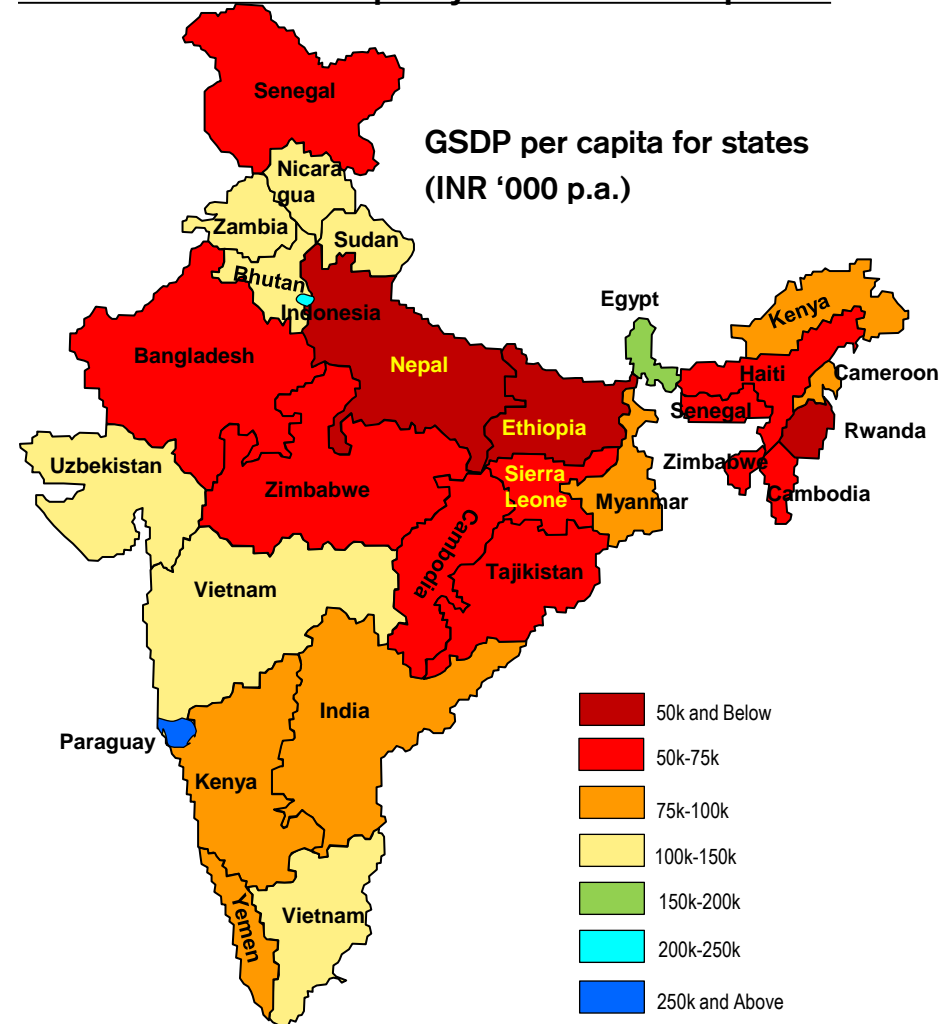
Surge of the states: federalism finally working, unlocking potential

# India more than just a country: home for 1/6<sup>th</sup> of humanity

## States house large populations



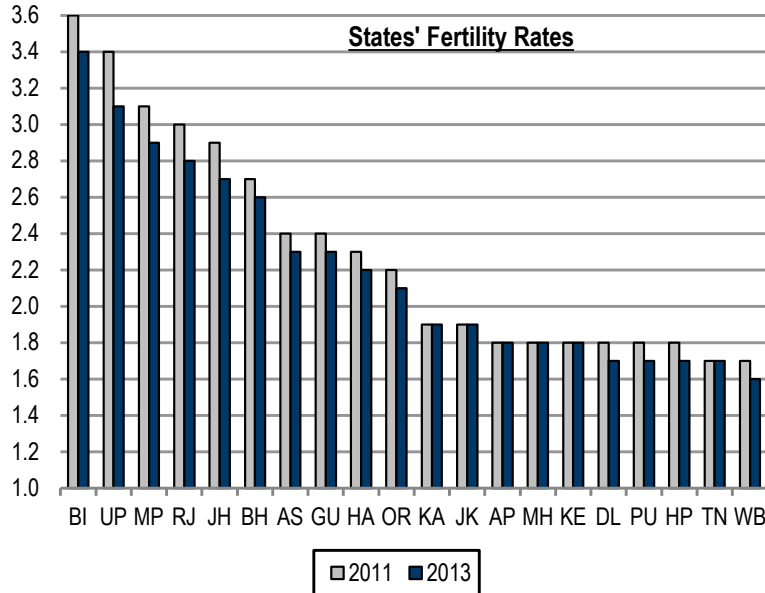
## With wide income disparity/level of development



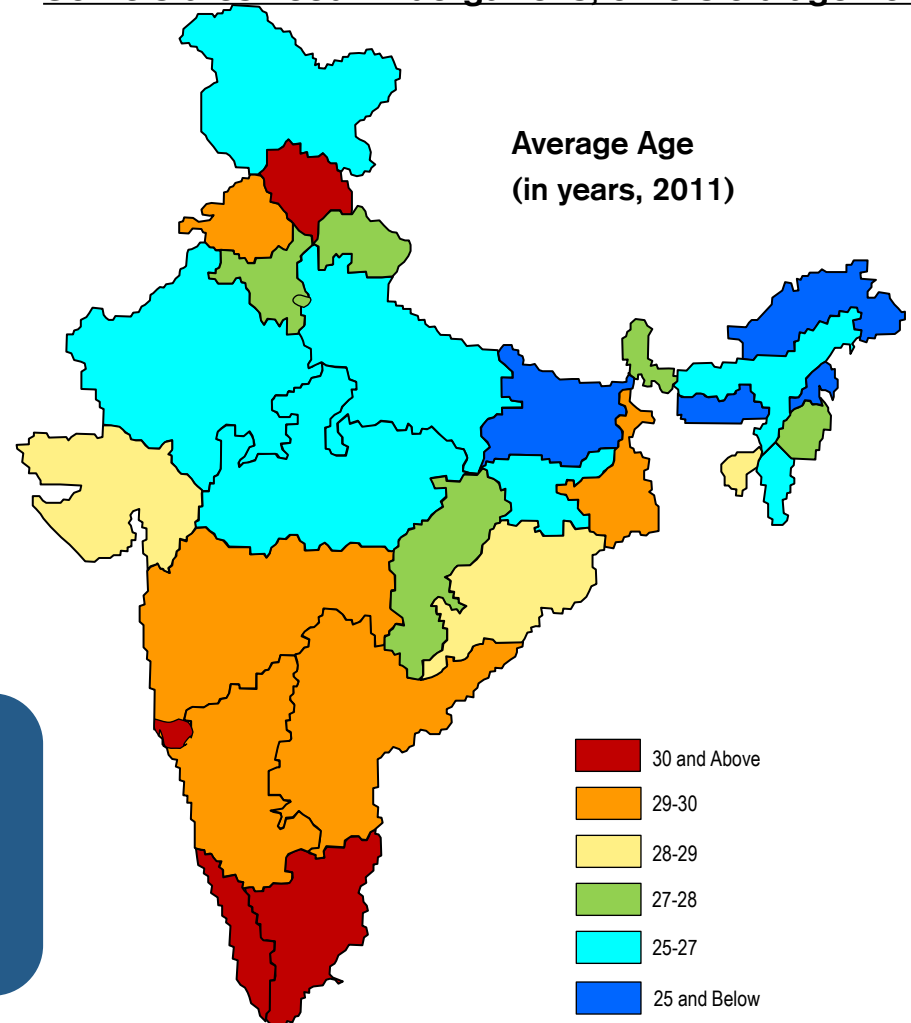
Source: Census of India, IMF World Economic Outlook, Planning Commission, CSO, Credit Suisse research

# Significant diversity, like in demographics

**Fertility Rates too vary widely across the country**



**Some states need kindergartens, others old age homes**

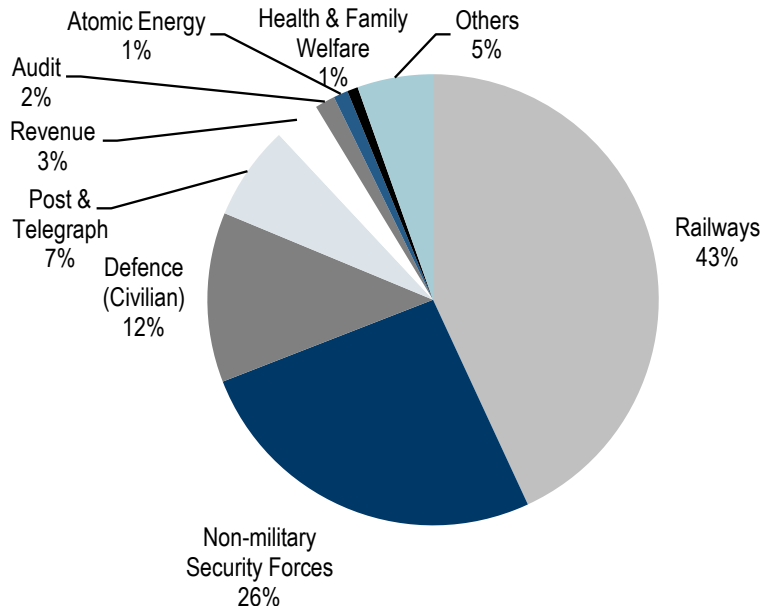


Some states need to spend on primary education, childcare and infant/maternal mortality whereas others need to spend on old age homes, and shut down nursery schools

Source: Census of India, Credit Suisse research

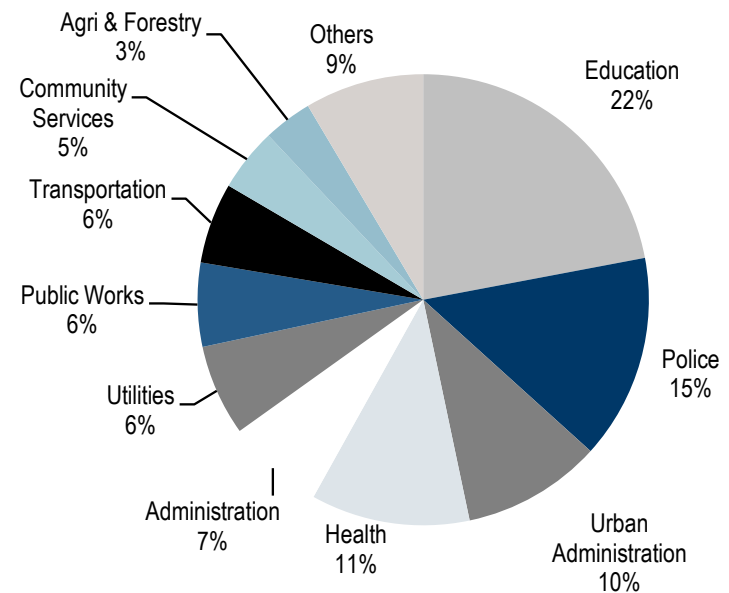
# Governance mainly provided by state governments

## Ex-Railways and Defence, central govt. is small



**Total Central Government Employment: 3.1mn**

## States provide most of government services

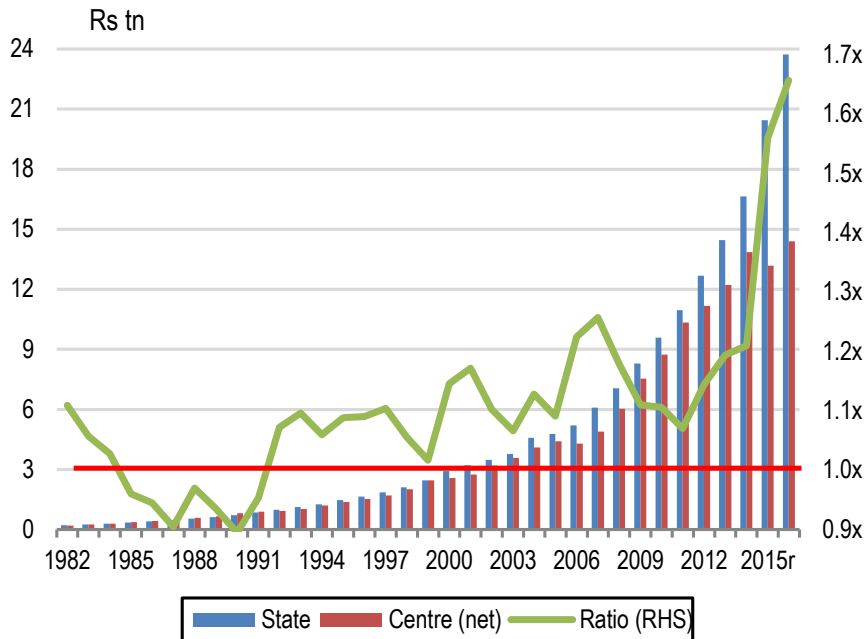


**State Government Employment: 12mn**

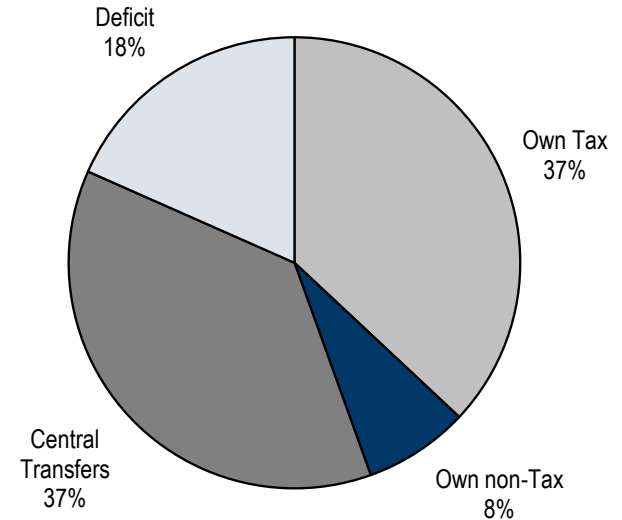
- Of the 3.1 mn employees of the central government, nearly 90% are in the Railways
- State government employment focused on essential services in the economy
  - Education, police, urban administration (including traffic police), healthcare services, utilities, public works

# State expenditure growing faster than that at Centre

## States spent 65% more than Centre in FY16



## Source of funds for rise in expenditure FY11-16



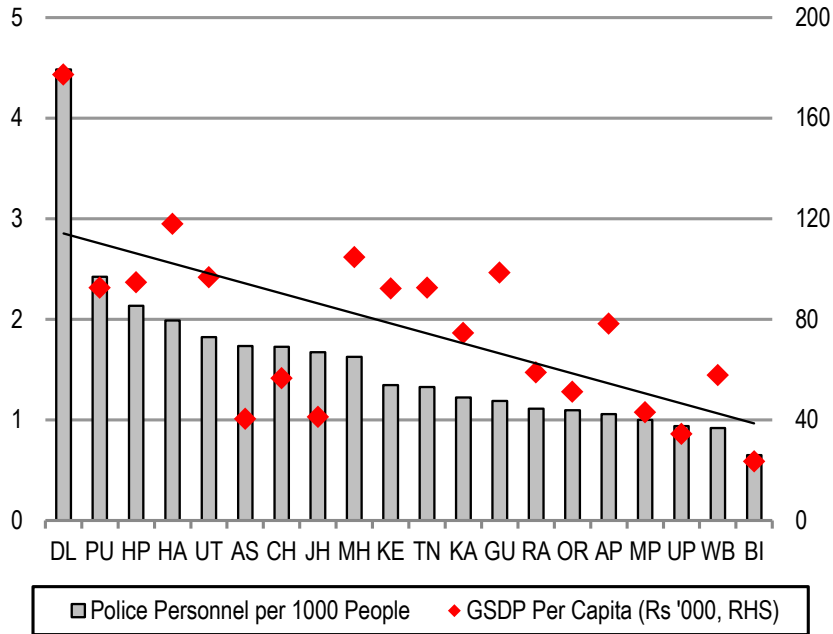
**Increase in spend FY11-16: Rs12.9tn**

- 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

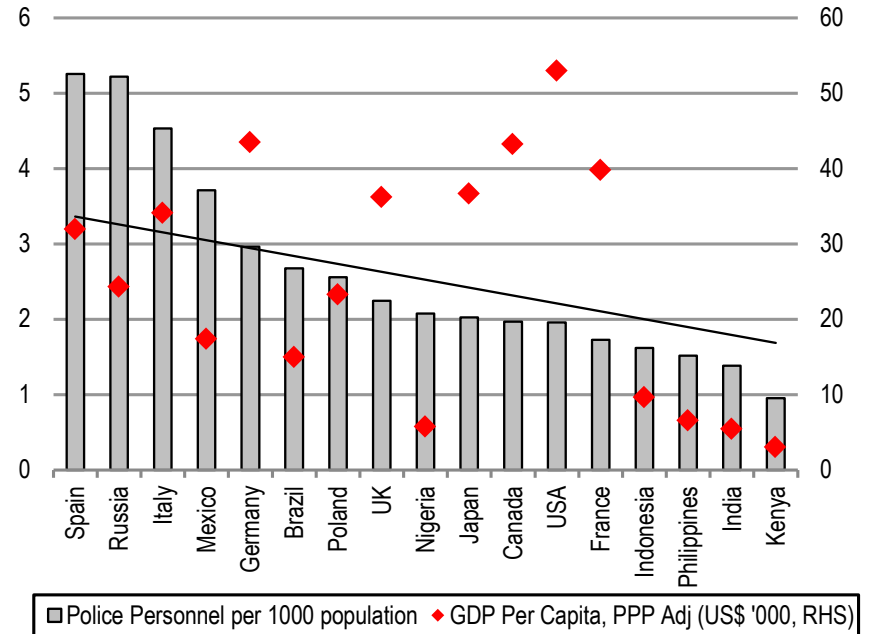
Source: RBI, Budget Documents, Credit Suisse research

# Causality is from employees to productivity

Police employment vs. per capita GDP of states



Police employment vs. per country capita GDP



- 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

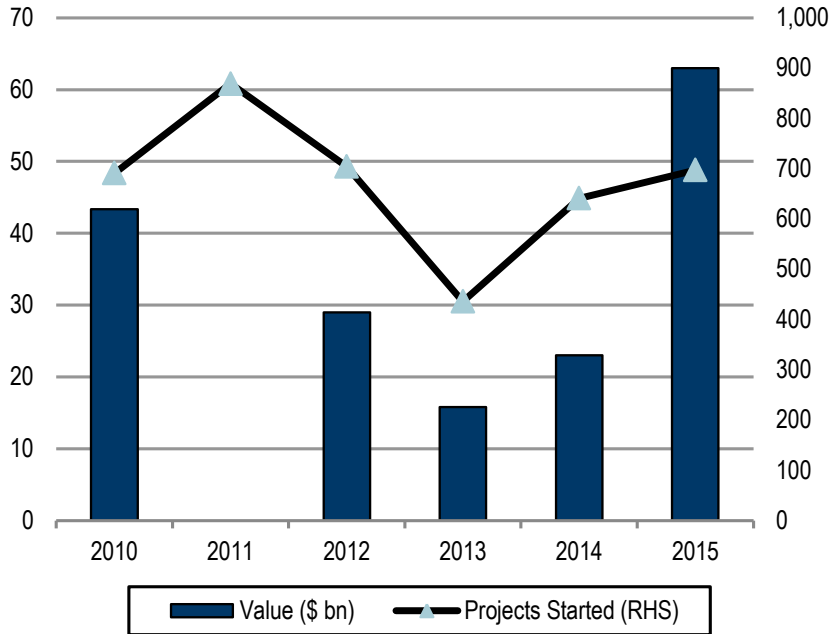


# State governments resetting ambitions

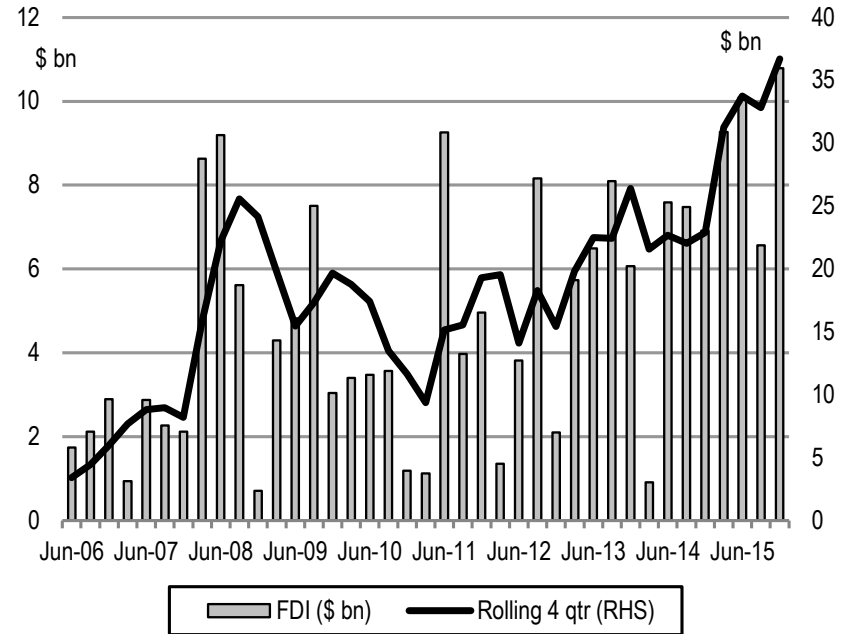
- Competition among states in easing rules of doing business
  - Number of days to get clearances, number of steps to register companies falling sharply
  - Land banks being made available to companies for speedy translation of plans into action: jobs and growth
  - Land acquisition: states easing rules, 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**



**FDI Cash Net Inflows already at record high**



- 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

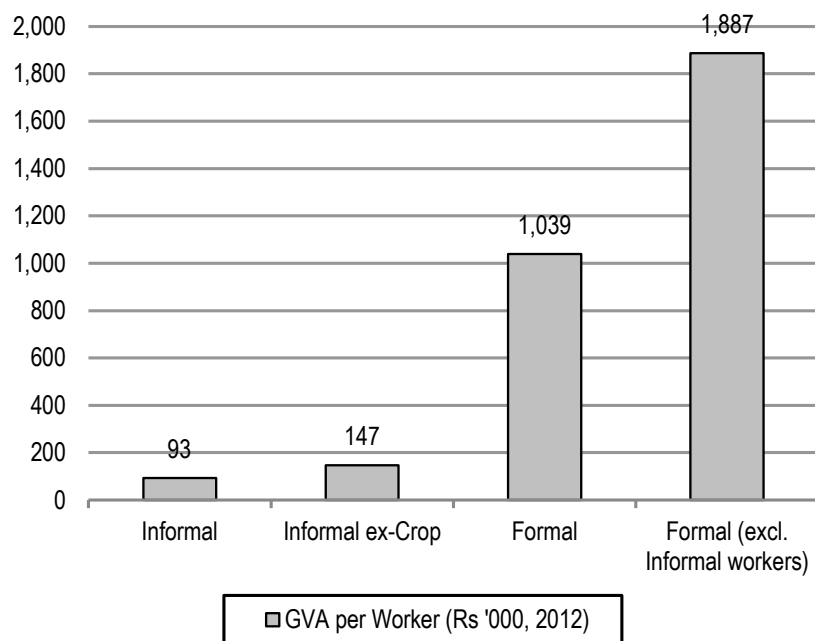
Small enterprises → Costly Capital → Low Growth

Informality → Low Productivity → Low Taxes → Small Government

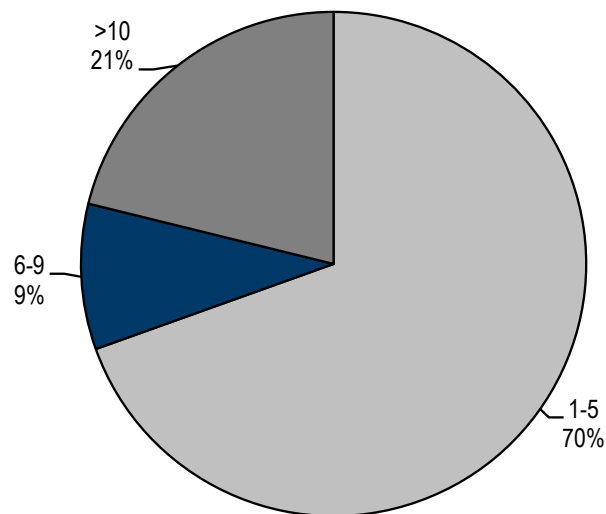
Both these vicious cycle likely to inflect in the coming few years

# Informality seems to mean very low productivity, small size

## Very low GVA per person in informal sector



## 79% of workers in enterprises with < 10 employees

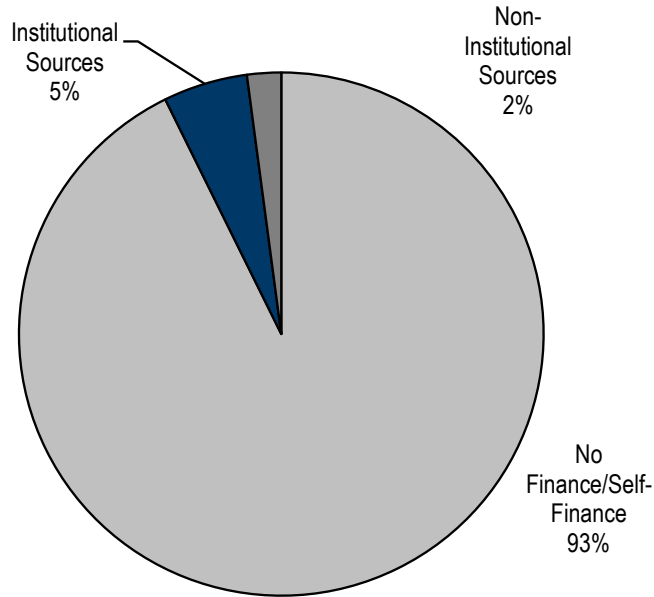


Non-Crop Agri Workforce by Number of Workers/enterprise (2013)

- 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 1 mn 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

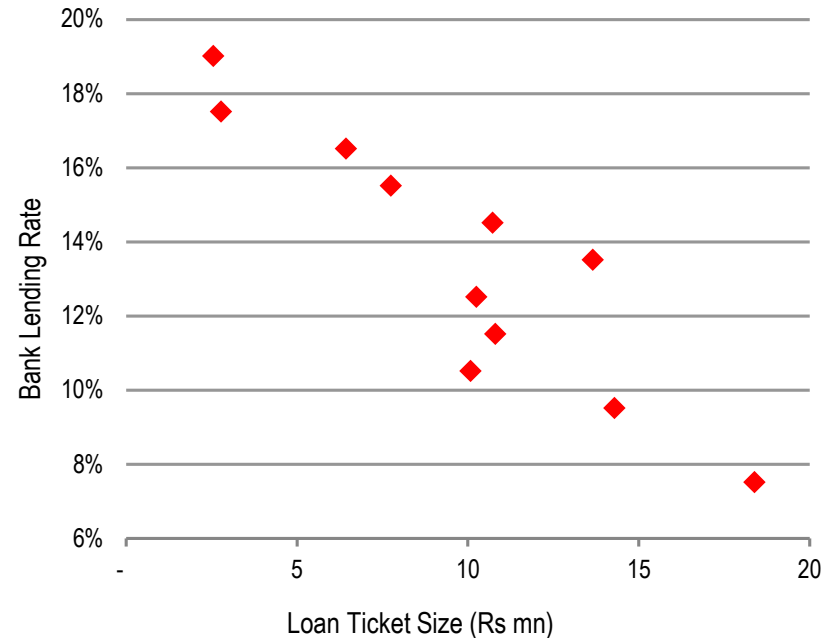
# Vicious cycle: small $\Rightarrow$ costly capital $\Rightarrow$ low growth

## Trouble is in accessing capital



Percentage Split of MSMEs by Sources of Finance

## As well as its cost

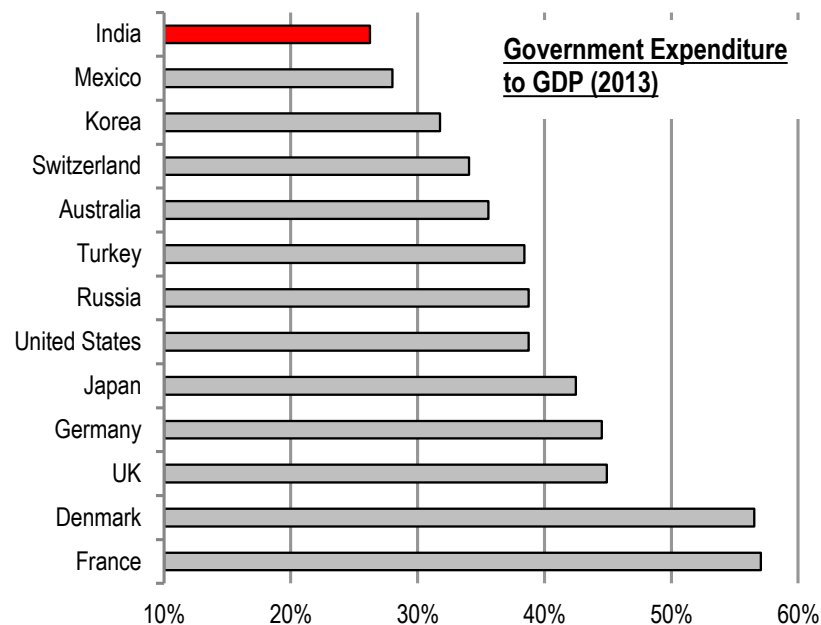
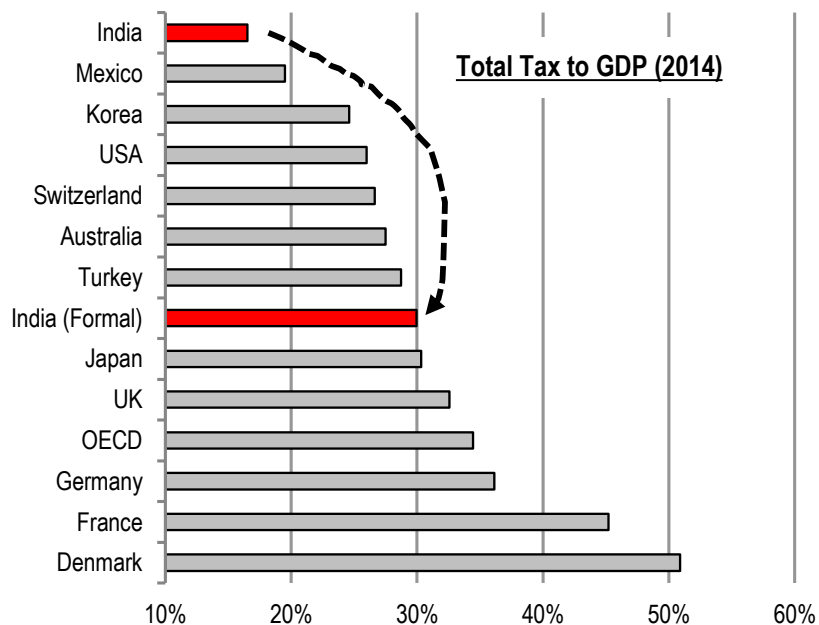


- Given the low productivity there aren't any savings to invest back in the business, and availability of external capital is also constrained
  - 93% of MSMEs as per 2007 census were self-financed
- The cost of capital for smaller firms in India is also much higher than it is for larger firms

Source: 6<sup>th</sup> 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

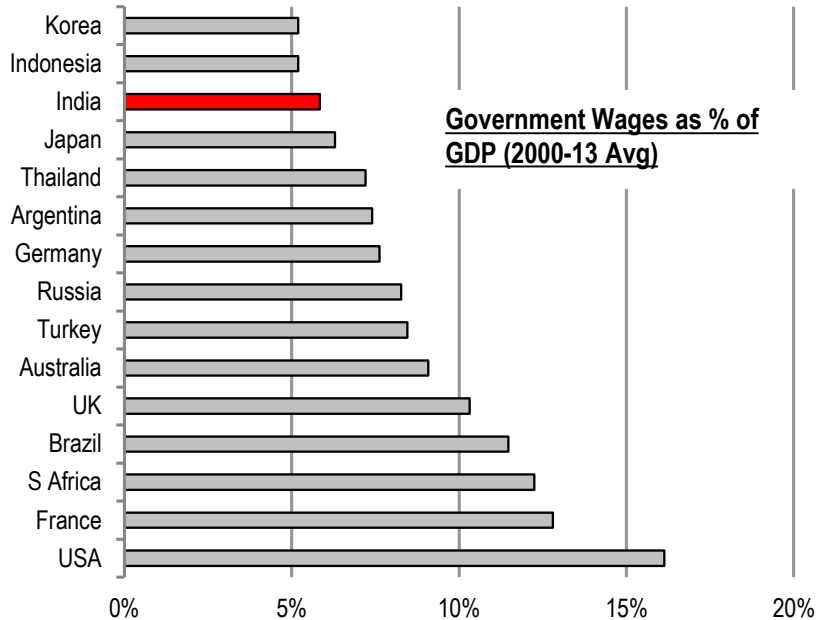


- India's headline tax to GDP at 17% is among the lowest in the world
- However, that for the formal sector is nearly 30%, among the highest in the world
  - Limited scope for squeezing more tax from the formal economy

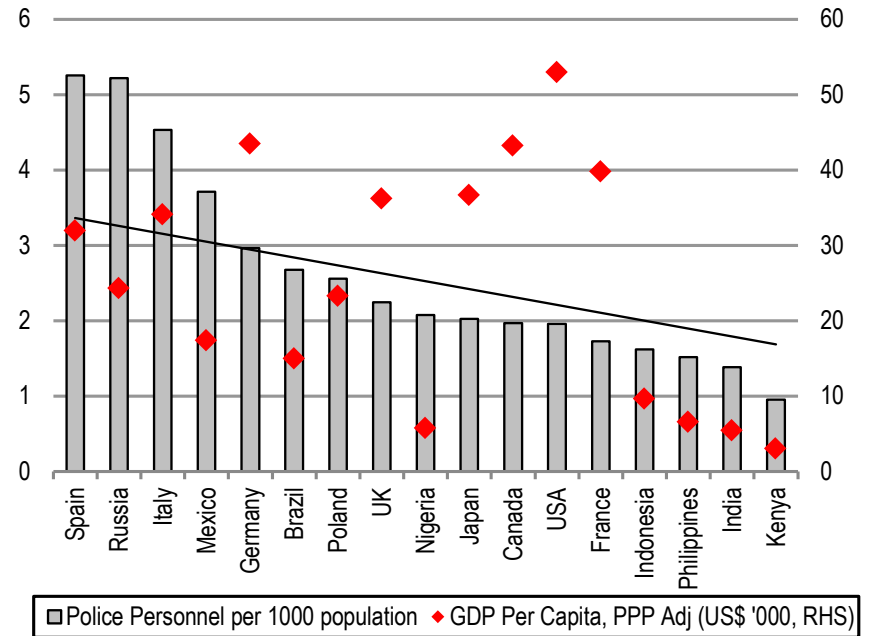
Source: OECD, IMF, Credit Suisse Estimates

# Low equilibrium: low tax $\Rightarrow$ small govt $\Rightarrow$ low GDP (2)

## The Indian government is too small



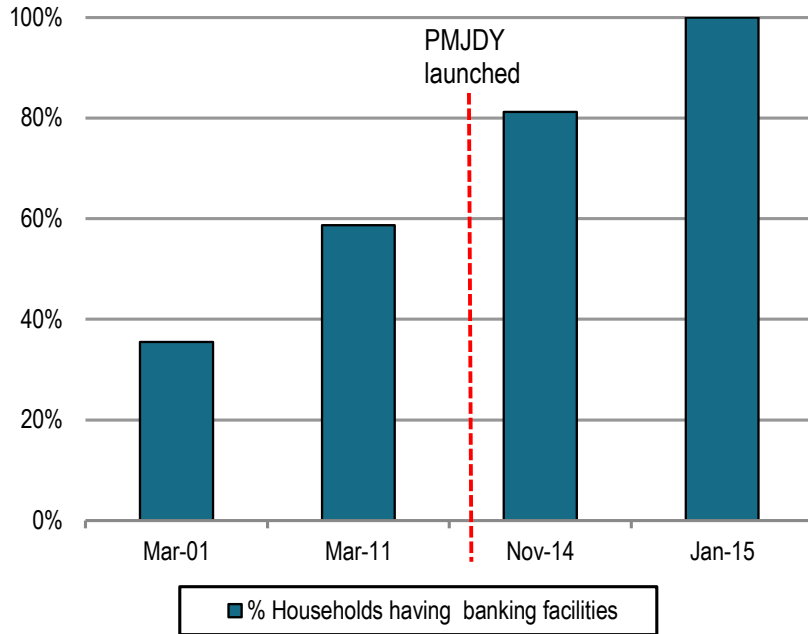
## An example: see the police force (adj. for population)



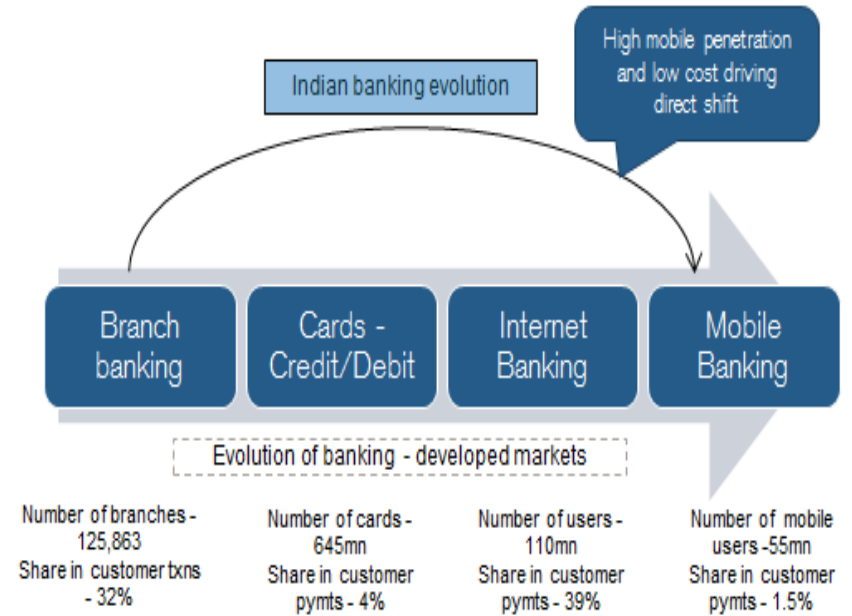
- The size of Indian government is actually smaller than most other governments
- India in 2013 had only 1.38 police personnel per 1000 population, among the lowest in the world

# Financial Inclusion: Technology helping (‘Sachetization’)

## 100% of households now have banking facility



## India likely to skip a couple of generations in banking



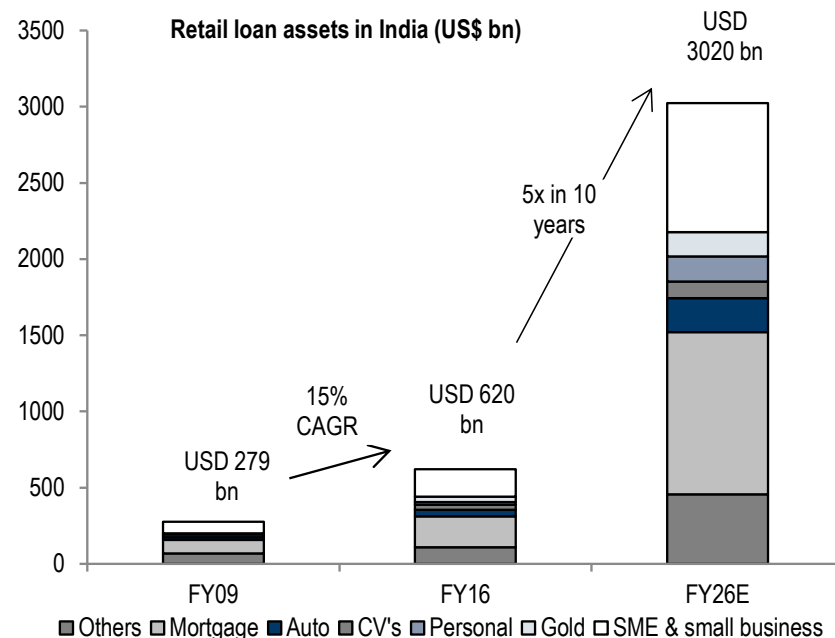
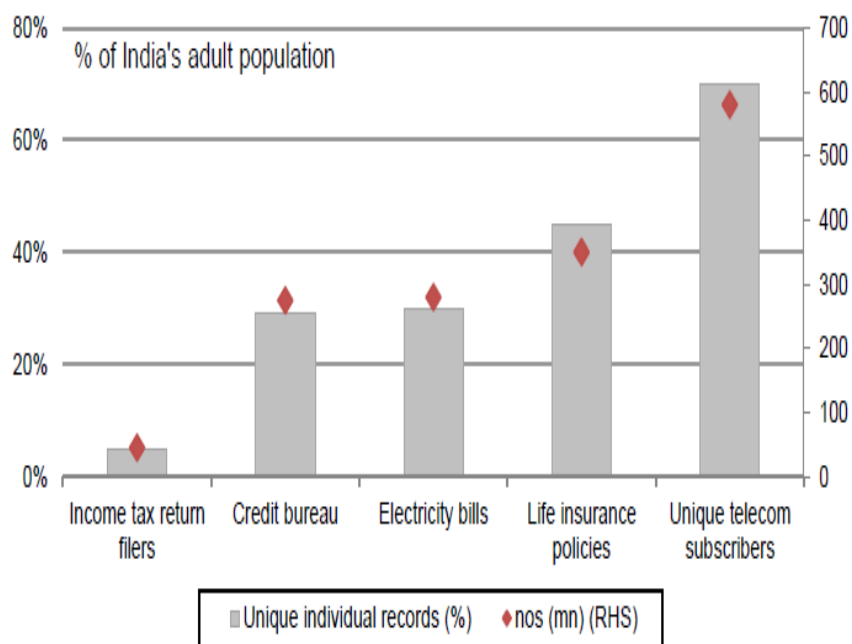
- PMJDY success is “sachetization” of the banking system enabled by technology
  - Change in KYC norms and mobile banking bring down cost of starting/maintaining bank accounts
- Usage of accounts picking up: cumulative account balance Rs348bn
  - As per SBI’s standards of two transactions a month, 20% of accounts now “active”

Source: PMJDY, RBI, Credit Suisse research



# Financial Inclusion: Enabling Environment is Ready

## Credit Bureau Coverage can be significantly expanded Digital Boost for Retail Lending



- 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

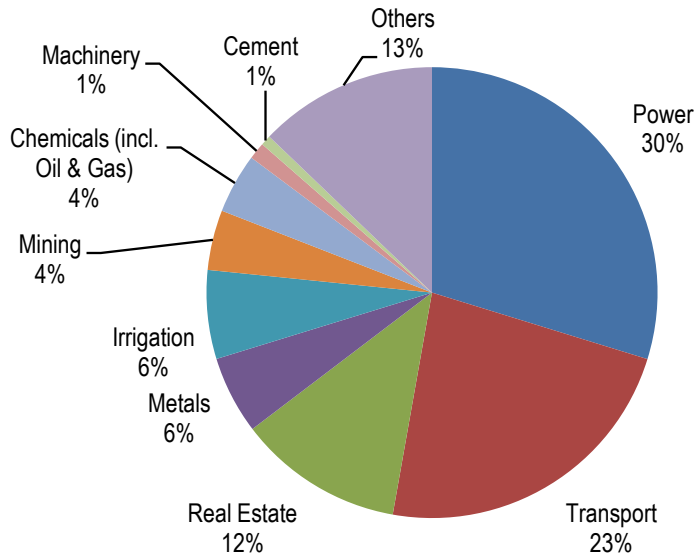
A stubborn business cycle downturn

Government has limited capacity to generate demand

Judicial and regulatory delays

# Overall capex revival not imminent, but pockets of strength

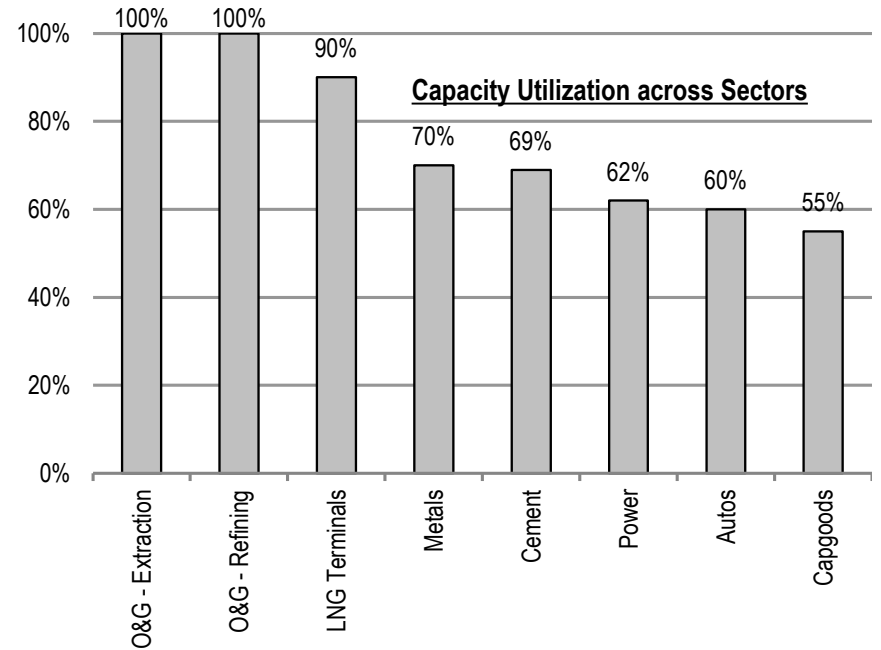
## Sector-wise split of ongoing projects



**Projects under Implementation: Rs91tn**

*As of Dec-15 Qtr. end*

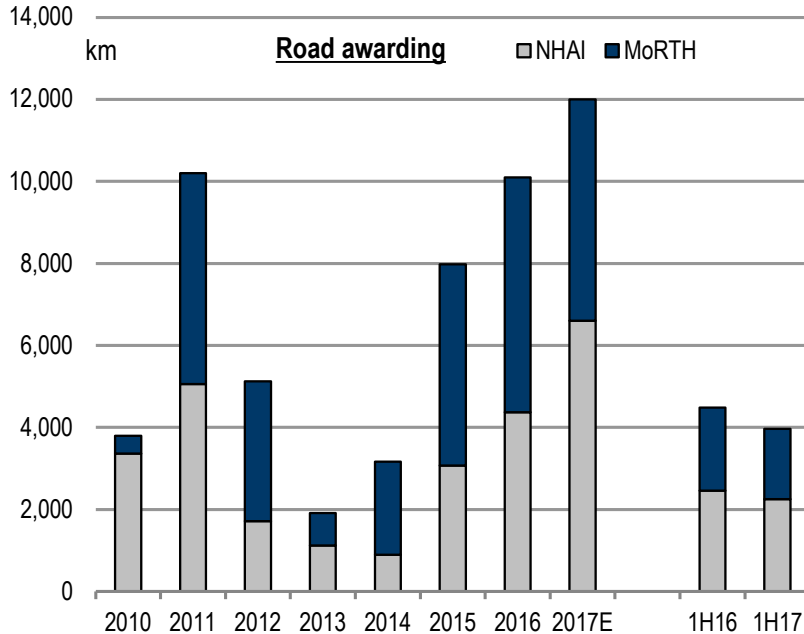
## Utilization by sector



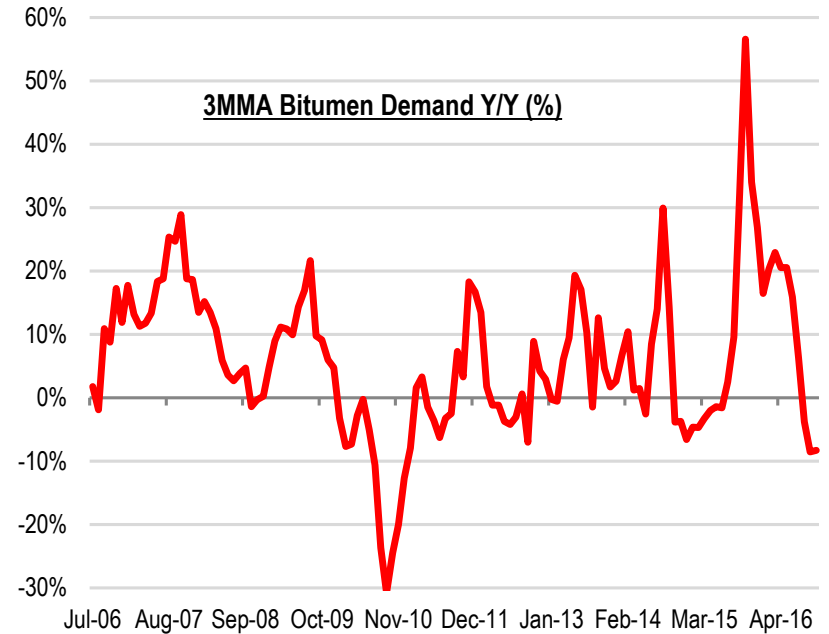
- Most large capital intensive sectors seeing low utilization
- Private sector capex weak not just because of utilization but also broken balance sheets
- Sectors where India needs capacity are under government control

# Building government capacity to spend a challenge

## Roads ordering momentum stalling



## Bitumen demand growth has slowed

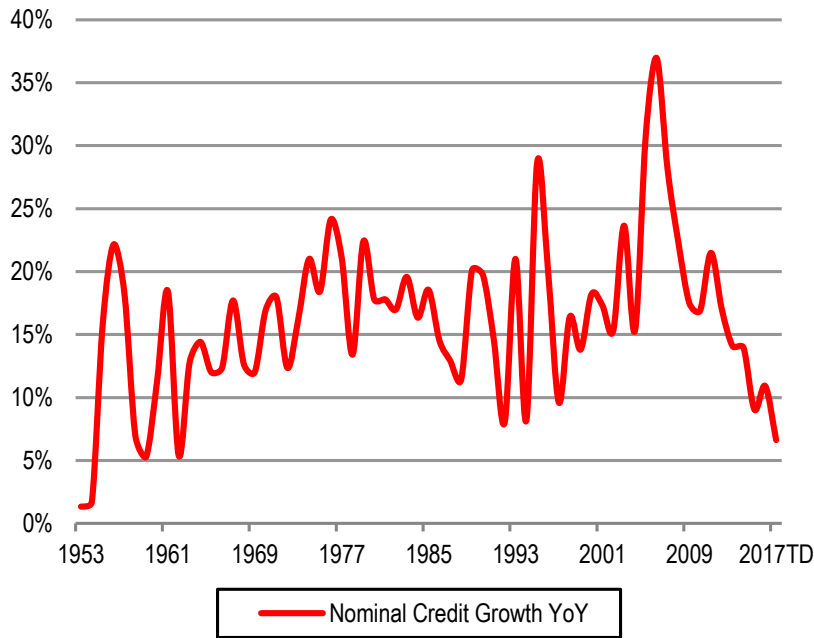


- Slowing growth in roads ordering shows slowing capacity to spend
- Similar challenges appearing in Railways and in Urban infrastructure

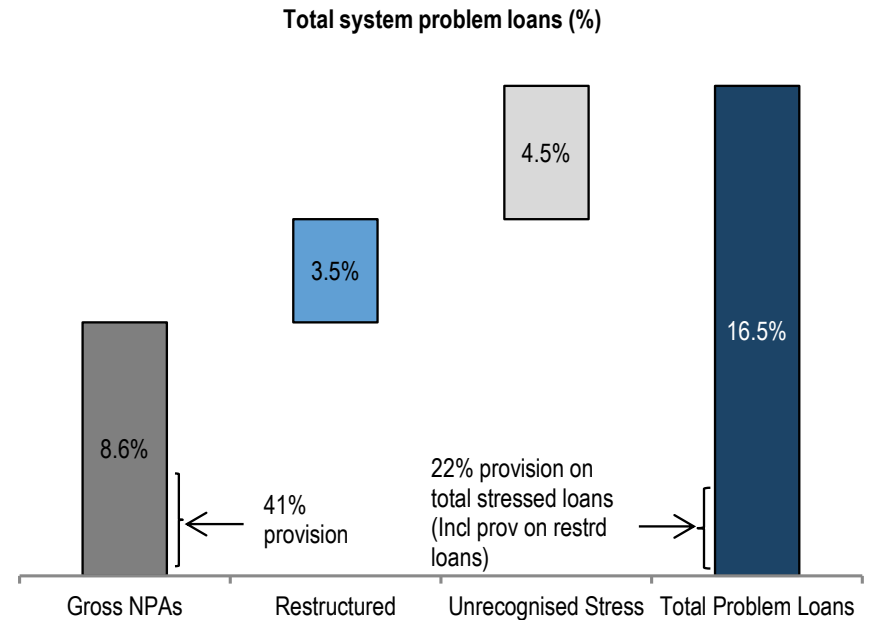
Source: PPAC, NHAJ, MoRTH, Credit Suisse research

# The Formal Banking System under stress

## Banking credit growth is at multi-decade lows



## Bad loans under-provisioned/unrecognised

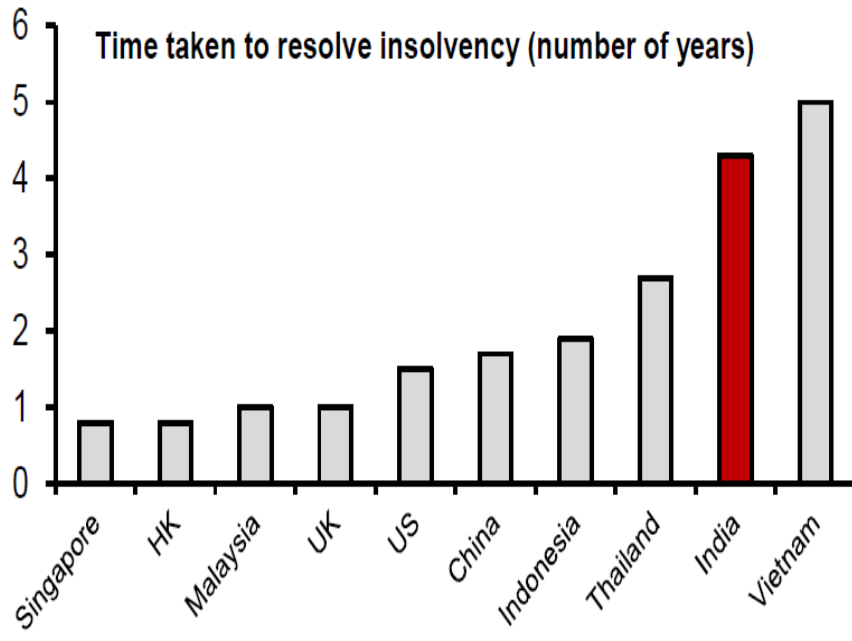


- Banking system credit growth is at 50 year lows, mainly because corporate credit, which is more than half of all banking system credit, is seeing near zero growth
- Significant under-reporting of problem loans: now a well known problem
- More stresses possible after and due to the demonetization exercise

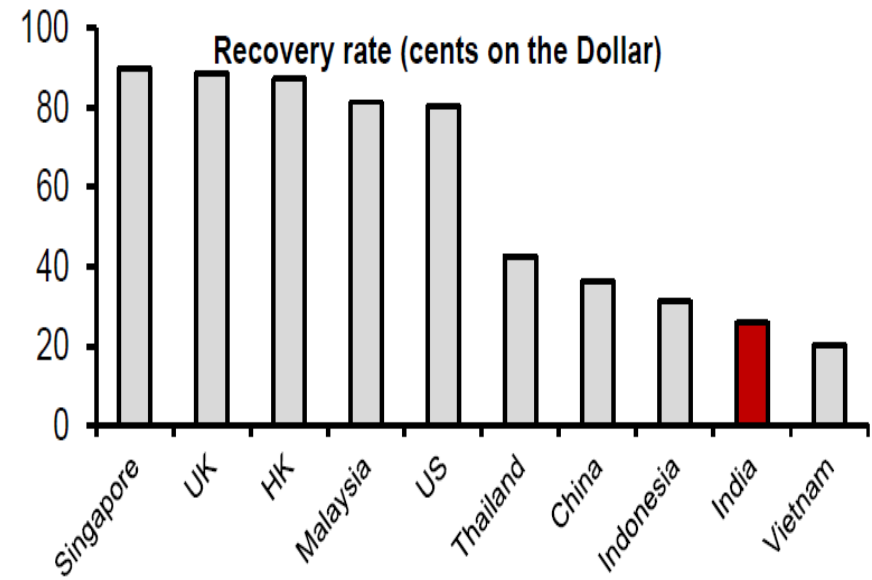
Source: RBI, Credit Suisse research

# Judicial timelines, infrastructural costs still too high

Insolvency resolution takes many years



Recovery rates among the lowest in the world



- 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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