Small is not necessarily beautiful

A case to preserve culture, while scaling up India's cottage industries

Dr. Venkatraman Anantha Nageswaran

ATHENA INFONOMICS

Abstract

India should support its small businesses to grow big, instead of incentivizing them to remain small. Culture, communities and cottage industries can be sustained through devolution to, and empowerment of local governments. Strengthening demand through educating young minds on the country's knowledge traditions would do more than government support to breathe new life into cottage and traditional industries, vocations and skills.

Disclaimer

This is a part of Athena Infonomics' initiative to disseminate policy research and thought leadership articles for wider consumption. Athena Infonomics makes no representations as to accuracy, completeness, correctness, suitability, or validity of any information on this paper and will not be liable for any errors, omissions, or delays in this information or any losses, injuries, or damages arising from its display or use. It is the reader's responsibility to verify their own facts. The views and opinions expressed in this paper are those of the author(s) and do not necessarily reflect the official position of Athena Infonomics. Assumptions made in the analysis are not reflective of the position of any entity other than the author(s) - and, since we are critically-thinking human beings, these views are always subject to change, revision, and rethinking at any time.

About the Author

Dr. Venkatraman Anantha Nageswaran

van@vansight.org

Dr. Venkatraman Anantha Nageswaran is an angel investor. He has invested in several Indian startups directly as well as through Aavishkar India Micro Venture Capital Fund, a vehicle co-founded by him. He sits on the boards of –

- **TVS Logistics – an international logistic service solutions provider;**
- **Drishtee Skill Development Center Private Limited;**
- **Torp Control Systems, a premier EPC service provider for Solar photovoltaic systems;**
- **Kerala First Health Services - a healthcare provider in the Ayurvedic space; and**
- **Aparajitha Corporate Services - end-to-end HR solution provider to various business across India.**

His other associations include the NPS Indian International School in Singapore, where he is a Director.

Dr. Nageswaran graduated with a postgraduate diploma in management from the Indian Institute of Management, Ahmedabad (IIM-A) in 1985. Thereafter, he went on to earn a Doctoral degree in Finance from the University of Massachusetts in 1994 for his work on the empirical behaviour of exchange rates.

A well-respected figure in the investment finance industry, he has worked at UBS and Credit Suisse in Switzerland, and later headed the Research for Asia at Bank Julius Baer & Co. in Singapore. He also served as the Chief Investment Officer of the bank for a while.

Presently, he teaches International Economics, Exchange Rates, and Financial Markets at leading B-Schools in Singapore as well as India.

Dr. Nageswaran regularly writes for his Tuesday column in Mint, an Indian daily business newspaper. He is also a regular commentator on global and regional economies in Bloomberg, Reuters and CNBC.

India's Problem: The 'BIG' is too Small

> "It is a historical fact that it was not the defeat on the battlefield of Plassey but the ruin of the Indian cottage industry that marked the beginning and the end of the process of India's enslavement...

> We have related this tragic tale of ruin and disaster in some detail, because its lessons are relevant even today; they warn and caution us. The situation is still worse today and it has taken global dimensions...

> Can cottage industries benefit from our Prime Minister's 'Start up India, Stand up India' programme? Do our land use laws come in the way of the cottage industries? Does the 24X7 power supply initiative in states like Madhya Pradesh, create a viable atmosphere for cottage industries? Do we see the dexterous hands of our craftsmen as our most important, albeit invisible, assets? Do we need to craft a special strategy to free the cottage industries from the exploiting middlemen and merchant capitalists? ...

> Shouldn't we introspect as to why the markets of our state and country are flooded with Chinese Rakhis? ..."

Those are some choice messages from the background paper circulated by the Government of Madhya Pradesh on the cottage industry for the 'Vichar Kumbh' that they organised alongside the Simhasth Kumbh Mela in Ujjain in May 2016. It asks all the right questions and these questions deserve responses.

An Open-Minded Approach is Necessary

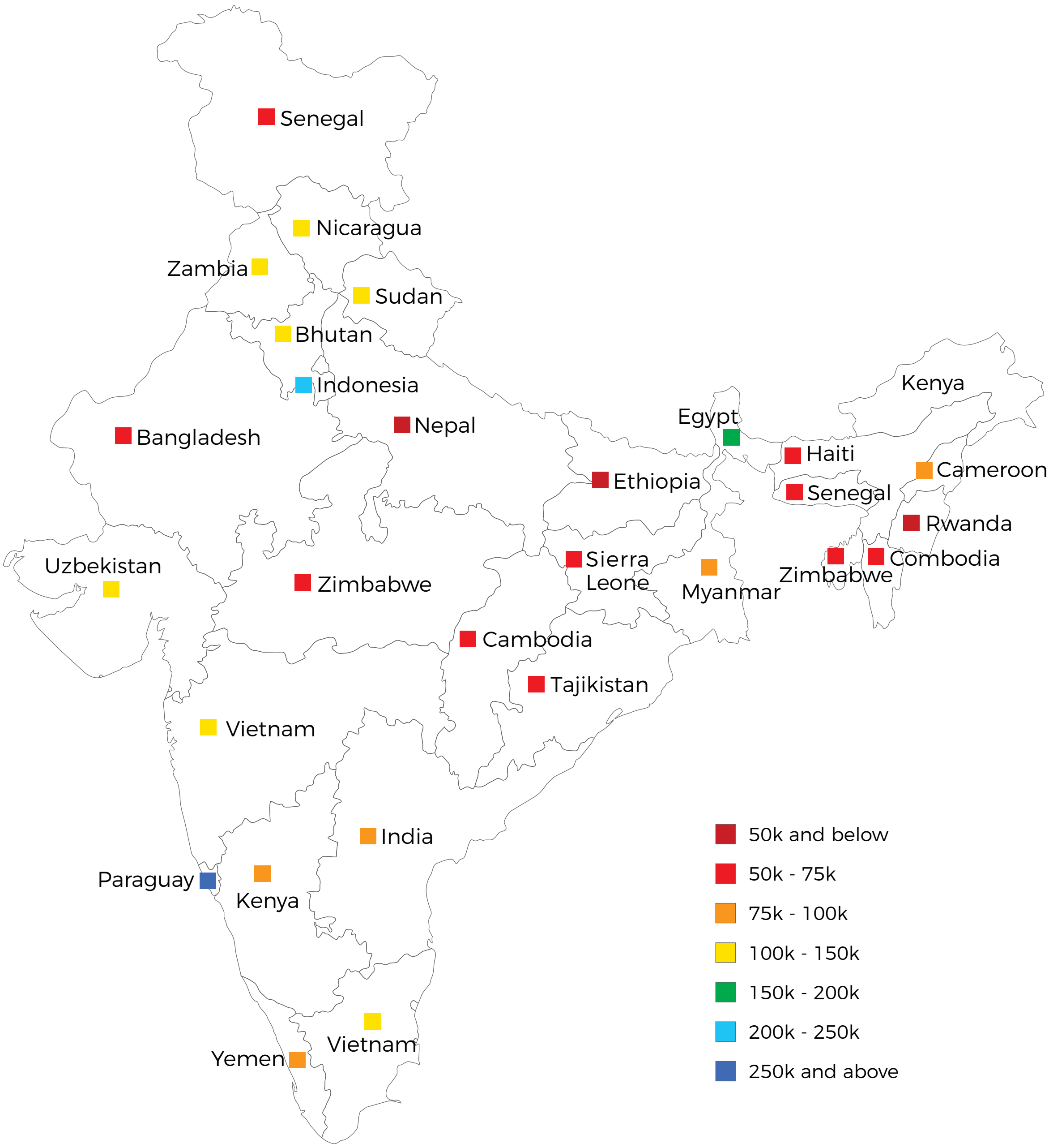
There are very few templates or models around the world that can guide India's policy making. India is a country with a population of 130 crore. Only one country is bigger than India in terms of population and its model of governance, politics, and economics, over the past forty years, has been quite dissimilar from India's, and hence it is not a viable template for India.

Figure 1: States house large population

Nearest comparable coutry in population for every state

Source: State of the Indian Economy, Presentation at the Vivekananda International Foundation April 26, 2016, Neelkanth Mishra, Credit Suisse (India)

Figure 2: With Wide income disparity / level of development



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

Source: State of the Indian Economy, Presentation at the Vivekananda International Foundation April 26, 2016, Neelkanth Mishra, Credit Suisse (India)

The above well-known map tries to equate the states of India with other countries based on populations. With states housing populations, similar to those of countries like Turkey, Mexico, Brazil, Argentina and Iraq, governance poses a huge challenge. In addition to that, India has unique problems of its own. In other words, India is unique in terms of the enormity of the challenge of the political and economic governance it faces, and that too, based on the election of governments democratically through adult franchise. There are far too many stakeholders and consequently too much noise.

The diversity of India and the complexity of governing it suggests that there cannot be one policy template for even a single state, let alone the entire country. Different districts and communities, for example, have different strengths and needs. This necessitates the need to explore and employ all possible solutions and approaches. To summarise:

> **India needs to tackle these with an open mind. Blanket attitudes such as**
> **'big is bad',**
> **'foreign is bad' and**
> **'small is beautiful'**
> **would be detrimental to India as they are ill-suited for the conditions it faces.**

It is well known that India's economic growth rate averaged around 3.5% up to the end of the 1970s. World Bank meta-country data shows that India's real GDP growth rate in Rupee terms averaged 3.5% between 1961 and 1980. In the 1980s, the growth rate averaged around 5.5%. But, even that proved to be unsustainable. Towards the end of the decade, India had run up a high fiscal deficit and faced an external funding constraint as well. Its meagre export earnings were insufficient to pay for short-term external borrowings. Although the episode resulted in the pledging of India's gold holdings in return for loans from the International Monetary Fund, it paved the way for the removal of shackles on the Indian economy.

However, throughout its post-Independence history, whenever India achieved a slightly higher economic growth rate, it has been followed by some combination of the following issues – an external financing deficit, a rise in non-performing assets in the banking system, a high rate of inflation and consequent currency overvaluation. This was the case at the end of the Seventies, at the end of the Eighties and again in 2012-13. The main reason is that India's production - whether in farms or in factories – is not efficiently organised.

Among other things, import substitution, comprehensive industrial licensing and reservation of production of many items for the small-scale sector were responsible for the failure of the Indian economy to develop a culture of efficiency. One does not wish to dwell on the imperatives that persuaded governments of the day to make these policy choices at an earlier point in time and pass judgement on them with the benefit of hindsight. However, it is a matter of fact that these policies had adverse implications on India's productivity and export competitiveness, keeping the economy always a step closer to external vulnerability. It continues to this day.

That is why it is important to ask the question whether small is relatively beautiful.

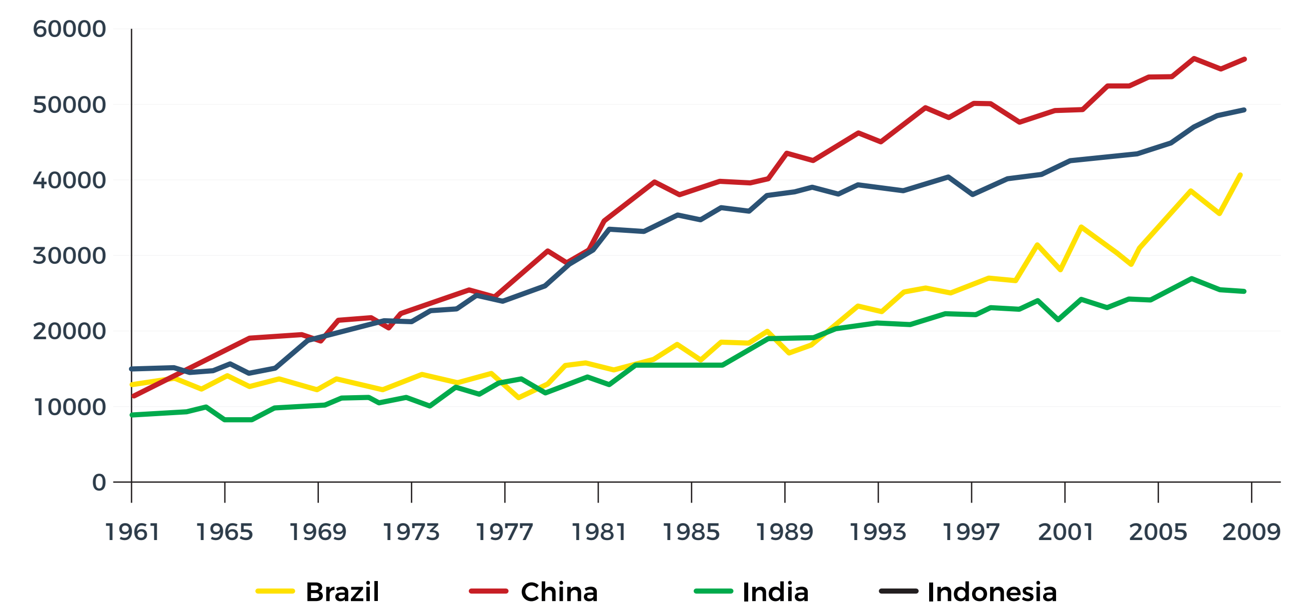
Is Small Always 'Beautiful'?

Table 1: Trend in yield per hectare of principal crops in India since independence

Items	Yield per hectare			Annual Growth Rate (%)	
	1949-50	1964-65	2008-09	1949-50 to 1964-65	1964-65 to 2008-09
All food grains (quintals)	5.5	7.6	18.98	1.4	2.4
Rice (quintals)	7.1	10.8	21.86	2.1	2.3
Wheat (quintals)	6.6	9.1	28.93	1.3	3.4
Coarse Cereals (quintals)	4.3	5.1	11.76	1.3	1.3
Pulses (quintals)	4.0	5.2	6.55	0.2	0.5
All Non-foodgrains	-	-	-	0.9	1.6
Oil seeds (quintals)	5.2	5.6	10.16	0.1	1.6
Cotton (kgs)	95	122	419	2.0	2.4
Sugarcane (tonnes)	34	47	62	1.0	1.2
Potato (quintals)	66	84	108	1.6	3.0
All crops				1.3	1.9

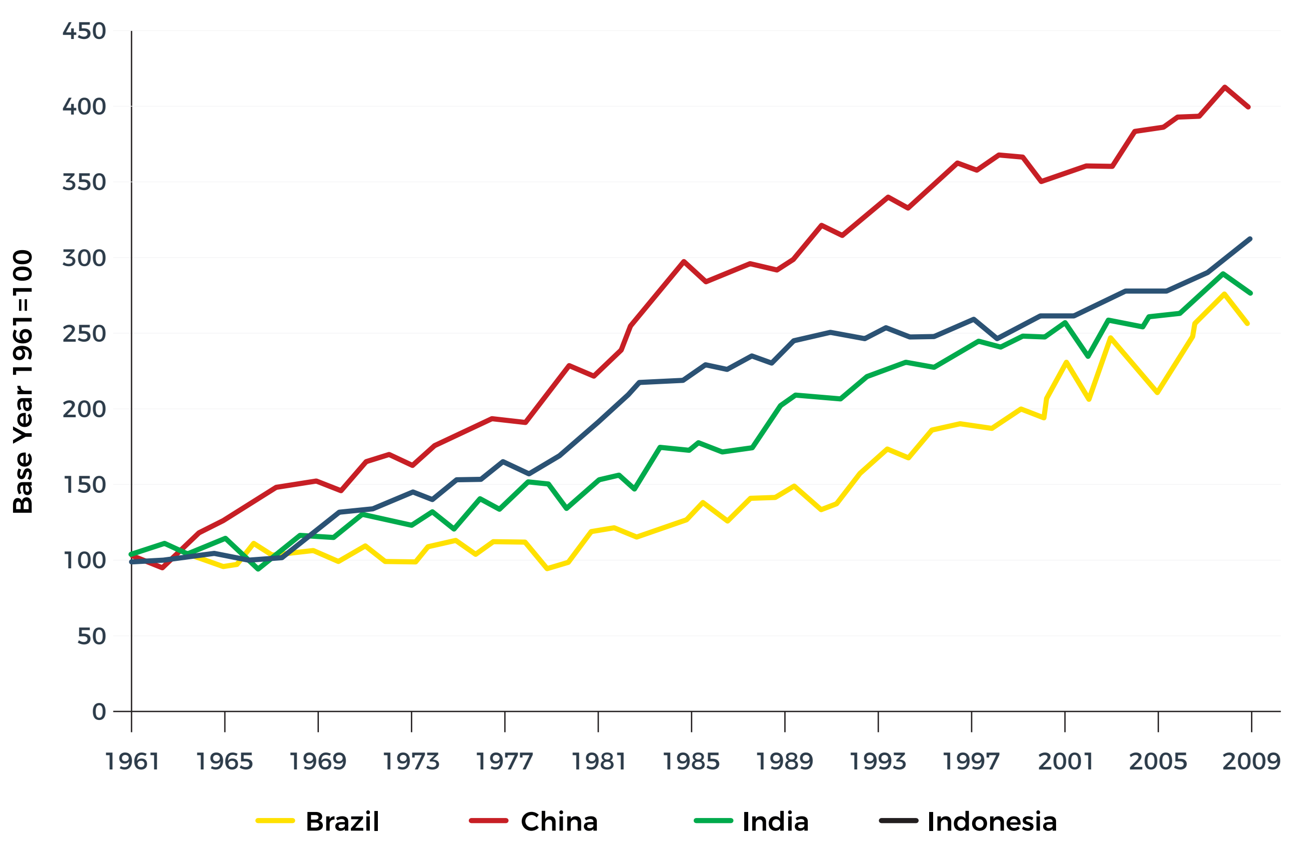
Source: 'Agricultural Production and Productivity in India' by Vidya Sethi
http://www.yourarticlelibrary.com/agriculture/agricultural-production-and-productivity-in-india/62867/ (accessed on 11th September 2015)

Figure 3: Total Cereals Yield (hg/ha) (1961-2010)



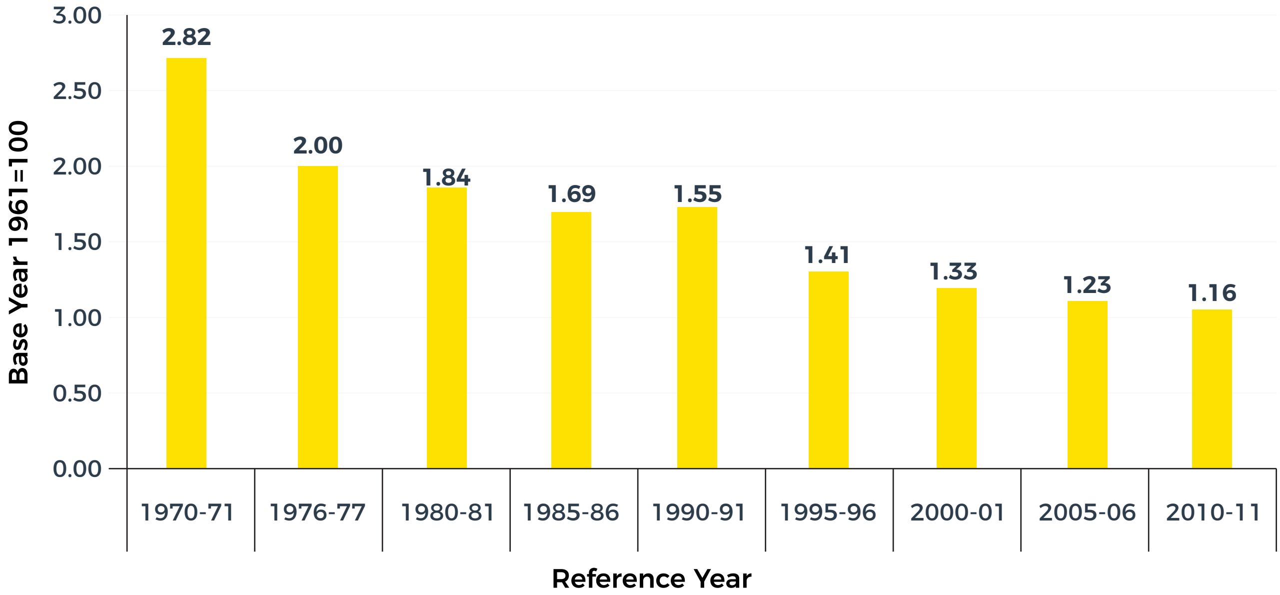
Source: Patterns of Structural Transformation and Agricultural Productivity Growth in 109 Countries: With a Special Focus on Brazil, China Indonesia and India (Based on a paper by Uma Lele, Manmohan Agarwal, Peter Timmer and Sambuddha Goswami, Global Conference on Agricultural Research and Development, Punta del Este, October 29, 2012) - accessed on 11th September 2015

Figure 4: Total Cereals Yield Growth (1961-2010)



Source: Patterns of Structural Transformation and Agricultural Productivity Growth in 109 Countries: With a Special Focus on Brazil, China Indonesia and India (Based on a paper by Uma Lele, Manmohan Agarwal, Peter Timmer and Sambuddha Goswami, Global Conference on Agricultural Research and Development, Punta del Este, October 29, 2012) - accessed on 11th September 2015

Figure 5: Average size of operational holdings as per different Agricultural Censuses



Source: 'State of Indian Agriculture 2012-13', Department of Agriculture & Co-operation
Ministry of Agriculture, Government of India (accessed on 11th September 2015)

Table 2: Size Group wise distribution of Average Holdings in the country

Sl. No	Size Groups	1970-71	1976-77	1980-81	1985-86	1990-91	1995-96	2000-01*	2005-06*	2010-11P
1	Marginal (below 1 ha.)	0.40	0.39	0.39	0.39	0.39	0.40	0.40	0.38	0.38
2	Small (1-2 ha.)	1.44	1.42	1.44	1.43	1.43	1.42	1.42	1.38	1.42
3	Semi-Medium (2-4 ha.)	2.81	2.78	2.78	2.77	2.76	2.73	2.72	2.68	2.71
4	Medium (4-10 ha.)	6.08	6.04	6.02	5.96	5.90	5.84	5.81	5.74	5.76
5	Large (Above 10 ha.)	18.1	17.57	17.41	17.21	17.33	17.21	17.12	17.08	17.38
All Size Classes		2.28	2.00	1.84	1.69	1.55	1.41	1.33	1.23	1.16

Source: 'State of Indian Agriculture 2012-13', Department of Agriculture & Co-operation
Ministry of Agriculture, Government of India (accessed on 11th September 2015)

Table 3: Distribution of number of holdings and area operated in India as per Agriculture Census 2010-11

Sl. No	Size Group	No. of holdings (in million)	Area operated (in million ha.)	Average operated area per holding (ha.)	Percentage of holdings to total holdings	Percentage of area operated to total area
1	Marginal (below 1.00 ha.)	92.4	35.4	0.38	67.04	22.25
2	Small (1.00-2.00 ha.)	24.7	35.1	1.42	17.93	22.07
3	Semi-Medium (2.00-4.00 ha.)	13.8	37.5	2.71	10.05	23.59
4	Medium (4.00-10.00 ha.)	5.9	33.7	5.76	4.25	21.18
5	Large (Above 10.00 ha.)	1.0	17.4	17.38	0.73	10.92
All holdings		137.8	159.2	1.16	100.00	100.00

NOTE: Total may not tally due to rounding off.

Source: 'State of Indian Agriculture 2012-13', Department of Agriculture & Co-operation Ministry of Agriculture, Government of India (accessed on 11th September 2015)

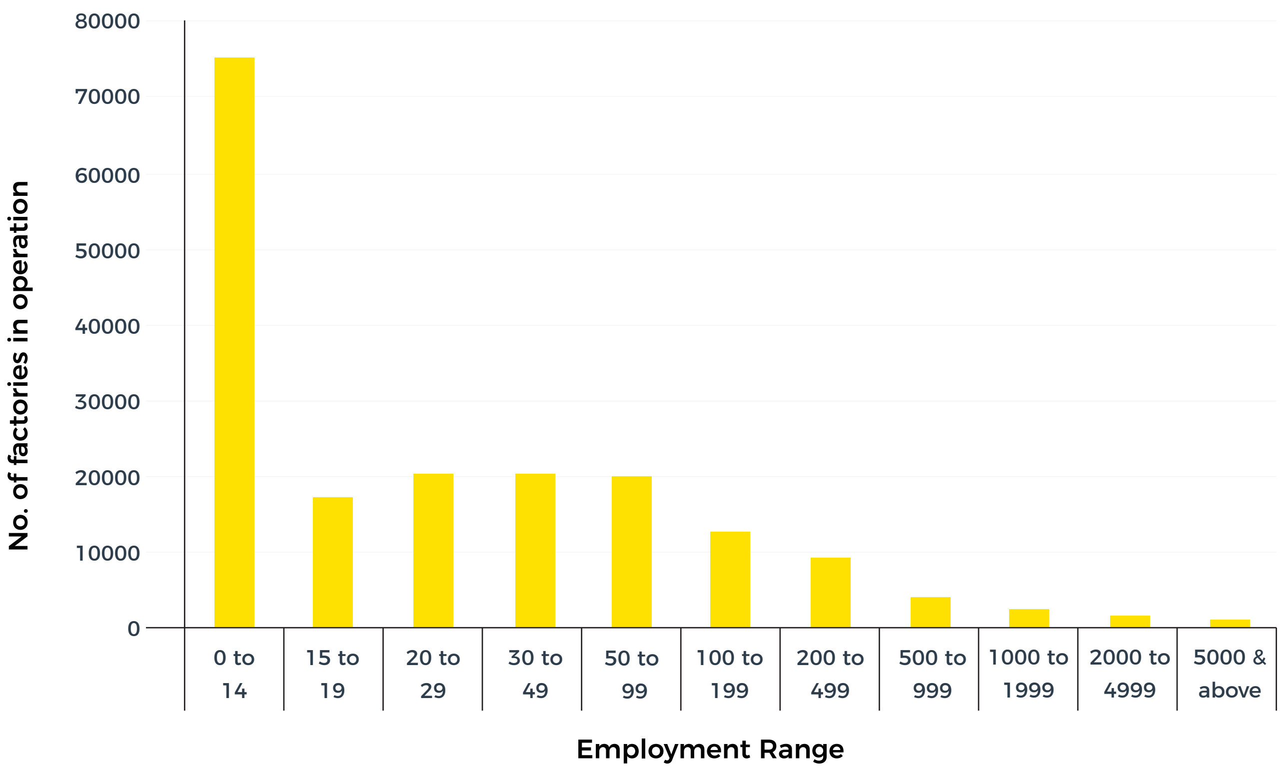
The tables and charts above demonstrate the nature of the problem. The average holding of Indian farmers has come down, regardless of whether they were small, medium or big to begin with. 85% of India's farms are less than two hectares. The **'State of Indian Agriculture 2015-16'** report is concerned that the trend of increase in the marginal farm holdings and reduction in the holding of bigger farm sizes is continuing unabated. Increased fragmentation has mostly adverse implications for agricultural productivity. Productivity in Indian agriculture is growing at a snail's pace, even when compared with other developing countries. The sector's contribution to India's economy is around 20%, but the proportion of agricultural workers in the economy-wide labour force is approximately 60%, showing inefficiencies in productivity. Workers should be encouraged to look for livelihood opportunities outside of agriculture. That would automatically raise agricultural labour productivity. This poses the question as to whether size, productivity and yields are correlated.

Furthermore, land consolidation by facilitating the sale of agricultural land is crucial. Even if amendments to the Land Acquisition Bill remain stalled, states should come up with their own template to facilitate the process. Small and marginal farmers would then move on to other remunerative vocations. Interestingly, a CSDS survey[1] found that most of them were in favor of the Land Acquisition Bill.

[1]Source: http://www.lokniti.org/pdf/Farmers_Report_Final.pdf

Factories, Industries & Companies

Figure 6: Distribution of Factories in Operation by Size of Employment: All-India



Source: Annual Survey of Indian Industries 2013-14.
Ministry of Statistics and Programme Implementation (released on 27th April 2016 and accessed on 25th May 2016)

Consider the following facts:

- As per the **'Annual Survey of Indian Industries'** (ASI) 2013-14, only 6.32% of factories had output of more than 100 crores of rupees. Yet, they deployed 75.9% of fixed capital; 75% of productive capital; 74.6% of invested capital; employed 43.6% of workers; paid 58.1% of all wages and 61.8% of all emoluments paid to workers in factories. Finally, these small proportion of factories with output of more than 100 crores of rupees contributed to 77% of the total factory output.

- In terms of capital employed, only 9.1 % of factories had a capital of 10 crores of rupees or more. Yet, they had 85.7% of fixed capital; 80.6% of productive capital; employed 48.7% of workers and more than 60% of wages and emoluments paid to workers in factories were paid by them. Importantly, they produced 73% of all output from factories. Their Gross Value Added (GVA) was 77.1%.

- In terms of number of workers, factories that had 100 or more workers were only 16.4% of all factories in operation. Yet, they had deployed 88% of the fixed capital; 85% of productive capital; 75% of workers and paid 82% of wages to workers. They produced 80.7% of the total output from factories and contributed 85% of the GVA from factories.

- Only 2% of the factories covered by the ASI generate Net Value-Added (NVA) of over Rupees 50 crores. They employ a quarter of the total employed in factories, provide 40% of all emoluments; generate half the total output from factories and 71% of NVA.

What about Incorporated Enterprises or Companies?

- Out of the 705,733 non-financial private limited companies, only 728 of them had paid-up capital of more than 100 crores. Yet, in terms of amount, they had 44% of the paid-up capital.

- The story is similar with public limited companies: There are only 1068 public companies out of 50,629 non-financial public limited companies. Yet, they had 79% of the paid-up capital of Rupees 1,066,897.86 crores.

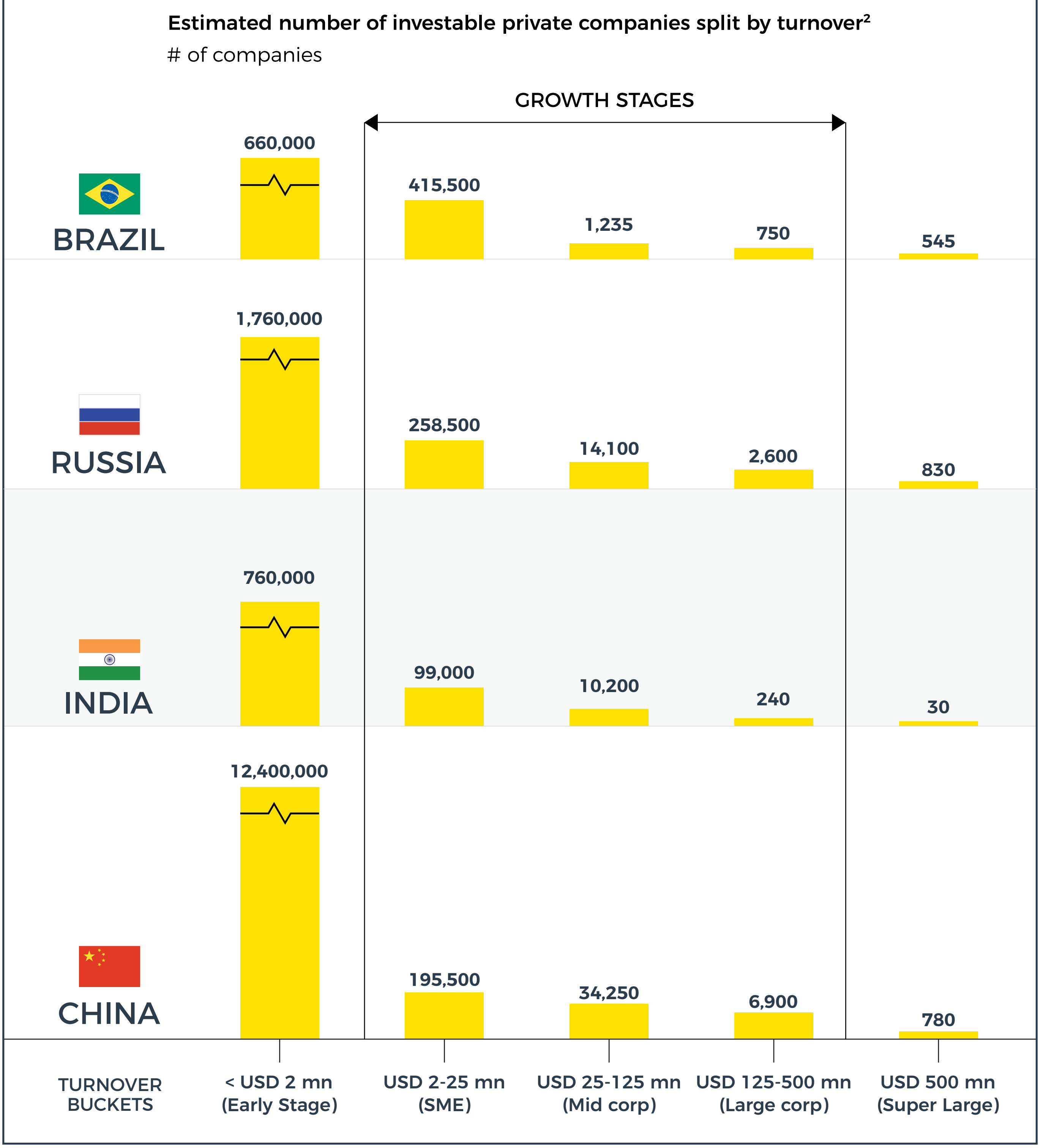
Source: Data Date: 31st Mar 2014. Revised PUC for companies limited by share for financial year 2012-13. (Rs. Crore), Ministry of Corporate Affairs (accessed on 11th Sept. 2015)

The above statistics demonstrate that whether in farms, factories (part of the Organised Sector) or in corporations, India has too many small players contributing too little in terms of output. There is an opportunity cost to the resources deployed in generating output in micro and small enterprises. These enterprises need to be encouraged, but not to remain micro and small.

India has big enterprises that utilise economies of scale, generating maximum output and GVA. But, there are too few of them. This is a cause for concern for the competitiveness of the Indian economy.

The numerous micro, mini and small enterprises have meant that the number of investable enterprises in their growth-phase in India is the lowest among the BRIC nations. This is represented in the chart below. The gap is too wide to be wished or simplistically explained away.

Figure 7: India offers relatively lower growth stage options compared to BRIC peers



Source: 'Indian Private Equity: Route to Resurgence'. Mckinsey Global Institute (June 2015)

Neither micro-credit nor micro-entrepreneurship help economies scale the development challenge. Financial inclusion and other forms of state support for micro enterprises should be aimed at helping them grow from their small beginnings and not at condemning them to the status of stillborn midgets.

[2]Total companies excluding those which are PSUs/Government or are public companies or belong to unorganized sector

India's Skewed Labour Force

All of us like children when they are small and young. When they age, we expect them to grow and improve in their physical and intellectual capabilities. If they remained small, parents would and should be worried. The size, shape and structure of Indian productive economy – farms and factories – are no different. The analogy fits. In the current scenario, policymakers are the parents who should be worried.

India should help its micro, mini and small enterprises to grow out of their humble origins. There is no pride in the fact that 90% of unincorporated non-agricultural enterprises do not maintain any sort of accounts. Apparently, the proportion was even higher at 94% for Own-Account Enterprises. Similarly, India should be worried about more than 45-lakh shops employing over 30-lakh persons.[3] That is less than one employee per shop. There is no data on how productive they are, since most of them do not maintain any books of accounts. There are no benchmark either, to assess whether they are deployed in the best possible vocation, etc.

> **"As per the survey carried out by the National Sample Survey Organisation in the year 2009-10, the total employment in both organized and unorganized sector in the country was to the tune of 46.5 crore. Out of this, about 43.7 crore were in the unorganized sector, of which 24.6 crore workers were employed in agriculture sector, 4.4 crore in construction, and remaining were in manufacturing activities, trade and transport, communication & services. A large number of unorganized workers are home-based and are engaged in occupations such as beedi rolling, agarbatti making, papad making, tailoring, and embroidery work."[4]**

It may be worthwhile to check, if at India's stage of development (per capita income of around USD1670 as of 2015), other countries continue to have such a large share of employment in the unorganised sector. A report published by the International Labour Organisation (ILO) in 2012 sheds light on that. There is evidence that India is at the extreme end of the spectrum, compared to other economies in the same league. In fact, India is the most extreme with 83.6% (of all non-agricultural employment) of its workforces engaged in informal employment.

[3]Prof. R. Vaidyanathan (2014): 'India Uninc.' Westland Ltd. (pages 33 and 89 respectively).
[4]Indian Labour Year Book 2011 & 2012 (page 18)

Table 4: Employment in the informal economy in non-agricultural activities by component, both sexes, latest year available, 24 countries

Country (year)	Persons in Informal employment		Persons employed in the informal sector		Persons in informal employment outside the informal sector	
	Thousands	Percentage of non-agricultural employment	Thousands	Percentage of non-agricultural employment	Thousands	Percentage of non-agricultural employment
Argentina (2009 IV Qtr.)	5,138	49.7%	3,317	32.1%	1,850	17.9%
Armenia (2009)	138	19.8%	71	10.2%	67	9.6%
Bolivia (2006)	2,069	75.1%	1,436	52.1%	647	23.5%
Brazil (2009)	32,493	42.2%	18,668	24.3%	13,862	18.0%
China[1](2010)	36,030	32.6%	24,220	21.9%	13,850	12.5%
Colombia (2010 II Qtr.)	9,307	49.7%	8,144	52.2%	1,444	9.3%
Costa Rica (2009 July)	754	43.8%	638	37.0%	193	11.2%
Cote d'Ivoire (2008)	n.a.	n.a.	2,434	69.7%	n.a.	n.a.
Dominican Rep. (2009)	1,484	48.5%	898	29.4%	593	19.4%
Ecuador (2009 IV Qtr.)	2,691	60.9%	1,646	37.3%	1,062	24.0%
Egypt (2009)	8,247	51.2%	n.a.	n.a.	n.a.	n.a.
El Salvador (2009)	1,242	66.4%	988	53.4%	277	14.8%
Ethiopia** (2004)	n.a.	n.a.	1,089	41.4%	n.a.	n.a.
Honduras (2009)	1,454	73.9%	1,146	58.3%	334	17.0%
India (2009/2010)	185,876	83.6%	150,113	67.5%	37,409	16.8%
Indonesia (2009)	3,157	72.5%	2,621	60.2%	532	12.2%
Kyrgyztan (2009)	n.a.	n.a.	887	59.2%	n.a.	n.a.
Lesotho (2008)	160	34.9%	225	49.1%	99	21.6%
Liberia (2010)	343	60.0%	284	49.5%	62	10.8%
Macedonia, FYR. (2010)	65	12.6%	39	7.6%	27	5.2%
Madagascar (2005)	1,271	73.6%	893	51.8%	378	21.9%
Mali (2004)	1,180	81.8%	1,029	71.4%	163	11.3%
Mauritius (2009)	n.a.	n.a.	57	9.3%	n.a.	n.a.
Mexico (2009 II Qtr.)	20,258	53.7%	12,861	34.1%	7,620	20.2%

[1]Six Cities **Urban Areas n.a. Non Available

Sources: Statistical update on employment in the informal economy, ILO - Department of Statistics, June 2012.

NOTES: Due to the possible existence of some formal wage employment in the informal sector, total informal employment outside the informal sector.

Second, the employment-population ratio as per the 2011 census was only 39.8%, which is considered to be on the lower side. India has the somewhat dubious distinction of having the third lowest labour force participation rate, with only Egypt and Honduras being worse-off than India.

Table 5: 24 countries - Selected Indicators, Latest Annual Data

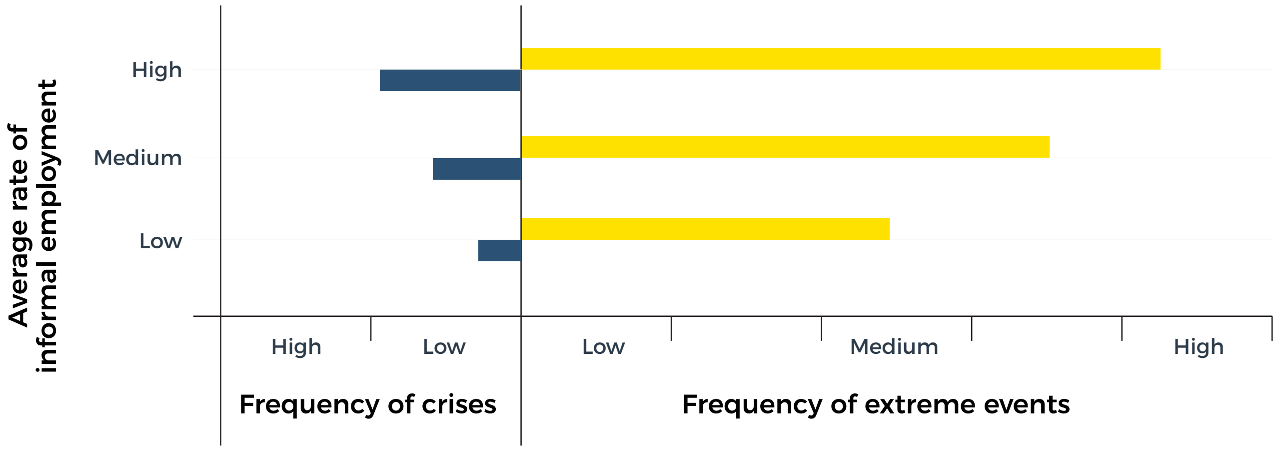
Country	Personals in informal employment	Persons employed in the informal sector	Labour force participation rate	Unemployment rate	Gross Domestic Product per capita	Poverty
	Percentage of non-agricultural employment	Percentage of non-agricultural employment	Percentage of Working age population	Percentage of Economically Active poulation	In current US$ (year 2010)	Percentage of Population living below national poverty line
Argentina	49.7%	32.1%	46.0%	7.7%	9,138	n.a.
Armenia	19.8%	10.2%	59.2%	18.7%	2,846	26.5%
Bolivia	75.1%	52.1%	56.9%	7.9%	1,858	60.1%
Brazil	42.2%	24.3%	62.0%	7.1%	10,816	21.4%
China[1]	32.6%	21.9%	70.1%	4.1%	4,382	2.8%
Colombia	59.6%	52.2%	62.7%	11.8%	6,273	45.5%
Costa Rica	43.8%	37.0%	60.5%	7.8%	7,843	21.7%
Cote d'Ivoire	n.a.	69.7%	40.7%	22.6%	1,036	42.7%
Dominican Rep.	48.5%	29.4%	64.3%	14.3%	5,228	50.5%
Ecuador	60.9%	37.3%	65.3%	6.5%	3,984	36.0%
Egypt	51.2%	n.a.	33.0%	9.0%	2,789	22.0%
El Salvador	66.4%	53.4%	42.4%	6.4%	3,701	37.8%
Ethiopia**	n.a.	41.4%	46.0%	16.7%	350	38.9%
Honduras	73.9%	58.3%	37.9%	2.9%	2,016	60.0%
India	83.6%	67.5%	39.1%	4.3%	1,265	27.5%
Indonesia	72.5%	60.2%	67.8%	7.3%	3,015	13.3%
Kyrgyztan	n.a.	59.2%	64.4%	8.4%	864	43.1%
Lesotho	34.9%	49.1%	42.3%	25.3%	837	56.6%
Liberia	60.0%	49.5%	62.8%	3.7%	226	63.8%
Macedonia, FYR.	12.6%	7.6%	55.7%	32.0%	4,431	19.0%
Madagascar	73.6%	51.8%	86.9%	2.3%	392	68.7%
Mali	81.8%	71.4%	49.4%	8.8%	692	47.4%
Mauritius	n.a.	9.3%	59.8%	7.7%	7,593	n.a.
Mexico	53.7%	34.1%	58.7%	5.5%	9,566	47.4%

[1]Six Cities **Urban Areas [n.a.]Non Available

Source: Statistical update on employment in the informal economy, ILO-Department of Statistics, June 2012

Such a high proportion of informal employment takes its toll on macro-economic performance of the whole economy

Figure 8: Informality and the long-term sustainability of growth (1990-2006)



NOTE: The figure presents average rates of frequency of extreme events, as measured by the kurtosis of the average annual GDP growth rates over the period 1990-2006. The 31 countries in our sample are grouped according to their average informality rates over that period

Source: Globalisation and informal jobs in developing countries, a joint study of the International Labour Organisation and World Trade Organisation (2009).

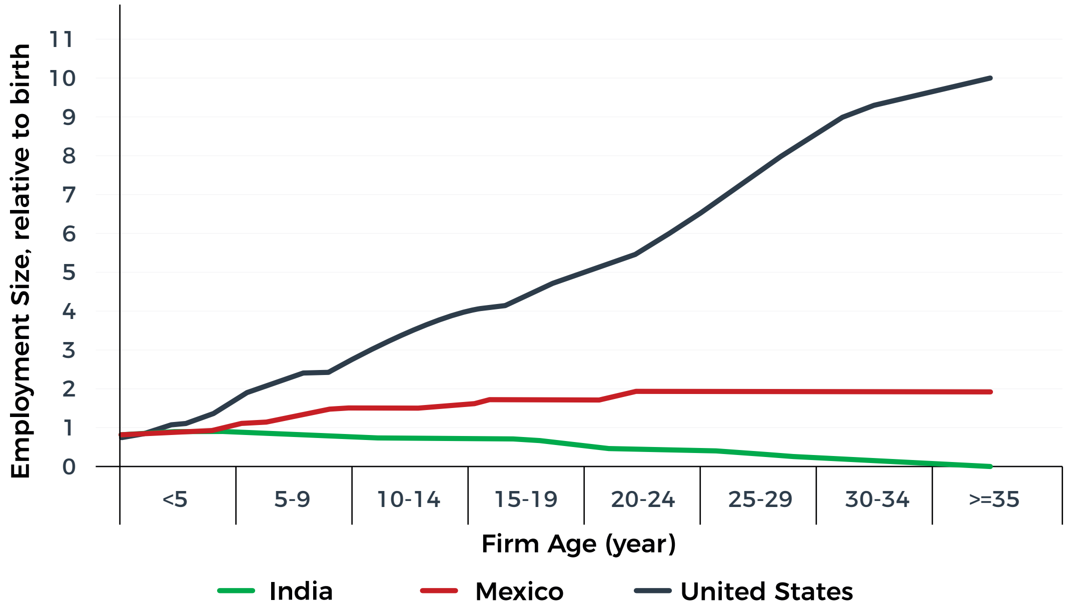
> **The above figure "shows that countries with large informal economies tend to experience more frequent growth crises and extreme growth events. Taken together, the two parts of the chart suggest that even though growth acceleration may occur more frequently in countries with larger informal economies, the risk of sudden stops and economic crises is also significantly larger in these countries, preventing sustainable long-run economic expansion. It should be noted that this illustration does not causally link the two phenomena but suggests an empirical regularity."[5]**

[5]Source: Chapter 5: 'Economic resilience: dynamics of informality', Globalisation and informal jobs in developing countries, a joint study of the International Labour Organisation and World Trade Organisation (2009)

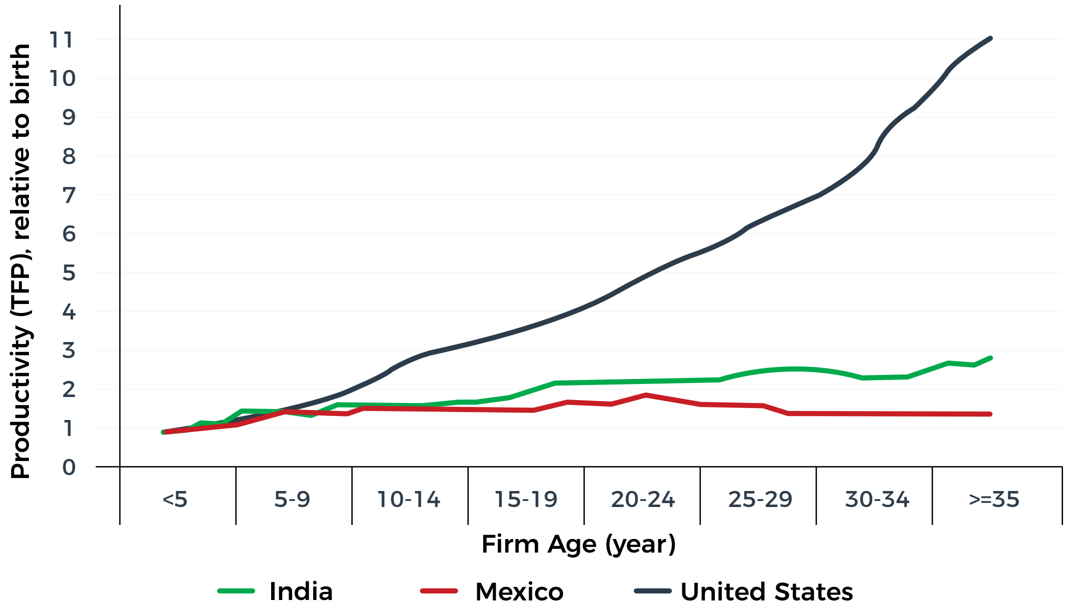
The chart below is extremely disconcerting. As firms age, they employ more people. India's model is an exception. Even as firms become more than three decades old, they do not employ more people. If anything, the employment size, relative to the size of employment at the birth of the firm, goes down! A large portion of this peculiar Indian feature has to do with the fact that firms remain small in nature. Perhaps, policy measures create a perverse incentive for them to remain small.

Figure 9: Many firms are born small and grow little in India and Mexico

A. Employment size over firm life-cycle



B. Productivity over firm life-cycle



NOTE: Figures present the average employment (or productivity) of firms in different age groups relative to the average employment (or productivity) at birth. Figures are computed using 1992 and 1997 data for the United States, 1998 and 2003 data for Mexico, and 1989 -1990 and 1994 -1995 for India.

Source: Chapter 2, IFC Jobs Study (January 2013)

Misallocation of resources – capital, labour, and public support - across firms is an important contributor to the persistence of low firm productivity. Chang Tai-Hsieh and Pete Klenow, economists from Chicago Booth School of Business and Stanford respectively, study economic growth and development. Through their research, they suggest that 40-60% of the total factor productivity differential between firms in India and the US is due to the misallocation of resources and capital among the millions of micro and small enterprises in India.[6]

> **As Ricardo Hausmann[7] , Harvard Economics professor of Venezuelan origin, never tires of quoting, "while two-thirds of workers in Mexico's Nuevo Leon state are employed by private incorporated businesses, just one in seven are in Chiapas state, and this is associated with a nine times per-capita income differential".**

Government policy should be geared to removing the state-imposed tax and non-tax (administrative and bureaucratic) obstacles that prevent small firms from growing big. Small and medium industries would grow around them. Over time, some of these may develop into large enterprises. As is evident, the employment intensity of formal and incorporated businesses is greater.

Concern for the poor does not mean that we keep them in poverty. Caring for the poor should not be confused with celebrating poverty. Similarly, India must support its small farms and factories (whether incorporated, organized or neither as per official classifications) to help them grow big, and not to retain them in their erstwhile position. It is worth reiterating that policy measures cannot and should not create perverse incentives for enterprises to stagnate at their inception sizes. Policymakers should be alert to the twin pitfalls of policymaking: the law of unintended consequences and the road to hell being paved with good intentions.

[6] Misallocation and Manufacturing TFP in China and India; Chang Tai-Hsieh and Peter Klenow; The Quarterly Journal of Economics, November 2009, pp 1403-1448 (http://klenow.com/MMTFP.pdf)
[7] Does Capitalism Cause Poverty; Ricardo Hausmann; Project Syndicate; August 21, 2015 (http://www.project-syndicate.org/commentary/does-capitalism-cause-poverty-by-ricardo-hausmann-2015-08)

Enter MUDRA Bank: Helping Enterprises Grow Big

The present union government has approached the task of aiding small businesses systematically. Its skilling missions and the establishment of the MUDRA Bank are important developments in enabling enterprises to grow big. Micro, mini and small enterprises were formerly discriminated against, in the provision of finance. If MUDRA Bank could eliminate that serious lacuna, then many entrepreneurs and enterprises can blossom. These are early days to judge the MUDRA Bank loans and their outcomes. The quantum of loans disbursed has cumulated to INR2.54trn in a short period since its inception. Bulk of the loans have been extended to individuals and are below Rupees 50,000/borrower.

The government cannot help them grow with these loans unless it holds them accountable for their own performance, and self-sustenance. The bank clearly recognises that its role is not just finance but also development of micro and small enterprises. It lists several constraints faced by non-corporate business sector: access to finance, skill development gaps, knowledge gaps, infrastructure gaps, policy advocacy needs, information asymmetry, lack of growth orientation, lack of market development/ market making and entry-level technologies.[8]

One of the key things in the list above is the lack of growth orientation. It will be important to inculcate that. Professor Ravi Kanbur notes that the bulk of the enterprises in India are unincorporated and informal.[9] Some evade formality [Column B in the table below]. Some avoid formality by keeping their businesses below the formal threshold [Column C]. For example, factories have to register themselves if they have ten or more workers (with electricity) or 20 and more workers (if they do not have electricity). These days, the binding limit has become 10 since even smaller firms operate with electricity. Some factories may choose to fragment themselves limiting themselves to nine workers just to avoid registration and the compliance that comes with it. They are the avoiders. But, a vast majority are simply exempt ('outsiders') since they operate with less than ten workers [Column D]. All these three categories – evaders, avoiders and the exempt – comprise the informal category. Those who are large and comply constitute the formal category [Column A].

[8]Source: http://www.MUDRA.org.in/AboutUs/Genesis
[9]Ravi Kanbur (2014): 'INFORMALITY: CAUSES, CONSEQUENCES AND POLICY RESPONSES, Working Paper
Charles H. Dyson School of Applied Economics and Management, Cornell University, Ithaca, New York 14853-7801 USA (August 2014)

Table 6: Compilers, Evaders, Avoiders and Outsiders under the Factories Act, 1948, in 2009-10*

Firm Characteristics	Firm Categories			
	A	B	C	D
	ASI Firms	NSSO Firms with 10 or employees	NSSO Firms with 9 employees	NSSO Rest
Number of firms	143,452	256,993	67,249	16,900,000
Share of firms	0.8%	1.5%	0.4%	97.3%
Total Employment**	11,500,000	4,543,668	605,245	29,700,000
Share of Employment	24.8%	9.8%	1.3%	64.1%
Mean Employment	79.9	17.7	9.0	1.8
Median Employment	21	13	9	1
Median Labour Productivity (Rupees)***	135,626	59,820	74,000	23,400

*Usage of power is ignored and only the criteria of 10 or more employees is considered for registration under the Factories Act, 1948.
Excludes firms with missing or zero employment.
**Includes unpaid family members/helpers working in the firm.
*** Capital here is defined as the value(market value for NSSO and book value for ASI) of assets at the end of the year
*** Labour productivity is total gross value added divided by total employment

Source: Ravi Kanbur (see **footnote 9** for details)

It is strikingly evident from the table above that ASI firms constitute just 0.8% of the total enterprises in the country and yet they have a share of 24.8% of the employment generated by all enterprises. What is both interesting and sad is that among ASI firms (which are registered), large enterprises constitute a very small share. See the table below. Only 16.4% of ASI registered firms (remember that they are only 0.8% of all enterprises in the country) have 100 or more workers. Yet they provide 75% of all employment provided by ASI registered firms and 80% of the output of all ASI-registered factories.

The challenge for policymakers, post-demonetisation, is obvious. It is to raise the share of ASI firms and, among them, firms that employ hundred or more workers from infinitesimal to miniscule!

Table 7: Annual Survey of Industries

	Percentage of such factories	Fixed Capital	Productive Capital	Invested Capital	Employment	Wages	Emoluments	Factory Output
Output of 100 crores or more	6.32%	75.90%	75.00%	74.60%	43.60%	58.10%	61.80%	77.00%
Capital of 10 crores or more	9.10%	85.70%	80.60%	81.88%	48.70%	64.38%	67.19%	72.95%
100 or more workers	16.40%	87.79%	84.48%	85.49%	75.29%	82.26%	82.84%	80.73%
NVA of over 50 crores	1.99%	51.31%	50.97%	48.69%	24.75%	37.50%	40.81%	49.89%

Source: Annual Survey of Industries 2013-14

Even small improvements in the share of ASI firms and the share of ASI firms with more than hundred workers might mean substantial improvement in national economic performance, productivity and output. Indeed, Porta and Shleifer argue that it is unrealistic to expect informal firms to transition to formal status. It happens all too rarely. They "continue their existence, often for years or even decades, without much growth or employment".[10] They conclude, on a note of resignation that, as the economy grows in size, the share of informality shrinks without, perhaps, shrinking in absolute terms, simply because the formal economy has grown in size.

They caution against taxing or regulating informal enterprises because such policies aimed at encouraging them to become formal may have the opposite effect. Such policies would drive them "out of business, leading to poverty and destitution of informal workers and entrepreneurs. The recognition of the fundamental fact that informal firms are extremely inefficient recommends extreme caution with policies that impose on them any kind of additional costs. The tables in the previous page confirm the unproductiveness and inefficiency of informal enterprises in India too.

Thankfully, India is not trying to tax or regulate them out of existence. It is trying to include them financially. In fact, an initiative like MUDRA Bank is needed to address productivity and working conditions in the informal sector and in informal employment. Most World Bank Enterprise surveys reveal that informal entrepreneurs cite 'access to finance' as their biggest obstacle to doing business.

[10] Andrei Shleifer and Rafael La Porta (2014): Informality and Development, Journal of Economic Perspectives-Volume 28, Number 3-Summer 2014-Pages 109–126

Table 8: Obstacles to doing business

Obstacles (Percentage of firms identifying an obstacle as the most important)						
	Informal Enterprise Survey	Formal Enterprise Survey				Formal vs. Informal
		Small	Medium	Big	All	
Access to financing	43.8%	20.6%	17.8%	13.6%	18.5%	-25.3%*
Political Instability	11.4%	9.5%	9.1%	11.7%	9.7%	-1.7%
Access to Land	11.2%	5.6%	4.2%	4.1%	5.0%	-6.3%**
Corruption	7.4%	7.3%	8.2%	6.0%	7.4%	0.0%
Electricity	7.3%	10.0%	9.8%	7.4%	9.8%	2.5%
Business Licencing and permits	6.3%	2.3%	2.7%	1.7%	2.4%	-3.9%**
Crime	3.4%	5.2%	5.0%	7.2%	5.4%	2.0%
Legal System	3.3%	0.5%	0.5%	1.9%	0.8%	-2.5%*
Customs and trade regulations	2.1%	3.2%	4.4%	5.0%	3.8%	1.8%
Uneducated workforce	1.8%	4.6%	6.0%	10.4%	6.0%	4.2%***
Labour Regulations	1.8%	2.6%	3.1%	4.8%	3.3%	1.4%
Tax Administration	0.1%	4.3%	6.7%	6.4%	5.3%	5.2%**
Practices of competitors in the informal economy	0.1%	14.4%	13.4%	9.9%	12.9%	12.9%*
Tax rates	0.0%	7.7%	6.2%	6.3%	6.8%	6.8%*
Transportation	0.0%	2.2%	2.9%	3.7%	2.8%	2.8%*

*,** and *** indicates significance at the 1,5 and 10 percent levels, respectively.
NOTE: This Table compares perceived obstacles to doing business reported by informal and formal entrepreneurs.

Source: Andrei Shleifer and Rafael La Porta (2014): Informality and Development, Journal of Economic Perspectives - Volume 28, Number 3 - Summer 2014 - Pages 109–126

It is important to ensure that improvements and enhancements to their businesses happen. One of the world's most widely hailed and successful social welfare program in recent years has been 'Bolsa Familia' in Brazil. It was launched by President Lula and has since expanded. Other countries have tried to emulate it. The program ensured that recipients complied with certain conditions and, importantly were subjected to monitoring and risked being dropped from the program if they did not keep up their end of the bargain[11]. Closer home, in Bengal, Bandhan, the Microfinance Institution, did not extend entrepreneurship loans to those clients who had not created at least two jobs in the previous year.[12]

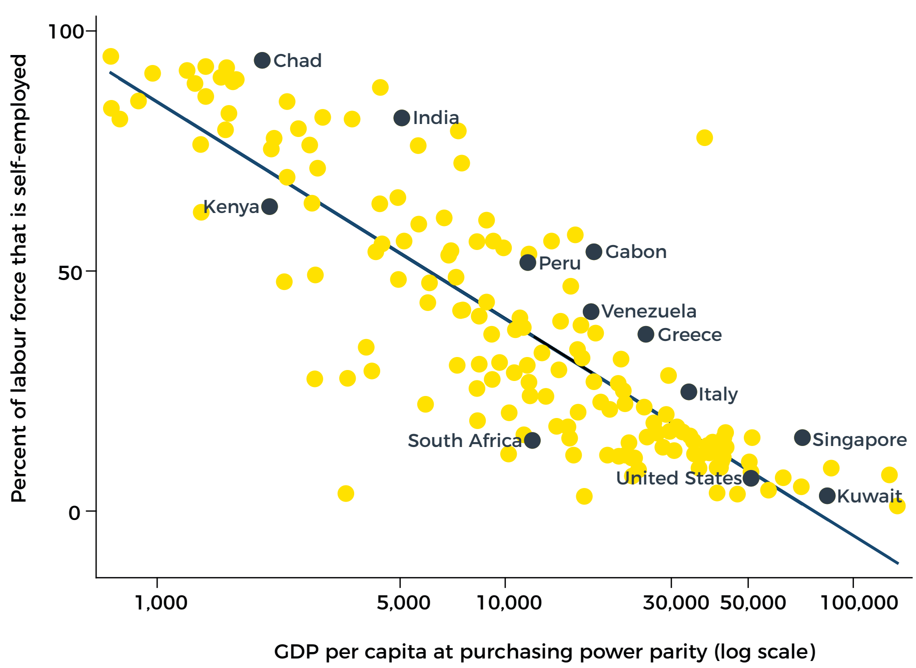
[11]Jonathan Tepperman (2016): 'The Fix – how nations survive and thrive in a world of decline', Bloomsbury Publishing, 2016
[12]See http://www.livemint.com/Opinion/MbfXXGjbrDsJjW2MEFHvOP/Civic-and-policy-lessons-from-Bandhan.html

Policy interventions without benchmarking and measurement are incomplete and ineffective. Absence of bookkeeping – production or financial – does not help. That needs to change. All MUDRA Bank borrowers must be required to report on their employment generation and other productivity parameters (output/labour, output/capital, sales/assets, etc.). Before requiring the borrowers to report on their progress (or the lack, thereof) on the identified parameters, the government should develop benchmarks and share them with lenders so that performance measurement is appropriately contextualised.

Apart from MUDRA, the Reserve Bank of India is licensing small finance banks. Further, the budget of 2016-17 explicitly incentivised job creation with the government offering to bear a portion of payroll costs. The focus on easing business conditions is timely because it would help small businesses the most. The lesser the scope for discretion and arbitrariness on the part of the petty government official, the greater the freedom of operation for the small and marginalised. Big businesses usually find their way through the regulatory maze and compliance costs are a small proportion of their overall operating costs. Finally, the exercise of removing obsolete laws at state and union levels must be hastened.

The withdrawal of specified bank notes (500 and 1000 rupee denominations) announced on November 8 has focused minds on the problem of pervasive informality in India. No country has ever made progress with such a level of informality and fragmentation with underdeveloped production capacity. Countries with high per capita incomes have low levels of self-employed workers. India is an outlier even among developing countries.

Figure 11: Self-Employment and GDP per Capita in 2013



Source: Andrei Shleifer and Rafael La Porta (2014): Informality and Development, Journal of Economic Perspectives -Volume 28, Number 3 - Summer 2014 - Pages 109-126

The macro-economic strategy document of the 2016-17 budget expressed the hope that the rising formality of the Indian economy would lift its potential growth rate. The government should first recognize and then persuade the public that its efforts are aimed at reducing, if not eliminating, informality in the Indian economy.

Sustained public articulation of its policy goals would serve many purposes for the government:

- It would define an over-arching vision and mission, enhance credibility and ensure policy continuity.
- It would direct the government's thinking on additional measures that are needed to achieve the goal.
- It could persuade visionary and like-minded state governments to undertake similar measures at their level.

The government should evaluate the impact of its interventions by:

- **the extent of reduction in informal employment,**
- **the rise in formal employment, and,**
- **the extent of mobility of firms to medium and large sizes. Data collection has to gear up accordingly.**

India Needs Relationships and Rules

It is useful to remember that small, open economies do not create small-sized firms. They seek to overcome the constraint imposed by their small economies by welcoming, enabling and establishing international scale production and service centres so that they could export them to the rest of the world. Thus, small economies seek to transcend the tyranny of the small. Therefore, it is illogical that a large economy should squander the natural advantage that its size affords by embracing smallness.

Professor R. Vaidyanathan of the Indian Institute of Management in his book (refer footnote no. 3), has two very interesting and thought-provoking chapters, numbered 12 and 23. The former deals with the role played by the non-banking financial sector and the latter on caste as social capital. A few castes and communities and their roles in providing social capital and financial capital have been highlighted. The fact that, in a country of 1.2 billion people, there are a handful of examples, which proves that they are the exception rather than the rule. Also, relationship-based financing and support systems are, by definition, extended only to those who are included in the system. In other words, they are not ideal for expansion and scaling-up. They cannot and do not cater to alien/alienated communities. By their very nature, their arena of operation is limited and hence, their influence and impact on the economy are limited.

In a working paper that possibly set the stage for the book that came out later, Harish Damodaran notes that although business activity had become more diffused throughout society, it had not demonstrated a uniform pattern across the nation, being confined mainly to the South and the West. The picture was far from dynamic in the North, for instance.[13]

Ultimately, in a world of open borders featuring fluid transfer of capital and competition across nations, networks and relationship-based arrangements will be easily overrun. Nor can they compete with large institutions with substantial capital base. Simply put, caste-based business-cum-social networks must transcend these very definitions to be able to grow. That is what Harish Damodaran, whose book ('India's New Capitalists: Caste, Business, and Industry in a Modern Nation') is cited by Professor R. Vaidyanathan, says in a short interview.[14]

He concludes that successful businesspersons from a particular community invariably align themselves with other businesspersons in their line of business, regardless of the community of their origin, rather than members of his/her own community.

[13]Harish Damodaran (2008): 'Banias and beyond: the dynamics of caste and big business in modern india', CASI working paper series, Number 08-04 (06/2008), Center for the Advanced Study of India, University of Pennsylvania, Philadelphia (https://casi.sas.upenn.edu/sites/casi.sas.upenn.edu/files/research/H%20Damodaran-CASI%20WP-final.pdf)
[14]Source: https://www.youtube.com/watch?v=VpeKNuH9MyA

> **"As communities get entrenched in economic space and capital accumulates and reproduces on an expanding scale, the atomistic calculations of individual capitalists tend to override the ideals of collective enterprise... All these indicate how sharpening internal differentiation and stratification exert a weakening influence on community solidarity, with well-to-do members being drawn towards new functional and class alignments cutting across caste lines. A Kamma[15] sugar magnate ultimately identifies his interests with other mill owners and not with fellow Kamma cane growers or workers. While community feelings continue to be strong among less successful members, these, if at all invoked by the elite, usually take opportunistic forms."[16]**

The social capital theory of economic development is well known in the literature and in Western societies. Economists and sociologists have acknowledged their role in enhancing economic welfare and other positive outcomes in the society. Clearly, relationships help overcome certain inherent deficiencies of rules-based economic arrangements. Trust is the bedrock of economic activity and relationships enhance trust. But, the Indian economy has grown to a size and complexity that it cannot thrive purely on relationship-driven economic activity.

For example, India's Thiruppur textile manufacturing hub is often cited as a success story of what India's relationship based economic model can achieve. To a limited extent, it is true. However, it is equally true that neither Thiruppur nor similar clusters have enabled it to become internationally competitive. The value added and employment generated by India's textile sector dwarfs that of smaller States like Bangladesh and Vietnam. But when a well-known international sports brand approached Nagesh Sharma, who runs an apparel sourcing company from Gurgaon, with a huge order for tracksuit pants, Mr Sharma tried to source the product from India. He found only one apparel factory could match the buyer's specifications. The primary problem was that India's garment factories are too small; they typically have 150 people and about 80 machines. The average factory in Bangladesh has 600 people.[17]

In short and in sum, India needs to create, nurture and encourage a rules-based society and economy even as it taps into the advantages and strengths conferred by traditional relationships.

[15]Kamma is a caste found largely in the southern Indian states of Andhra Pradesh, Telangana and Tamil Nadu.
[16]Source: Harish Damodaran: 'India's New Capitalists: Caste, Business, and Industry in a Modern Nation, 2008
[17]See Rahul Jacob: 'Will garment factories move to Vietnam?' (March 2, 2016)
(http://www.business-standard.com/article/opinion/rahul-jacob-will-garment-factories-move-to-vietnam-116030201031_1.html)

Modern nation-states need strong economies to provide them a sense of security and self-confidence. An exclusive emphasis on organising economic activity around communities would have suited a different context and a different era when there were no modern nation-states and there were only communities. The stresses and the strains generated by the scale that the world has achieved makes many of us yearn for times when life was a lot simpler in many ways. In some cases, it may not be possible and may even have adverse consequences, when it is superimposed in a socio-economic context that has grown out of it.

Devolution:
The Key to Culture, Communities and Cottage Industry

Earlier sections examined the economic consequences of romancing the small. When it comes to preserving **communities, culture and cottage industries (the 3Cs)**, there are concrete approaches that serious and committed governments can pursue.

It is justified for governments to be concerned with cottage industries and communities. As identified in the Madhya Pradesh background paper on the theme of 'cottage industries', they are not just an economic issue but a cultural one. The best way to preserve culture is to strengthen communities and empower them to administer themselves. They will know their culture and industries better than city-dwellers and urban policymakers. In other words, the spirit of the Fourteenth Finance Commission should percolate down from states to local governments. Not only should there be resource allocation to local governments but they should be untied as the union government has done for states. Currently there is very little discretion for village Panchayats to determine their expenditure priorities.

Strengthening village administrations will therefore not only help with the financial devolution, but also with enabling their empowerment in terms of making hiring decisions (of experts, etc.). This measure will be truly revolutionary in nurturing and supporting traditional industries, culture and craft.

Creating the Demand for the 3C

It is also useful to focus on the demand side for Indian culture and the output of cottage industries, rather than indiscriminately supporting their production. In other words, how about getting the people of the State, of the country, to demand offerings that reflect the best of Indian culture, art and craft? This requires that their choices are better informed.

'Knowledge Traditions and Practices of India' is a set of elective courses for Grades XI and XII developed for the Central Board of Secondary Education (CBSE). The course was prepared under the expert guidance of Prof. Jagbir Singh and Prof. Kapil Kapoor, well-known scholars of India's intellectual traditions. Their efforts were supported on the CBSE side with the active collaboration of Shri Vineet Joshi, then-chairman, and Dr. Sadhana Parashar, then-Director of Academics & Training, along with her Academic team.

It was the first time in the history of Independent India that a government body has produced such a comprehensive course on India's cultural and intellectual heritage, complete with rich illustrations, numerous extracts from primary texts, explanatory side notes, lists of online and offline resources, suggested projects and other activities. Volume 1 of the textbook (for class XI) was released in 2012, while Volume 2 (for class XII) was published with some delay in 2015. A team of scholars contributed to the textbooks' modules, which were edited by Prof. Kapil Kapoor and Prof. Michel Danino. Most of the modules are also available online here.

However, for some inexplicable reason, the course is languishing now. It has not been pursued vigorously and earnestly and schools have not been persuaded to offer these electives to students. As long as India's younger generation remains ignorant and uninformed of its cultural traditions, they will not be interested in the offerings arising out of traditional cultural institutions and cottage industries.

Even if CBSE were slow on the uptake, interested State governments could introduce the material to Higher Secondary students. That is a better and more durable way to assess and strengthen demand for the products and services of cottage industries.

The Art of Policymaking with Open Minds

Open minds among policymakers are of utmost importance in India given its large size and diverse population. Policy experimentation is the key to arriving at the right mix for the right location. Willingness to experiment and commit mistakes, make data-driven course corrections, abandoning one approach and trying another or even a mix of approaches in different locations, are desirable ingredients of policymaking and implementation. Governance accountability institutions and judicial institutions should also have to reform to facilitate such a practice.

In more practical terms, an attitude of 'either/or' towards size, technology and foreign investment is neither desirable nor necessary. Pro-poor, pro-farmer, pro-micro and small businesses need not and should not mean anti-rich, anti-industry and anti-large. India needs and can accommodate all. Technology developed in the West – internet – is now enabling many artisans and craftsmen to form their own collectives, bypass intermediaries and market their wares globally.

In 70 years since independence, India has missed the equivalent of a quarter century due to poor economic policies dictated either by politics, or by a defensive and diffident mind-set, or a combination of both. Under its modern-day leadership, India should be confident of competing. To succeed in the competition, the dominant ruling dispensation in India and its advisors must shed their exclusivist mind-sets rooted more in romanticism but very little in empiricism.

Proposals made in this paper

1

Whining and victimhood should be deployed as tactics but cannot be made habits.

2

We need open minds. Blanket attitudes such as: 'big is bad', 'foreign is bad' and 'small is beautiful' would ill serve India.

3

Land consolidation through sale and acquisition of land is to be urgently facilitated

4

Policy should be geared to removing the state-imposed tax and non-tax (administrative and bureaucratic) obstacles that prevent small firms from growing big.

5

Policy initiatives to be continuously monitored to avoid creation of perverse incentives.

6

MUDRA Bank beneficiaries must report and be monitored for job creation, for growth and for productivity improvement.

7

Government to measure its policy interventions on the criteria of reduction in informal employment, generation of formal-sector jobs and growth in the proportion of medium to large firms.

8

Financial, administrative and governance empowerment of local government institutions for rejuvenation of culture, communities and cottage industries.

9

Strengthen demand for traditional culture and cottage offerings by educating and exposing young minds to 'Traditions and Knowledge Practices of India'.

10

Small is beautiful in children. In adults, it is a problem. It is no different with enterprises.

ATHENA
INFONOMICS
www.athenainfonomics.in