Burden of "Start-up"! Why Entrepreneurship is hurt?

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"Ease of doing business" ranking published by the World Bank ranked India at abysmally low of 142 in 2015 out of 189 economies, which was worse than its ranking of 140 in 2014. The economies are ranked on 10 parameters like a) starting a business, b) dealing with permits, c) getting credit, d) protecting minority investors, e) enforcing contracts etc. India's standing on these parameters clearly show that except "protecting minority investors" India is ranked in the bottom 25% on almost all other parameters.

In every aspect of doing business, organisations face multiple hurdles. It is disheartening to note that India has remained in the bottom 25% for many years. The fact that India is currently a hotbed of entrepreneurial activity, despite this backdrop, speaks volumes of spirited effort being put in by our entrepreneurs. One wonders what it could have been if matters were easier.

A deeper look at a parameter like "starting a business" highlights that India has 13 procedures as against around 8 in South Asia and 5 in OECD countries and it takes on an average 30 days to complete the formalities in India while it is 16 days and 9 days in South Asia and OECD, respectively. Similarly, in "enforcing contracts" average time taken in India is 1,420 days compared to the average of 1,077 days and 540 days in South Asia and OECD, respectively.

One would think that successive governments would have worked overtime to improve India's competitiveness in attracting domestic and foreign investors however; the experience in the last one and a half to two years does not inspire much confidence. This got accentuated with the enactment of the New Companies Act of 2013.

The government of the day passed the Act in a great hurry mainly to address the concerns raised because of fraudulent practices followed by a few large companies and the involvement of a few private shell companies in the large scams. One of them was involved in collecting huge sums of deposits from public flouting all rules and the other manipulated its accounts. In response, the Government tightened the rules and regulations applicable to all private companies concerning the operational aspects and "suffocated" large number of companies. It was a classic case of throwing the baby with bath water.

When an entrepreneur starts a new business the intent is to solve some real problems faced by the society - either of consumers or enterprises. Instead of creating an enabling environment the government came up with legislation full of provisions that were either not thought through or those created significant challenges in implementation. The businesses had to endure a prolonged period of uncertainty and delays. This required significant amount of redrafting, as a result of which two legislations the Companies Act of 1956 and the new Companies Act co-existed for almost a year. It is incomprehensible as to how the government of the day allowed such a poorly drafted legislation to go through despite having the best talent and advisors at its disposal.

This article captures only some of the provisions as examples – capitalisation of securities application money, loans from shareholders or directors to the company, annual returns, formal meetings, stock options etc.

The new Act made the process of "issue and allotment" of shares extremely difficult for private and start-up companies. They have to issue "prospectus" at the time of raising additional capital and complete the process within defined timelines. This is an entirely unwarranted bureaucratic requirement for private companies and it only led to additional compliance cost without any tangible benefits. Entrepreneurial organisations need to be agile and can't do mindless "form filling". Some recent amendments have eased the problem but the procedure has not been dispensed with.

Further, the new Act places restriction on loans from shareholders and directors to companies if such loans are funded by borrowings from others etc. This has been relaxed recently but only up to 100% of free reserves. A start-up company is very unlikely to have free reserves so this relaxation makes very little difference for a number of companies which are looking for that additional "seed" capital. The Act needs to differentiate between loans for genuine business needs in start-up companies, given the highly risky nature of business and loans of dubious nature. The start-up ecosystem is plagued by lack of access to credit. Despite the announcement of various schemes by the government the progress on the ground is extremely slow. The banking sector, already in the middle of a serious NPA crisis, is unwilling to lend to genuine SMEs and in such a scenario sometimes the promoters or directors have no choice but to borrow in their personal capacity and lend the amount to their enterprises.

Another form of bottlenecks that add to the compliance worries is in form of secretarial standards which are applicable for all types of companies - large and small, listed and private. These standards are applicable for board as well as shareholder meetings and require a small private company or a start up to conduct the meetings in a same manner and adhere to same compliance procedures as that of a large listed company. Every company has to upload rather repetitive information in its annual returns / directors' report. A large company may well be within its means to afford such compliances which may not be the case for a start-up. Such bottlenecks may also contribute to de-motivating entrepreneurs which ultimately reflects on the ease of doing business quotient of India.

The existing regulations are not conducive to entrepreneurs in grant of stock options. In cases where a start-up has more than one founders and is being managed by one of them, it is in the best interest of the start-up to incentivise the managing founder by awarding him stock options. However, Companies Act prohibits grant of options to promoters of any company – listed and private. As a result, the start-up has to make do with dispensing cash in form of salary to the managing founder.

Apart from the Companies Act, a new entrepreneur has to ensure compliance of his start-up with many other regulations. For instance, mandatory registration under the Shops & Establishments Act, Employees' Provident Fund, Employees' State Insurance Corporation, various tax numbers, etc., would require around one lakh rupees in compliance costs along with a significant amount of time and effort which can divert entrepreneurs from focusing on scaling their start-ups. Even after somehow managing to comply with most of the regulations, entrepreneurs are subject to multiple unnecessary inspections which lead to harassment.

The least the government can do is create a single portal which publishes a list of all compliances to be met by private companies and start-ups. Any entrepreneur who incorporates a company has no idea how to ensure to comply with all the requirements and as a result majority of companies are not fully compliant. A single portal will at-least provide all the required information to the entrepreneurs at one place, making their task a lot easier. However, it is still not an excuse for the government to burden private companies with a myriad range of compliances.

The government of India should focus its efforts towards providing exemptions, rather than compliance requirements for small fledgling businesses and start-ups. As an example, Singapore exempts small private companies from statutory audit requirements. No such exemption is provided in India and every company, however small it may be, has to audit its accounts thereby adding to its compliance costs. In order to increase ease of doing business, private companies should be allowed to give self-declaration for compliance requirements. However, there should be strict penalties in place for those who misuse it.

Another factor which contributes to a low rating in ease of doing business is different states having different rules and regulations. For example, some states in India require professional taxes to be deducted from salaries of employee of private companies. It is the responsibility of the company to deduct and pay such tax, failing which attracts monetary penalties. Professional tax is collected by a few states while others do not levy any such tax. This practice of different states-different rules is not only illogical and unnecessary but also leads to confusion, mistakes and ultimately paying fines. There should be a uniform set of rules and regulations throughout India, across all the states.

It is very obvious from the above that the Government needs to articulate the objectives it plans to achieve through enactment of new laws and think through implementation process before enacting it in parliament. No doubt, the old Companies Act had outlived its life and the business environment had changed dramatically over the last 50 plus years. What the government needs to do is to ensure speedy and effective enforcement of a number of provisions that already exist in our laws rather than adding very onerous ones in new legislations that makes the lives of law-abiding organisations very difficult. The unscrupulous entities anyway find short cuts despite having stringent norms defeating the very objective of enactment.

It is no wonder India scores so poorly both on starting a new business and on enforcing contracts. The government needs to identify the reasons for our low score on ease of doing business and consciously work on rapid improvement in its ranking. The opportunity that India offers today as a large domestic market, large pool of talent, demographic dividend etc. can be further leveraged by addressing challenges faced by enterprises. A combination of these measures can improve competitive position of our nation significantly and accelerate the growth for the benefit of the entire society.