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Beyond Tax-breaks: how smart governments are enabling startups??

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Are tax exemptions, tax holidays, export and import based incentives only tools to promote and sustain a vibrant domestic startups ecosystem? Most governments, including several state governments in India, certainly seem to believe so. Smart governments adopt four approaches to grow and sustain a dynamic start-up ecosystem.

Remove friction

While there is lot printed material about ease of doing business, procurement is an area that smarter governments have put their energies in. Governments realize committing a certain portion of the public procurement is required to shelter and protect, this goes only a mile to address the sustainability of startups. In knowledge intensive sectors like Defense, Aerospace, Medical technologies and even in IT infrastructure like Data centers, smarter governments realize "eliminating" procurement bias against the startups is the key step. Procurement policies are designed to support incumbents, often large companies that have no incentives to disrupt existing business structure. It is funny to see many RFP for critical technologies that insist on a particular turnover, number of years in business and references for first time project. It becomes murkier when the procurement rules are lenient to foreign registered firms compared to a domestic one, even for replacements and technology switch and upgrades. An Indian startups that has developed a digital replacement for an analogue component may find getting nod from technical evaluation committee (TEC) tougher than passing through park straits. Smaller countries like Singapore have realized one way to attract startups is by changing procurement move away from L1 and T1 to capability specific. What the changes in procurement allow is an opportunity for startups to hone their product, and gain a reference customer. Chance to prove their offering in a real life setting legitimizes their business and adds credibility to their product. Israel the much visited and benchmarked destination for our bureaucracy and think tanks has institutionalized this approach in many sectors including Defense, Security systems, and Irrigation. While some changes are being proposed by central and state governments fear of audit and apathy that has bred over years limits the market access to startups. Market access offers them an opportunity for Proof of concept; recognize improvements post-adoption and importantly client references for other markets.

Ottawa has earmarked $300 million of its procurement budget to buy new technologies from startups through its Build in Canada Innovation Program (BCIP). Many startups find selling to their government agencies is harder that selling to foreign customers, who in turn ask why they were unsuccessful in their own domestic market. For high growth domestic startups becoming vendor to their own government is crucial step in its growth. Government as a first customer can play a major role, to be marque customer and help validate the products and services to allow startups not only succeed domestically but globally. U.S.Small Business Innovation Research (SBIR) programs spends up to $40 Million a year to fund feasibility studies and early-stage R&D by startups. Under SBIR government will fund up to $150,000 for a proof-of-concept and up to $1.5 million for follow-on R&D. Many startups end up selling the final product to the government as well.

Supportive financial systems

Government's latest initiative like Startups India and Stand-up India need more pronounced support for IP, scaling up and capacity building. Banks require companies to provide last 3 years income tax returns and they expect the companies to be profitable before they can lend capital. Collateral free CGTME scheme has disbursed only 6% of the loans to start-ups and majority of the disbursements were for primarily existing clients whose risk profiles were very well known. The 4th All Indian survey of MSME's indicates about 90% of their financial requirements is met through informal sources. Currently startups are eligible for IT exceptions for three years they need to obtain certificate of eligibility from DIPP. However, only 8 of the 111 applied qualified for exemption. Even with the audacious fund of fund –the Rs 10,000 crore corpus announced by Prime Minister, meeting the requirements of startups finance would be a challenge. The Annual Report of Ministry of MSME 2015-16 states that MSME require about INR 44 trillion of which 35 trillion is debt demand and 9 trillion for equity. Even with 3000+ specialized branches in public sector, reach and access to finance for MSME and startups is limited. Pressurizing SIDBI to increase investment commit from 15% to 35% for the fund of funds is not going to increase the flow of lending capital into market. In Israel, the office of the Chief scientist with an annual budget of $450 Million offering 80% of seed funding to about 200 startups an year, the most successful ones have come private capital. Only way governments can ensure enough capital exists is to open up the lending sector. This could be done by encouraging Peer to peer lending. Startups can gain a boost if some changes can be brought about in personal income tax laws. Permitting a limit of 25,000 to 40,000 per individual for starts ups registered at approved Incubation centers or startups that have won awards at regional and national level competitions can expand the availability of lending to support startups innovation.

To support easy access to startups, USA has introduced a novel scheme Regulation A+ that allows loans or contracts to be traded on P2P platforms or in secondary market. Regulation A+ expands entrepreneurs' access to capital allowing them to go to crowd and publicly advertise their capital requirement. This allows the founders to preserve their equity and yet access funds that are required to scale up their ideas. Regulation A+ provides an exemption for US and Canadian issuers seeking up to USD 50 Million in a 12-month period from filing reports with the SEC and since these securities are unrestricted they can be traded in the secondary market. Implementing a similar scheme in India would open up new avenues for investment for not just for high net worth individuals, but ordinary citizens as well. Currently, if an individual wants to become an angel investor he/she needs to be tangible assets of at least Rs. 2 Crores, excluding value of principal residence, and have experience as a serial entrepreneur, or as a senior management professional with at least 10 years of experience. To add to these relatively high requirements, the individual needs to be a part of an angel investor network. With just over 2 Lakhs high net worth individuals in India, this means that 99% of the Indian population is at present unable to invest in startups even if they are well-informed, understand the risk and have the capital that businesses are seeking. Recent data shows most angel investments are sub 10 lakhs and equity trade-off are highly skewed towards investors and not founders. When startups raise funds through angel investors and venture capitalists they tend to lose out on a lot of equity and hence, control over the business. On an average, by the time a startups with two co-founders raises funds from family and friends, angel investors, venture capitalists, and finally public offering, they'd be left with only 17-18% stake in their business. Smarter governments introduce financial instruments which leave the startups founders with the right equity in their hands.

Enable Legitimacy

Getting first customer and sustaining revenue over years is a key challenge to startups. In many high technology areas, reference customer base is key to market expansion. Government across the world recognizes adoption of domestic startups product or services provides legitimacy to the startups. Early adoption and associated changes allow the startups to create robust offerings that can meet market need across regions. London based SETL, the first company to develop a digital ledger benefitted from sandbox program of UK's Financial Conduct

Authority (FCA). Under this program, any company can develop solutions for FCA get to test their idea first and can talk with the regulator on its applicability. This not only takes away the risk out of the new idea, but also provides legitimacy for the startups to reach out to newer market based on successful adoption in UK. E-governance, defense and education sectors are where respective government not only set-aside markets for their domestic technology start-ups, but actively protect this turf from any encroachment. The generous act of their governments helps these companies to assiduously gain scale and build robust products. Israel medical devices industry, which is highly export intensive, is a great example of legitimization. About 40 new life sciences startups are launched each year and just about 20% of them turn profitable. Government not only intervenes in product ideation but also in adoption and adaptation of the devices to other markets. Government healthcare programs are the labs for proof of concept validation and scaling up.

Promotion and advocacy

Governments extensively use their export-import mechanisms including regional lending institutions to actively promote domestic startups to other countries. Singapore through its myriad government agencies including Govtech, IDA, MDA, and EDB actively promotes domestic startups into Middle East or African markets. It is not just ST engineering or Allan Defense that find actively positioned for international markets, many a smaller companies too find themselves wrapped in silk for smart city and policing related projects. Germany's Innovation made in Germany programs promotes startups through extensive network of German industry associations including Indo-German Chamber of Commerce (IGCC). Its productronica is another classic example of how governments can use international trade fair to support domestic startups.

Peter Seller's, Being there (1979) Hollywood film, has an insightful message about industrial growth. In the movie, US President asks a simple and sheltered gardener whether growth could be simulated through temporary incentives. Sellers who played the gardener makes a profound statement, garden needs to watered regularly, weeds needs to removed and roots supported to run deeper to survive across seasons and witness growth. Governments across the world recognize the best approach they can choose to support startups thrive is not be managing infrastructure (like STPI centers), but by creating an enabling environment that allows the startups to grow stronger and more sustainable to market forces. They have to play a nurturing role at some stage, manage market failure for some technologies and get out of the startups way at some time

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