Time to rethink takeover regulations

When it comes to a listed aviation company, it has the worst of both worlds

WITHOUT CONTEMPT

SOMASEKHAR SUNDARESAN

As this column goes to print, millions of column-centimetres of newsprint would have been inked with analysis of the lenders trying to save Jet Airways. Some would argue that a business that is insolvent should simply be allowed to fail, regardless of the immediate impact on the system. Others would argue that the state must bail out infrastructure companies. Yet others would argue that regulators have been arbitrary and have discriminated for and against airlines for reasons best known to them.

Cutting through the noise and the clutter, one facet of regulatory policy stands out when it comes to the aviation industry. The industry stands between a rock and a hard place when it comes to dealing with regulatory policy. Under exchange control laws governing foreign investment in aviation, no foreign airline is permitted to hold more than 49 per cent in an Indian airline. Under securities laws (takeover regulations), any acquisition of 25 per cent or more in any listed company requires the acquirer to make an open offer to buy at least another 26 per cent from other shareholders.

In other words, one law would require a foreign airline to stay below 50 per cent equity ownership while another law would force a foreign airline to potentially go above 50 per cent. An inherent contradiction in vision of regulations — talk about the "ease of doing business in India".

Airline after airline has tripped between these hurdles. No foreign airline could effectively take a close look at Kingfisher to take it over and run it, thanks to this situation. Acquirers in SpiceJet side-stepped the very obligation to make an open offer right under the nose of the capital market regulator. Relying on a provision that exempts open offer obligations on acquisitions pursuant to a scheme of arrangement approved by a competent authority (then, high courts; now, the National Company Law Tribunal), a revival plan for SpiceJet approved by the aviation ministry was held out to be a "scheme of reconstruction" approved by a "competent authority". The audaciously creative interpretation did not meet with even a whisper of interest, much less objection, from the Securities and Exchange Board of India, the capital market regulator, despite extensive media coverage.

Now, it is the turn of Jet Airways — Etihad, already owning 24 per cent appears to have been tripped by this dichotomy while the lenders who have pumped in money (they had accommodated with Kingfisher too) will do their best to sell this asset to someone who can run the company well. They will be hamstrung by the very same piquant (some may say, pungent) regulatory dichotomy — different regulatory requirements pulling the deal in different directions.

While exchange controls seek to protect ownership of vital Indian assets in Indian hands — not just majority ownership, but substantial management too must vest in Indian hands — securities laws seek to protect shareholder interests by providing an exit opportunity to shareholders when there is a substantial change in ownership of a listed company. Being unable to meet either would render the transaction illegal. Therefore, when it comes to a listed aviation company, it has the worst of both worlds.

A simple way to reform this situation is by providing a regulatory framework to help shareholders choose whether they indeed want to avail of the right given to them under the securities laws, or if they would waive such a right. Called a "whitewash" provision in other jurisdictions, essentially, this would entail a proposed transaction to be put to the shareholders asking them to vote on whether they want an open offer to be made to buy their shares. If a high percentage of shareholders (say, 90 per cent) were to confirm that they do not want an open offer and would rather have their company bailed out, the obligation to make an open offer would stand waived.

In other words, shareholders, whose interests are protected by the open offer obligation, suffer by holding on to dud shares of a company that no one can bail out. The whitewash regime enables an option to bail out companies with the owner of the right to an open offer (shareholders) choosing to waive their right for their own choice of a bigger and better deal that would potentially preserve the value of their investment.

The Takeover Regulations Advisory Committee (Disclosure: the author was a member) did recommend such a regime, but it has been mothballed for nearly a decade now. It is time to dust off.

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CHINESE WHISPERS

Money matters

The wealth of some politicians is growing fast. While Telangana and Andhra Pradesh top the list for producing the wealthiest leaders in the country, Tamil Nadu tops the list of billionaire politicians. In Telangana, Konda Vishweshwar Reddy of the Congress is the richest among politicians of the three states with family assets worth ₹895 crore. Andhra Pradesh cabinet Minister P Narayana, owner of the Narayana Group of Institutions, has declared family assets worth ₹667 crore. Andhra Pradesh Chief Minister N Chandrababu Naidu has declared family assets worth ₹574 crore. YSR Congress Chief Y S Jaganmohan Reddy's assets, combined with that of his wife and daughters, are valued over ₹510 crore against ₹311 crore he had declared in 2011. In Tamil Nadu, Congress' Kanniyakumari candidate and businessman Vasanthakumar tops the table with assets worth ₹417.49 crore, followed by Makkal Needhi Maiam's Coimbatore candidate R Mahendran, whose declared assets total ₹133.30 crore.

Taking slogan to heart

Upset at not being granted a party ticket for the coming Lok Sabha election, Uttar Pradesh's Hardoi Member of Parliament Anshul Verma *(pictured)* on Wednesday joined the Samajwadi Party. Shifting camps is nothing usual before an election, but what made Verma's move interesting was the fact that he handed over his resignation to one of the *chowkidars* at the Bharatiya Janata Party headquarters in Lucknow. Looks like Verma took his party's "*main bhi chowkidar*" slogan more seriously than it was intended to be. He later clarified that he was not granted an audience with any "responsible BJP leader".

Baby walker

Finance ministry arm Dipam is trying to depend less on the likes of LIC for public sector undertaking (PSU) share sales. Speaking at an event, a Dipam official highlighted that investments by state-owned insurers and banks in PSU disinvestments this fiscal have been much less than the previous fiscal. However, the downside of this has been that two PSU's initial public offerings struggled to garner full subscription, forcing them to lower the price and extend their closing dates. An investment banker has an interesting take on this: "An IPO without LIC support is akin to a baby trying to walk without a walker. You are bound to fall," he said.

Highs & lows of Vistara's flight plan

The Tata-SIA joint venture is entering the international market at an opportune time but could run into the headwinds of bilateral air service agreements

SURAJEET DASGUPTA

TAKE TWO

For Vistara, the painful wait for over a year to fly abroad is over. And the green signal a fortnight ago, after months of dithering, could not have come at a more opportune time.

Two major domestic airlines are in a mess — Jet Airways and Air India — and are being readied for sale this year (Air India for the second time). Both are full-service carriers like Vistara.

On Monday, bankers ousted Jet promoter Naresh Goyal, took over the management of Jet Airways, and committed to put in money to nurse it back to health. The airline, which has over two-thirds of its fleet grounded on account of money owed to lessors, has slashed services to Dubai, stopped all flights to Abu Dhabi and cancelled numerous flights to and from Singapore, Bangkok, Hong Kong, Riyadh and Doha, among others.

The bankers expect to find a new investor to take control by May, but aviation experts say it would take six to eight months get the airline back in shape. Plus the government is preparing to sell Air India after an aborted attempt last year and, therefore, will not add any more aircraft to its overseas fleet.

This is just the kind of vacuum Vistara could fill.

The outbound business is too competitive for the Tata-Singapore Airlines (SIA) joint venture to reveal a specific time-line for its overseas operations. But a spokesperson said the airline will fly to destinations within the A-320 flying range (three or six hours), which suggests West Asia and South East Asia. To this end, the airline plans to add 56 aircraft, partly on sale and lease, deliverable from the second half of 2019 to 2023. This will include six 787 Dreamliners, for middle- and long-haul flights. Vistara also wants Delhi to be a key hub for its global foray.

But will the 51:49 joint venture between the Tata group and SIA change the international aviation travel business in India? That too when the airline is yet to make a major dent in the domestic skies? Four years after it took wing, Vistara's domestic market share is 3.9 per cent share (January-February 2019), smaller than its other joint venture, Air Asia (5.2 per cent); and it is still deep in the red with losses of ₹431 crores in FY18. With a fleet of 22 Airbus aircraft, it flies to 24 destinations compared to a fleet of 119 and 45 destinations by Jet Airways.

This cautious approach is apparently deliberate: It's the international business that is the focus, with the domestic service acting as a feeder network.

The international foray is crucial for SIA's global ambitions. Though the island nation's flag carrier dominates the India-Singapore route with a 40 per cent market share, the Vistara joint venture enables it to tap the lucrative westbound market, which accounts for over 70 per cent of international passengers from and to India. The West Asian market (United Arab Emirates, Oman and Qatar) alone accounts for 45 per cent of this and is dominated by the Big Three Gulf carriers. Currently, Singapore Airlines accounts for just 6.5 per cent of that market from India.

There are, however, some air pockets ahead for Vistara's overseas flight plans. For one, SIA has been unable to grow on the India-Singapore route because it has exhausted its seat allocation under the bilateral air services agreement and the government is not heeding to its request to allocate it more seats. It could have got over the seat restrictions by using Vistara to fly to Singapore using the unutilised seats from India. But that option is dwindling with over 80 per cent of the seats from India to Singapore already being used. This leaves Vistara little leeway for additional capacity on the route. And even there, carriers like Air Asia India (which is planning to fly abroad), IndiGo and Air India are planning to expand capacity.

Seat allocations will be a bigger challenge in West Asia. Indian carriers have already used their entire rights on seats under the bilateral agreements with the UAE and over 90 per cent with Qatar. The government may decide to raise these allocations but this is an unlikely proposition in the immediate future because doing so would reduce valuations for Jet and Air India in a sale.

Second, it will also face infrastructure constraints within the country — for instance, there is no slot in Mumbai to permit more flights and that is a key destination for international travellers.

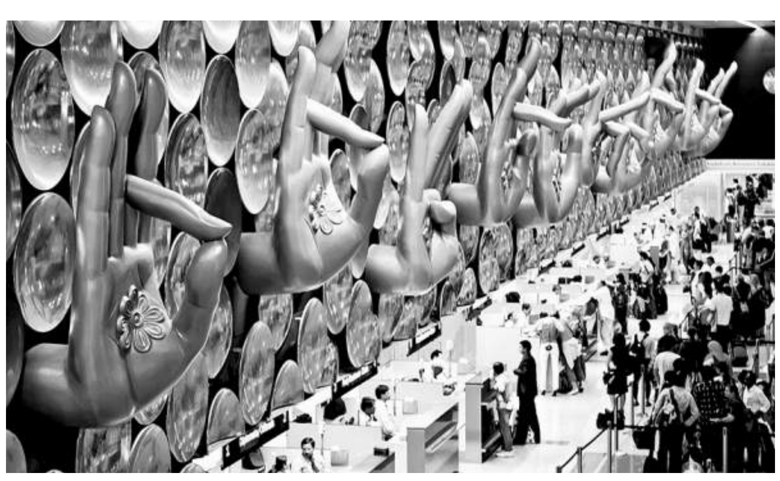
Of course, the airline could surmount this problem and gain a huge head start if it bought a stake in Jet Airways. It could utilise the slots available with Jet in over 20 cities across the country and West Asia, plus the invaluable ones at Heathrow. Asked about this possibility, the Vistara spokesperson said, "Our plans are independent of the status of any other airline operation. We will be interested in acquiring slots in cities that align with Vistara's international plan."

INSIGHT

Indian aviation must fly

If there are any poster boys of the success of India's less-than-full-hearted move to a market economy, they are aviation and telecom

DHIRAJ NAYYAR



NOT IN SYNC **In India, the development of airport infrastructure has not kept pace with growing demand. Big cities like Delhi, Mumbai and Bengaluru ought to have multiple airports**

The dominant headlines from Indian aviation this past fortnight have revolved around the ailing Jet Airways, the grounded 737 Max 8 aircraft of SpiceJet and the overall squeeze in the sector that may also be pinching passengers' pockets. Amidst all that gloom, there is the (non-headline) news from the latest world airport traffic rankings from Airports Council International that, in 2018, Delhi's IGI airport saw the maximum growth in passenger traffic among any of the top 20 busiest of the world. In the process, Delhi has also become the 12th busiest airport in the world ahead of major hubs, Frankfurt and Guangzhou. A paradox of booming demand and struggling airlines.

India cannot allow aviation to fail (but that doesn't mean airlines should be bailed out by the government). If there are any poster boys of the success of India's less-than-full-hearted move to a market economy, they are aviation and telecom. A true measure of the success of free markets isn't just the rise of profitable businesses and dollar billionaires. Equally, it must involve considerable, quantifiable benefit to the consumer. Just 20 years ago, it would have been unthinkable to imagine that 800 million Indians would have access to a phone and that 200 million Indians would be travelling in airplanes every year. In addition to bringing efficiency and affordability to the lives of consumers, both sectors have also contributed hugely to job creation.

But the fact is, aviation is a tough business, anywhere in the world. In the US alone, the world's largest aviation market (India is now the third largest) there have been some 100 airline bankruptcies. There have been high profile busts in Europe too with many countries folding up flag carriers or selling them to foreign airlines. Inherently, aviation is a very competitive and high cost business. In India, government policy has pushed the cost curve further up.

One-third of an airline's cost is fuel cost. Aviation Turbine Fuel (ATF) is taxed at very high rates in India. At times when global fuel prices are high, charging those rates would make most airlines unviable. Even in times of moderate global oil prices, taxes on ATF must be lowered. Aviation is no longer a luxury. It is just another mode of conveyance. Ideally, it should be brought in under the GST but the centre and states that have got addicted to over-taxing all kinds of fuels are not likely to relent easily.

The other challenge for aviation in India is that the development of airport infrastructure has not kept pace with growing demand. Big cities like Delhi, Mumbai and Bengaluru ought to have multiple airports. Elsewhere in the world, low-cost carriers usually fly to secondary or tertiary airports around major cities where user charges are lower than in major airports. In India, all airlines have to use over-crowded airports with high user fees. Private participation in airports (other than Delhi, Mumbai, Bengaluru, Kochi and Hyderabad) had been going slow until the recent bidding out of O&M (operation and maintenance) operations in six state-run airports to private players. The government should, on a fast track, divest all airports which have substantial traffic to private players and encourage them to build second airports in big cities. The government can focus on building greenfield airports in smaller cities where private investment is not forthcoming but where there may be latent demand.

Perhaps the biggest obstacle to the growth of a healthy aviation sector is the terminally sick Air India on which the government has spent close to ₹60,000 crore over the last decade without achieving any turnaround. The bottom line is that the airline is using its assets inefficiently, whether it is aircraft or landing rights or bilateral international rights, or a bloated workforce. All these assets would be better used if Air India was either shut down or sold to the private sector. Needless to say, such a sale will not happen if the government imposes stringent conditions as it did in 2018 when no buyers came forward. A dose of pragmatism is necessary.

Crucially, the government needs to remove the 49 per cent cap on foreign airlines investing in an Indian airline. There are only two ways to prevent chaos around a failed airline (and this applies to Jet Airways too). First, put the airline into the bankruptcy process or ensure a change in promoter and management. Second, liberalise policy so that the pool of buyers for a failing Indian airline is the largest possible. That requires foreign airlines to participate fully.

Of course, poor management may still lead to business failures. With the right enabling environment, market forces will take care of that.

The author is chief economist, Vedanta

LETTERS

Tall promises

This refers to "Lok Sabha polls: Rahul Gandhi promises ₹6,000 a month for poorest 20%" (March 26). In 1971, when Indira Gandhi coined the slogan "garibi hatao", the then Jan Sangh leader Atal Bihari Vajpayee was quick to point out that hatao meant "to move from one place to another" and that if the Congress party really meant business, it should promise "mitao garibi", which meant eradicating poverty. Following her return to power, Indira Gandhi did try to valiantly remove poverty by conducting loan melas through the nationalised banks, which only led to middlemen lining their own pockets.

The present announcement by Rahul Gandhi appears to be a last-ditch attempt by the grand old party to capture power by hook or by crook, by making irresponsible promises. What makes it a sad reading is the committee that has proposed this scheme includes eminent economist Dr Manmohan Singh. There is, of course, not a word about how the nation would mobilise the staggering amount of the estimated ₹3.5 trillion per annum that would cost the exchequer. Nikita Khrushchev was spot on when he said, "Politicians are the same all over. They promise to build a bridge even where there is no river."

V Jayaraman Chennai

Don't blame RBI

This refers to "Wilmar set to take RBI to court over Shree Renuka" (March 27). The February 12, 2018, Reserve Bank of India (RBI) circular clearly outlines the requirements for a non-performing asset (NPA) account to be upgraded as a standard account. One of the ways is change of ownership. Wilmar was reportedly a 38.57 per cent owner of Shree Renuka Sugars when the latter defaulted on the loans given by banks and was classified as an NPA account.

In the sections applicable to restructuring of advances under the aforesaid circular, it is clearly mentioned that a NPA account cannot be upgraded by change of ownership if the acquirer is disqualified under Section 29A of the Insolvency and Bankruptcy Code (IBC) 2016. As Wilmar was a party to the default by virtue of holding 38.57 per cent of the equity of Shree Renuka Sugars, it stands disqualified as an acquirer under the IBC. Hence it cannot ask for upgrade of the account by virtue of change of ownership as it was already a substantive owner when the account of Shree Renuka Sugars became an NPA and hence disqualified. This norm has been upheld even in the NCLT. Hence holding the RBI responsible for its problem is not correct.

Arun Pasricha New Delhi

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HAMBONE

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India in elite club

Govt, DRDO deserve praise for Mission Shakti

India has propelled itself into an elite club of nations which has successfully demonstrated its capabilities in anti-satellite technology, with the Defence Research and Development Organisation's (DRDO) anti-satellite missile (ASAT) shooting down a low-orbital satellite on Wednesday. The DRDO deserves compliments for its display of technical expertise, which Prime Minister Narendra Modi termed as "Mission Shakti", and the government must be applauded for its courage in giving the go-ahead for this test. Research on the closely-related anti-satellite and anti-missile projects has been going on since at least 2010. By 2012, DRDO had claimed five successful demonstrations of anti-missile technology by intercepting and blowing up missiles. Indeed, the Chief Scientific Adviser of the time, V K Saraswat, claimed India possessed "all the building-blocks of anti-satellite technology" in 2010 itself.

The fact that this anti-satellite technology is indigenously developed adds to India's credentials, given that for many decades India was kept away from acquiring key technologies, forcing the country to develop its own space and nuclear capabilities. The acquisition of this technology is also expected to have spin-offs that India can exploit for commercial use, both domestic and globally. The capability achieved through the test provides credible deterrence against threats to the country's space-based assets from long-range missiles.

However, it remains to be seen whether India faces international criticism for actually doing something that it has long possessed the capacity to do. India is among the signatories that have ratified The Outer Space Treaty, which aims to keep space free of weapon. Although it is not in technical violation of that treaty, which only bans weapons of mass destruction from space, this demonstration will be seen as going against the spirit of an agreement to keep space demilitarised. In that context, it is reassuring that the prime minister has been quick to point out that the intent of the Mission is to defend India's space assets and not to start an arms race in space.

In practical terms, however, the test demonstrates little that was not already known about India's capacities in this regard. India obviously has the ability to track satellites, given its own programme. It also has a tested array of ballistic missiles and the ability to deploy weapons in space. A section of the DRDO scientists had said in the past that they would prefer to demonstrate a grasp of anti-satellite technology by a "fly-by" test where a satellite is tracked, and an anti-satellite missile is aimed to pass very close to the target without hitting it. This is because blowing up a satellite creates debris which puts other satellites and space infrastructure at risk. When China blew up a defunct satellite in 2007, to demonstrate anti-sat technology, the debris damaged a functional Russian satellite, and came close to hitting the International Space Station. However, these concerns may be unfounded as the Indian defence ministry has been quick to clarify that the test was done in the lower atmosphere to ensure that there is no space debris; and whatever debris that is generated will decay and fall back on to the earth within weeks. In a future war, the ability to destroy enemy satellites, thus degrading surveillance and communication systems, and also to interdict incoming missiles, may be important.

Promoting FPOs

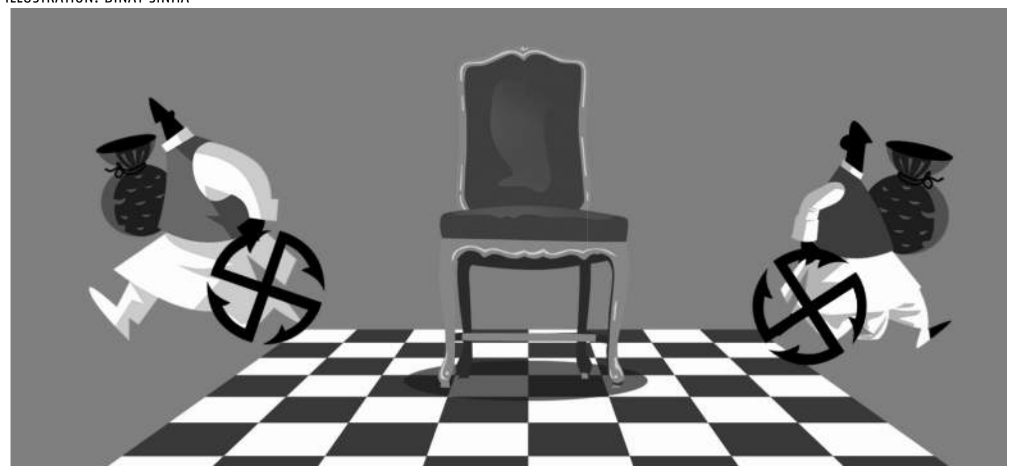
Farmers' producer organisations need incentives

Farmers' producer organisations (FPOs), also known as farmers' producer companies (FPCs), need to be promoted earnestly to alleviate economic distress in rural areas, considering the role they can play in enhancing the earnings of their member-farmers. The way their count has swelled from less than 200 in 2010 to over 4,000 today is an indication of the success of this new model of agri-business. As professionally-managed enterprises conducting business on behalf of the farmers, they enjoy better bargaining power to procure inputs and services and sell the farmers' output. They are also better equipped to facilitate value-addition of the farm produce to ensure higher returns in almost all fields of agriculture and its allied activities like horticulture, plantations, dairy, poultry, fisheries and others. Even the landless, tribals and those subsisting on collections from the wilds have gained by forming such organisations.

The FPOs are basically the hybrids of cooperatives and private companies which retain the merits but discard the demerits of both of them. The Companies Act has especially been amended by incorporating Section-IX A in it to allow creation and registration of this new category of farmers' companies under this law. While the participation, organisation and membership pattern of these companies are more or less similar to the cooperatives, their day-to-day functioning and business models resemble those of the professionally-run private companies. Significantly, each shareholder of the FPO has one vote, irrespective of the size of shareholding, and the shares are not traded on the stock markets to forestall any risk of hostile takeover by way of equity acquisition. However, the task of promoting these organisations has been entrusted to parastatals like the National Bank for Agriculture and Rural Development (Nabard) and the Small Farmers Agribusiness Consortium (SFAC) which have their own limitations in ensuring effective hand-holding.

Of the few pro-FPO initiatives taken recently by the government, the most noteworthy are the announcement in the 2018-19 Budget of a five-year tax holiday and setting up of a small credit guarantee fund of ₹100 crore. The FPOs were taxed at 30 per cent earlier. However, many of the critical woes of this sector still remain unaddressed. These include difficulties in securing institutional finance, inability to operate in the regular agricultural markets and the lack of legal recognition under the contract farming regulations. The banks are usually wary of granting loans to the FPOs as they do not have assets of their own to serve as collaterals. Consequently, the FPOs have to rely on loans from non-banking financial companies or micro-finance companies to raise working capital at very high interest rates. Strangely enough, the facility of cheap bank loans with liberal subvention of interest by the government that is available to individual farmers is denied to the FPOs, though they are purely farmers' organisations. Worse still, many other kinds of concessions, tax exemptions, subsidies and benefits provided to cooperatives, startups or other grassroots farm bodies have not been extended to the FPOs. They also usually face resistance in operating at the regulated *mandis* because of the resistance offered by the licensed traders and their cartels who wield significant hold over these markets. These issues need to be addressed expeditiously to enable the FPOs to perform to their full potential for the benefit of the farmers.

ILLUSTRATION: BINAY SINHA



Time for proportional representation?

Current electoral system is unhealthy for Indian democracy

JAIMINI BHAGWATI

Election expenses for political parties and candidates have far outpaced inflation in India. For the 2014 Lok Sabha election the combined expenditure of candidates and political parties per seat was rumoured to be between ₹5 crore and ₹80 crore. The legal spending limit for a Lok Sabha candidate is ₹54 lakh to ₹70 lakh depending on the size of the state. Aspirants for assembly seats are required to keep their spending in the range of ₹20 lakh to ₹35 lakh. However, there are no spending limits for political parties. The Election Commission (EC) has urged successive governments to enact legislation to cap election spending by political parties to 50 per cent of the ceilings for individual candidates.

Over the past few decades, enhanced deployment of armed police and election observers has reduced blatant exchange of cash for votes and physical intimidation. However, even if the EC were to deploy more personnel, it may be difficult to detect overspending or eliminate election related violence. The distortionary impact of higher spending on results in Indian elections is difficult to estimate except that candidates who have more financial resources have an unfair advantage. The increasing electoral costs also gives an edge to well-heeled candidates with dubious and criminal backgrounds.

Under these circumstances the EC should examine electoral practices around the world which could be adapted to reduce the impact of money power on Indian elections. For example, Germany, Japan, Sweden and the Netherlands use proportional representation. Half the seats in the Bundestag, lower house of the German parliament, are elected on the first past the post system used in India. For the remaining 50 per cent of seats voters indicate their preference from one out of the several parties in contention. Political parties list their candidates for the Bundestag in a descending order of preference. Details are at *https://www.dw.com/en/how-does-the-german-general-election-work/a-37805756*.

Germany with a population of 81 million has 709 members in the Bundestag. India's population of 1.35 billion is almost 17 times that of Germany but the Lok Sabha has just 545 members. It is high time for India to at least double the number of members of parliament (MPs) in the Lok Sabha. For illustrative purposes Lok Sabha membership could be doubled to 1,100. For 550 seats the current system of first past the post could continue. For the remaining 550 seats voters would indicate their preference for political parties based on their manifestos and declared lists of candidates.

The membership of all state assemblies could be doubled too with 50 per cent of the seats decided by the same proportional representation system. The Rajya Sabha could continue at its sanctioned strength of 250. This will have the beneficial effect of reducing the importance of the indirectly elected Rajya Sabha if and when a joint vote with Lok Sabha is held. In Germany, parties which get below 5 per cent of the vote share are not allotted any proportional representation seats. In India to consolidate parties, this percentage could be pegged higher, say at 10 per cent.

If 50 per cent of seats in the Lok Sabha and state assemblies are decided through proportional representation, the debate would shift more towards explaining what parties expect to deliver. For instance, on March 25, 2019, the Congress party announced that if it comes to power after the coming general election, it will implement a minimum income scheme for the poor. This has probably shifted some attention from candidates to parties and with proportional representation this would happen more systematically. Parties would be expected to explain how their income support and loan waivers would be funded without compromising on basic aspects of governance such as security, health and employment generation programmes.

Right now the practice in India is to bring in talented persons, who are not likely to win direct elections, to Parliament through the Rajya Sabha. High spending and intimidation tactics may be less effective in proportional representation. Hence gifted and public spirited individuals may find that the barriers to being elected to the Lok Sabha are lower under a proportional representation system.

There should be no requirement of reservations for the additional proportional representation seats in the Lok Sabha and the state assemblies. However, the existing reservations of seats for the direct elections should continue. Political parties would figure out that their candidates for proportional representation would have to be sufficiently diversified based on gender, social and economic backgrounds. If parties ignore popular sentiment about this issue, they may win less than 10 per cent of the proportional representation votes and hence get no seats in this category.

Doubling the numbers of Lok Sabha and state assembly members will double the cost on their salaries and allowances. When the difference in the number of seats between the party in power and the principal opposition is small, we are often subjected to the absurd sight of state assembly members being sequestered in expensive holiday resorts to prevent them from defecting. The higher cost on remuneration for the additional MPs and MLAs would be a small cost to pay for better representation.

In the unlikely event that political parties do get together to pass the required legislation for proportional representation, courts may well rule that this would be inconsistent with the Constitution. In that case legal remedies would have to be sought including possibly a country-wide referendum. In any case, nothing is lost in thinking big about changing our electoral system which is "broken" in many ways.

To sum up, voting for the next Lok Sabha will take place in April-May 2019. Once the new government is in place at the end of May, it should be asked to take a serious look at moving to proportional representation. Readers of this column may well think that all this is a pipe dream. Well, nothing ventured, nothing gained. Continuing with the current electoral processes with forever rising use of unaccounted money is not sound either for the health of Indian democracy.

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Behind the 'Down Beta' of Indian markets

VIKRAM LIMAYE

In November, I had authored an article in *Business Standard* regarding the reduced 'Down Beta' of Indian markets post demonetisation. This article was based on a research paper titled *Reduction in Cost of Capital in Indian Markets*, co-authored by Gautham Kanthasamy and Prasanna Tantri of the NSE-ISB Trading Laboratory, ISB, Hyderabad. To recap, the 'Beta' of any asset is a term used to quantify the movement of the asset's price with respect to the market. Researchers further classify this Beta into two categories — up market Beta and down market Beta. Here, up Beta measures the Beta of the financial asset on days when the market is up and down Beta measures the Beta of the asset when the market is down. In a nutshell, the authors basically find the following: Post demonetisation, Indian markets don't fall as much as they used to in response to a fall in the global markets. In summary, the argument is that Indian markets have now become relatively less sensitive to global negative shocks while retaining their sensitivity to positive shocks. As is apparent, this is very different from the famous decoupling argument where a market becomes less sensitive to global shocks in general, both positive and negative.

For any form of business research, a real assessment of the reliability of findings is assessed through an out-of-sample test. This test basically involves studying the data in a time frame not used in the original research and examining if the conclusions hold true there as well. Such a test is considered to be a rigorous one as researchers cannot influence the data unlike an in- sample forecast. In an in-sample test, a researcher can drop outliers in the data or change parameters in order to draw results that can support a pre-determined conclusion. For example, if the researcher is examining data from January to December but finds that the results hold only from February to November, then he/she can conveniently drop the first and the last month before reporting the findings. However, such possibilities are low in out-of -sample forecast.

The authors of the paper examine data from January 1, 2000 to July 31, 2018, in order to draw their conclusions. Hence, the out-of-sample time period that they examine to study whether their conclusion of a reduction in 'Down Beta' of Indian markets holds true is August 1, 2018 to December 31, 2018. In this period, the Dow has fallen from 25,333.82 to 23,327.46 (fall of 7.92 per cent), MSCI World Index has fallen from 2,146.1 to 1,883.90 (fall of 12.2 per cent) whereas the NIFTY50 Index has fallen from 11,346.2 to 10,862.55 (fall of 4.3 per cent). This implies that the NIFTY50 Index has been a rank outperformer in this period of downturn in global markets. Additionally, this has happened in spite of an idiosyncratic shock— that is, the NBFC crisis occurring in the Indian markets. This clearly validates that the observations of the authors hold to a very significant extent.

The authors further look at trading volumes to see the reasons behind why this has happened. Since a large portion of the trading volume in Indian markets occur in the derivatives segment, the authors examine participant-wise volumes here. They observe that there has been a systematic increase in the participation of DII (Domestic Institutional Investors) in the derivatives market in comparison to other types of market participants. The other types of investors in the markets are FII (Foreign Institutional Investors), Proprietary Traders (brokers who trade on their own account) and Clients (brokers who trade via a client's account). By observing a time frame of one year around demonetisation, the authors find that the volume traded by DIIs (as a proportion of total volume traded) increases significantly. This implies that there has been an increase in inflow of capital by DIIs into the market in the time period after demonetisation. On an average, DIIs are less susceptible to global shocks when compared to FIIs. As a result of this, their increased presence in the market in terms of volume could possibly be the reason behind a reduction in the 'Down Beta' of Indian markets.

This increase in volume of DII trading could also be attributed to the increased allocation of funds by retail investors to mutual funds over the past two years. According to data provided by AMFI (Association of Mutual Funds in India), in the two financial years preceding demonetisation, the total fund inflow via mutual funds into the equity market stood at ₹1.20 trillion. In the two years post demonetisation, the same statistic stood at approximately ₹2.15 trillion. This has largely been driven by investing through the SIP route —an average of ₹6,300 crore per month is invested into the market by retail investors post demonetisation. This is almost double in comparison to the average of ₹3,600 crore per month prior to demonetisation. Therefore, it is reasonable to hypothesise that domestic funds have contributed significantly to the phenomenon highlighted in this article.

It is too early to declare with confidence that Indian market's down beta has come down significantly from a long-term standpoint without incremental tests being conducted over time. In case the phenomenon holds, then it is likely to result in lower cost of capital for Indian firms, leading to increased valuations. One has to see when markets will take cognizance of this phenomenon.

The writers is MD & CEO of the National Stock Exchange

Reshaping India's fiscal architecture

BOOK REVIEW

ISHAN BAKSHI

That the terms of reference of the 15th Finance Commission are contentious is beyond contestation. Whether it is the controversy over shifting the population base to 2011 from 1971 for determining states' share in tax devolution, or the mandate given to the 15th Finance Commission to review the recommendations of its predecessor commission or, for that matter, recommendations that could entail creating incentives to states for implementing the centre's flagship schemes.

These issues have been vociferously debated over the past months. Now, a new book titled *Indian Fiscal Federalism* explores these and many other issues in great detail. The book written by Y V Reddy, former governor of the Reserve Bank of India (RBI) and chairman of the 14th Finance Commission, and G R Reddy, advisor to the Telangana government, begins by carefully tracing the evolution of India's fiscal architecture. Each chapter dwells on critical issues such as the approaches of various finance commissions through the ages, the changing nature of centre-state fiscal relations, public debt and so on. The authors have also examined the impact of recent changes on India's fiscal architecture, such as the shift to the goods and services tax regime and the creation of the Niti Aayog.

On the contentious issue of which population estimates are to be used for determining the distribution of tax revenues across states, the authors appear to be in favour of shifting the population base to 2011 from 1971. They argue that contrary to public perception it is not only the southern states that have witnessed a decline in their share in population between 1971 and 2011. Others such as Odisha, West Bengal, Punjab, Assam, Himachal Pradesh and Goa have also observed declines. "Fundamentally, the needs of the future cannot be assessed on the basis of the population of the past. The use of the 2011 census is less unfair than of the 1971 census," note the authors.

The terms of reference also suggest that the 15th Finance Commission take into consideration the fiscal situation of the Centre after the recommendations of the 14th Finance Commission, coupled with the continuing imperative of the national development programme, including New India-2022.

Now, this is a rather unusual request. As the authors note, "Should the finance commission become another instrument for such policies, undermining its role as an arbiter of competing demands from the Union and the states and as one that assures the predictability of transfers?"

As these transfers typically fall outside the purview of the Finance Commission, the authors rightly note that "The 15th Finance Commission cannot avoid being perceived to be an instrument of political or economic agenda if it takes the goals for new India 2022 in its considerations too seriously."

Another critical but often neglected issue in India's fiscal debates is that of the phenomenal rise in the share of cesses and surcharged levied in the recent past. As revenue from these sources does not form part of the divisible tax pool and are not shared with states, many have argued that this subverts the spirit of cooperative federalism. The authors estimate that the revenue from cesses and surcharges have risen from 2.3 per cent of the centre's gross tax revenue in 1980-81 to 14.3 per cent or ₹3.24 trillion in 2018-19 BE.

"These (cesses and surcharges) neutralise the increase in tax devolution recommended by successive finance commissions" note the authors, adding that "the hope that the share of cesses and surcharges will reduce with the roll-out of GST has been belied for now."

Another issue that has received less attention in public discourse is the impact of the dismantling of the Planning Commission on India's fiscal architecture. Now, under the erstwhile regime, state governments often raised objections over the functioning of the Planning Commission. However, its successor, the Niti Aayog, had two specific opportunities to address these concerns, note the authors.

The first opportunity arose with the restructuring of centrally sponsored schemes in the aftermath of the recommendations of the 14th Finance Commission. This was an opportune moment to evaluate the whole architecture of these schemes.

However, while the Niti Aayog was involved in this process, the authors contend that the manner in which these schemes were structured shows that "the effort was only to shift greater responsibility on to states in terms of financing." There was no qualitative change in either the design or implementation of the central schemes that was promised when the Planning Commission was wound up.

Another opportunity arose a few years ago when the Centre removed the distinction between plan and non-plan expenditure. The authors contend that this opened up space to undertake a comprehensive sector wise review of capital and revenue expenditures. However, this was not done.

INDIAN FISCAL FEDERALISM
Y.V. Reddy and G.R. Reddy
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