The big questions in streaming music

Both publishing and video industries would gain from looking at the licensing battle being played out in the music business

MEDIASCOPE

VANITA KOHLI-KHANDEKAR

Should content licensing be statutory or voluntary? That is the question a Bombay High Court ruling in May this year raises. In a case filed by Ramesh Taurani's Tips Industries against Airtel's music app Wynk, it held that Wynk cannot store or use music owned by Tips without its consent. Justice S J Kathawalla held that Section 31D of the Copyright Act does not extend to internet broadcasting — that it only covers broadcasting through radio and television. That means over-the-top streaming services (OTTs) or music apps that want to use say Saregama's music need to take permission or a license from it.

That would have been the normal course anyway. But Section 31D was created in 2012 as an exception to this general rule in order to allow a statutory licensing arrangement between music companies, and radio/TV broadcasters of music. The idea was to protect artistes who were signing away their rights to dodgy agreements. Therefore, under the current rules, a radio station can simply pay as royalty a two per cent share of its ad revenues, and use Tips or T-Series or any other music company's repertoire.

"Section 31D was introduced when broadcast radio was overburdened with infrastructure cost and licence fees. Today, it is a ₹3,000 crore industry but pays just ₹60 crore in royalty that is distributed among record labels, authors, composers and publishers. It is antiquated and irrelevant," says Blaise Fernandes, president & CEO, Indian Music Industry. He points out that in almost every major music market — in the US, large parts of Western Europe, South Korea among others — the licensing of music for interactive services is voluntary. Many of these countries have statutory licensing but only for linear broadcasting services, like radio.

Voluntary licensing means that the buyer and seller negotiate and agree on a price — it assumes a competitive market. India's ₹1,400 crore music industry is very fragmented and hyper-competitive. On the other hand, there are a few telecom operators, most with their own music apps. So Bharti Airtel has Wynk, Jio has Saavn. Gaana is part of the Times Group, one of India's largest media firms. Then there is Apple's iTunes and Spotify. The biggest Indian music companies are a tiny fraction of any of these multi-billion dollar tech, telecom or media firms. It is for all practical purposes a buyers' market. That explains why a routine negotiating argument between Tips and Wynk landed in court.

To this inequality add another factor. In September 2016, the Department of Industrial Policy and Promotion issued a memo to the Registrar of Copyrights. It stated that the provisions of Section 31D covered internet broadcasting too. It is just a memo but it opened a can of worms. It seemed that any app could just pick up the music it wanted a la radio broadcasters. The court stepped in to say they can't.

Almost 70 per cent of the Indian music industry's revenues come from digital or streaming/downloaded music. Digital advertising continues to grow at a scorching 28 per cent even as subscription revenues have been rising. In a buyers' market, if interactive services are allowed statutory licensing at two per cent, it takes away all the upside in the growth of digital for music. In the interest of fairness then either the licensing should be voluntary or royalty rates under statutory licensing must rise from two per cent to say 10-15 per cent.

There is a larger point here besides the wrangling about statutory versus voluntary licensing.

Music is the petri-dish industry for all the changes that the internet is wrecking on media. It is the lowest bandwidth entertainment product, so it is always the first to be hit by any disruption. The biggest was compression technology in the late 90s. Every experiment the music business went through — from criminalising consumers and litigating with file sharing firms such as Napster — have helped the rest of the entertainment business learn crucial lessons. From over $25 billion in 1999, the global music industry fell to $14.1 billion in revenues in 2014 before bouncing back. Since then it has been on a growth path with more than half its revenue coming from digital.

In India, as both films and television enter a similar phase of disruption with OTT services, a close look at what is happening to music would help.

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IL&FS fallout: Lessons for rating agencies

It is time to rethink about their working style, oversight and remuneration

SUDIPTO DEY

The recently filed chargesheet by the Serious Fraud Investigation Office (SFIO) in the IL&FS case has not directly indicted crediting rating agencies (CRAs) for not raising the red flags well in advance before the eventual financial meltdown of the beleaguered infrastructure lending group. However, this does not let them off the hook.

In its chargesheet, filed last week, the SFIO noted that the top management members of IL&FS "deliberately presented falsified, spruced up, deceptive and misleading" financial statements to the credit rating agencies, who continued to give them the highest ratings till the later part of 2018.

While explaining the modus operandi of the financial fraud, the chargesheet said: "The incorrect provisioning of investments in half-yearly financial statements were of great significance as such incorrect financial statements were being used by the rating agencies for various new instrument rating and surveillance rating. These particular financials were also used for borrowing from market. Wherein such incorrect financials were used to lure the investors investing the public money."

The Securities and Exchange Board of India (Sebi), which regulates CRAs, through its own investigation, has already taken note of the lapses on part of the rating agencies,namely India Ratings & Research, ICRA, and Credit Analysis and Research (CARE), in the IL&FS case. Earlier in February this year, the Standing Committee on Finance, chaired by M Veerappa Moily, submitted its report suggesting several measures to strengthen the credit rating framework in the country.

The panel suggests a fundamental shift in how rating agencies are remunerated for their services. It said that the regulator should consider a shift to the "investor-pays model" or "regulator-pays model" from the current practice of the "issuer-pays model". The other key recommendations are mandatory rotation of credit agencies and lower threshold for agencies to register with the regulator to foster competition in the market. Experts, however, are divided over the implications these measures would have on the regulatory landscape for rating agencies.

TAKE TWO

The clamour for a shift in the remuneration model is driven by the assumption that once the issuer stops paying for credit rating, the rating agencies would start producing honest and accurate reports, say experts. The upside of the issuer-pays model is that it ensures that the entire spectrum of investors — whether big or small — have access to the credit rating report. However, in an investor-driven exercise, the credit rating is available to those who can pay to obtain it.

Priyanka Devgan, counsel at law firm VERUS, points out that in a regulator pays or investor pays model, CRAs may tend to offer lower than the accurate rating. "In the case of investors a lower than accurate/warranted rating helps investors to avoid downgrading. In the case of regulators, by offering lower than accurate rating, CRAs would tend to hedge their liability with the regulator," she adds.

Experts say the issuer-pays model will always be conflicted with inherent limitation. Vidisha Krishnan, partner at law firm MV Kini & Co, feels that the investor pays model should ideally be brought back with adequate checks and balances.

However, there are some like Sudhir Bassi, executive director, Khaitan & Co, who feel that the issuer-pays model still has relevance for India. "The need of the hour is better supervision of the rating process within the rating agency, rather than changing the business model in relation to who pays for rating," he says.

There are some who feel that India could use a mix of the three models. "It is important to try out a mix of models to fundamentally re-align the interests of the CRAs and the investors, and remove distortions," says Shreya Prakash, research fellow, Vidhi Centre for Legal Policy.

The panel's recommendation on rotation of credit agencies is something most experts agree on. Though the jury is still out on whether this move helps to improve independence. Rotation of credit rating agencies, modelled on the rotation of auditors under the Companies Act, is likely to sever long-term relationships that CRAs and issuers enjoy. "This may promote healthy competition between CRAs and improve accountability for ratings," says Prakash.

However, the move may create pressure on the new CRA to downgrade the earlier CRAs rating, is an apprehension that some experts have.

The idea of lowering the registration standard for CRAs does not find favour with most industry players and legal experts. "Lowering registration standards may impact the ability of CRAs to provide reputational capital. One would have to be very careful while lowering registration standards," warns Prakash.

Most experts feel that the eligibility norms for registration should be further tightened to ensure that only entities with institutional background, large pool of qualified and experienced people and reasonable net-worth are eligible to apply for registration. "Credit rating is a critical function in the domestic economy as well as the international markets. We need to have a few highly regulated and reliable players", says Krishnan.

Perhaps the way forward could be the introduction of uniform rating standards — on the lines of accounting standards for the accounting profession — with a separate regulating authority for enforcing those standards.

MAKING CREDIT AGENCIES LIABLE

How other countries do it

EUROPEAN UNION AND UK

- The European Union introduced the concept of civil liability of CRAs through Article 35a in the EU Regulation in 2013
- Under the Article, a civil liability could be imposed in the event of intentional commission or gross negligence by the rating agency or in case of damage to investors
- In the UK, the Credit Rating Agencies (Civil Liability) Regulations, 2013 allows an action to lie against a CRA only if there is an intentional commission of an infringement or if the infringement occurs due to gross negligence, amounting to recklessness

UNITED STATES OF AMERICA

- Traditionally, the USA provided extensive exemptions to CRAs from liability for their statements
- Following the global financial crisis, the USA was one of the first jurisdictions to impose civil liability on CRAs through the enactment of the Dodd-Frank Act

HOW INDIA MONITORS CRAS

- The Securities and Exchange Board of India regulates CRAs through the Sebi (Credit Rating Agencies) Regulations, 1999

If CRAs default in India, Sebi could:

- Suspend/cancel its certificate of registration; prohibit them from taking new assignment or contract for a specific period; issue warning
- Sebi has powers to impose penalties on CRAs for indulging in fraudulent and unfair trade practices. The penalty imposed could range between ₹5 lakh and ₹25 crore
- However, there seems to be no direct remedy for investors who rely on faulty credit ratings
- There is need for clarity on whether Section 35 of the Companies Act, 2013 that imposes civil liability for misstatements in prospectuses, is applicable to rating agencies

Source: Regulation of Credit Rating Agencies in India by Vidhi Centre for Legal Policy

CHINESE WHISPERS

Out of place

Bureaucrats in the food and civil supplies department of the Rajasthan government were embarrassed when a porn clip popped up on the screen in the midst of a video conference, through which a meeting was underway in Jaipur. The meeting was chaired by Mugdha Sinha, secretary to the department, at the NIC (National Informatics Centre) room in the secretariat on Monday. "In the middle of the video conference, an obscene clip started playing on the screen. I immediately called the NIC director and asked him to probe the matter and give a report on this," she said. Nearly 10 people, including department officials and NIC representatives, were in the room and district supply officers from all the 33 districts of the state were participating in the meeting through the video conference. The meeting was held to review various schemes and programmes. "A decision on this will be taken on the basis of the NIC director's report," she said.

The ministry of frugality

On Tuesday, Junior Minister for Health, Ashwini Choubey, took the Delhi Metro from his residence to Udyog Bhawan and covered the rest of the distance to his office by foot. He also stopped along the way to plant a few saplings outside the ministry building. Just the day before, doctor-turned-politician and Bharatiya Janata Party leader Harsh Vardhan pedalled his way to office. After reaching office on a bicycle on his first day as union health minister, he had said his priority would be to vitalise the implementation of the Ayushman Bharat-Pradhan Mantri Jan Arogya Yojna.

Resignation politics

Is the Congress government in Chhattisgarh destabilising itself? A few days ago, Chief Minister Bhupesh Baghel announced the resignation of Advocate General (AG) Kanak Tiwari. Surprisingly, Baghel didn't wait long in appointing Satish Chandra Mishra new AG. Soon after, Tiwari accused the state government of removing him just because of his opposition to the way its ministers functioned. He even challenged the government to show his resignation letter. The opposition parties, the Bharatiya Janata Party as well as the Janta Congress Chhattisgarh, have cashed in on the opportunity, accusing the government of creating a constitutional crisis.

INSIGHT

Avoid the 'template' approach

KAVIL RAMACHANDRAN & SOUGATA RAY

Indigo has hit an air pocket. It is surprising that the most successful airline in the country with a market share of over 40 per cent is getting into a gridlock on their growth strategy, thanks to an unexpected way the shareholders agreement between the two promoters is reaching an end point. While the matter appears to be simple and legalistic, it actually has major possible implications for the future of the organisation and its stakeholders. We will discuss the importance of a well-crafted shareholders agreement and the need for its dynamic alignment with the organisational strategy to protect the long-term interests of all stakeholders.

A shareholders agreement (SHA) is a legally valid contractual agreement among a group of shareholders, normally among promoters. It is critically important to define the terms and conditions of transfer and transmission of shares by the signatories, particularly if it involves outside the families of the promoters. The crucial role of SHA was first widely discussed and recognised when Emami took over Zandu Pharmaceuticals in 2009. Due to major disputes between the two promoter families, the Vaidya family decided to sell their entire 23 per cent promoter stake to Emami without first offering it to the Parekhs, the other promoter with about 18 per cent stake. The transaction could not be stopped by the Parekhs as no SHA existed between the promoters.

Since then family businesses and business partners have generally been cautious to have a clearly drafted SHA to avoid ambiguity of ownership that might impact the family and business. Such a SHA would also have an exist or termination clause, always prepared based on multiple scenario analysis of the implications of the chosen exit route on the promoter family and the organisation.

When the holding of each promoter is significantly high, an open ended SHA can lead to major turbulence in the organisation as is possible in the case of Indigo where each promoter has over one-third holding. Naturally, an outside buyer will have significant influence on the organisation's strategy and performance. There are likely to be major headwinds created in the process affecting its strategy and leadership.

Wealth implications to other promoters/shareholders is also high. A badly drafted SHA can lead the families end up experiencing avoidable hard landing, all due to pilot error. Since a lot of the promoter wealth is locked in shares that are dependent on market caps and valuations, major lapses in managing the SHA can give rude shocks to the families involved.

Given that ownership structure and organisational strategy are intertwined, both need to evolve with time to be in tune with the changing aspirations of stakeholders and market dynamics. If the SHA is frozen in time, specific clauses in the SHA may pose significant leadership challenges to change strategy. For instance, the Indigo promoters ought to have recalibrated the SHA while going for listing or later by synergising the same with the growth strategy; this is particularly so in a VUCA world.

Therefore, family owners and business partners must recognise that just crafting a well thought out SHA is not good enough. They have to revisit the SHA periodically, make amendments or fine tune specific clauses of the SHA and sometimes add new clauses so that SHA never hinders management to change strategy being in sync with the changing dynamics of the market and keep the organisation nimble, flexible and responsive.

Promoters should ensure that they study the policies and processes forming part of a SHA. They should not be "template"-driven and blindly go with external advice without understanding the implications of any provision. Unfortunately, not all smart business leaders are aware of the criticality of a well drafted, completely contextualised SHA. They should do multiple scenario analysis and develop a SHA that is appropriate for their context.

Indigo co-founders/promoters not paying adequate attention to this aspect prior to listing has triggered a crisis. This, like the Zandu Pharmaceutical case, must raise an alarm bell among the family owners and business partners to not only reinforce the need for crafting robust and well thought out SHA for respective organisations, but also highlight the need for revisiting and recrafting SHA from time to time. It also raises question about the prudence of continuation of certain clauses of SHA of the promoters prior to listing that may fall foul with the letter and/or spirit of corporate governance in an organisation listed in the stock market.

Share ownership and strategy have to be closely aligned fundamentally. It is basic that any discussion on ownership structure, shareholder agreements and strategy of both family and business, involves assessment of the implications of the decision on every constituent of the system; this is crucial to help protect individual promoters' interests and also the institutions they create. The heart of a SHA lies in trust but the legal provisions should provide to protect it always.

Ramachandran is professor and executive director, Thomas Schmidheiny Centre for Family Enterprise, Indian School of Business; Ray is professor, Indian Institute of Management Calcutta

LETTERS

Language formula

The government did well to retreat from the perilous course of imposing Hindi and drop the 'Hindi clause' from the draft NEP in the face of the backlash from Tamil Nadu and some other non-Hindi speaking states. At the same time, it has to do more to assure southerners that it has no intention to make the study of Hindi in schools compulsory. To put it plainly, it has to abandon the ill-conceived proposal to introduce and implement the three-language formula across the country. It is pointless to say that students are free to make a choice. The problem is deeper than it looks like.

The opposition to the imposition of Hindi stems not just from the linguistic perspective, but also from the perception of it being a 'cultural invasion'. Our mother tongue is an integral and inseparable part of our culture. Everyone cherishes their identity and would not let anyone else tamper or tinker with it. Linguistic chauvinism entails foisting a language on others and not in resisting a language foisted on us. Like it or not, linguistic diversity is the reality of India. It is not necessary to elevate any one language to the status of a 'national language' or accord primacy to it just because of the numerical superiority of its speakers. As free citizens of a free country, we have the freedom to choose the language we wish to use. The government of the day, whatever its linguistic preference, cannot thrust Hindi down our throat. We urge Prime Minister Narendra Modi to assure non-Hindi speaking people on the language issue.

G David Milton Maruthancode

Timely availability

The Economic Survey is an important official document used widely by students, researchers and teachers alike for studying the trends in the Indian economy and contains a wealth of useful data. Till some years ago, it used to be published by the government and was available in the market two to three days after the presentation in the Parliament. However, since the last few years, it is being published by Oxford University Press (OUP) and becomes available in the market almost one month after its presentation in Parliament by the finance minister. By this time, its utility is almost lost. It is requested that the government should restart the practice of publishing the Economic Survey itself or, if this is not feasible, direct OUP to release the Economic Survey either two three days prior to presentation in Parliament or within a week of its presentation.

V K Puri New Delhi

For the people

For critics who had a hard time believing the exit polls and now the outcome, the mandate reflects public cheer/empathy towards a down-to-earth regime that prioritises the accomplishment of basics, stays connected with the masses on a regular basis and values the need for national security. It is important, especially for the "intellects", to be cognizant of the ground reality as voter attitudes in the present era are highly dynamic, difficult to speculate and increasingly governed by recent present events. Political strategy driven by a persistent non-constructive culture, backed by weak leadership and counting on derogation of peers, not only disrespects the public mandate but also fails to promise stability. The over-critical attitude hardly appeals the larger masses.

Attitude as well as aptitude hold the key to accomplishing welfare initiatives in the true spirit. At the end of the day, an open-door style of governance and result-orientedness are the factors that matter.

It is time that political entities comprehend the rising expectations of the middle class and collaborate to fulfill the growth objectives. A transparent, modest and conducive style of leadership, which respects the aspirations of the economically weaker sections and the middle class and aims to resolve chronic problems compassionately is able to differentiate itself from the rest. A federal structure with a multi-party system requires that tall leaders make conscious efforts to set high benchmarks of governance instead of being part of the problem and expending time and effort in putdowns and comebacks. Vested interests, false propaganda and opportunistic alliances ought to take a back seat, if a government were to promote welfare initiatives and gain people's confidence.

Girish Lalwani New Delhi

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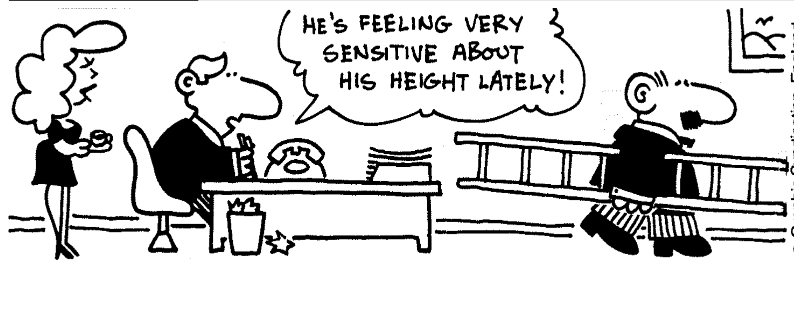
HAMBONE



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Tightrope walk

New FM has multiple pressures to balance when drafting Budget

Now that the general election has been concluded, attention must turn to the Union Budget for 2019-20, which will be presented in early July. The interim Budget, presented in February, laid out certain estimates for the spending and revenue pattern over the year. But it is clear now that the situation has turned even more adverse. A slowdown in growth over the past three quarters is likely to impact revenue. The targets set in the interim Budget will definitely appear to be ambitious in this scenario. The interim Budget figures showed that corporate tax collections would be higher by 15 per cent in 2019-20 over the collections in 2018-19 and that personal income tax collections would increase by an even greater proportion — 34 per cent. The Central Board of Direct Taxes has already asked for a reduction of the target as growth is wavering. Goods and services tax collection, closely related to the health of the economy, is projected to increase by 31 per cent in the interim Budget for 2019-20 over actual collections in 2018-19. These numbers are almost impossible to achieve, which means the Budget will have to trim both revenue and expenditure to better reflect the deceleration of economic activity caused by slowing consumption trends.

The official data showed the government went in for an expenditure cut of ₹1.45 trillion from the projections in the Revised Estimates of around ₹24.5 trillion for FY19 to keep its fiscal deficit target at 3.4 per cent of gross domestic product. This means a double whammy — the bills overdue have to be paid in this fiscal year and the axe could fall on investment in the physical infrastructure as there will be little potential for the government to increase spending in order to revive growth. Besides, the fiscal consolidation path has been a major commitment from this government even if it has been modified once or twice in response to unexpected or populist spending. Any further deviations will only dent the government's hard-earned reputation for fiscal prudence, which is a price that it should not be willing to pay. In addition, given that the growth slowdown is linked to a crisis in private investment, the government should avoid laxity on its fiscal deficit or growing its debt profile further. Enhanced crowding out of private investment is the last thing that is needed.

It is also clear that there is little scope for such populist spending in the remainder of the year. The government has already felt it necessary to indulge in some extra expenditure, with an expansion of the farmer-centric PM-Kisan scheme, announced at the first meeting of the Union Cabinet after the elections. This expansion is to cost ₹12,000 crore more in addition to the ₹75,000 crore earlier planned. Thus, in spite of considerable temptation, the new finance minister will have to avoid big giveaways to various sections of the electorate. Few will envy Ms Sitharaman's task. The best that can be done is a tight, fiscally prudent Budget with no splashy headlines or populist giveaways.

Many teachable moments

The Kasturirangan report is exhaustive in its scope

Now that the headline three-language formula has been removed from the draft education policy, attention can be turned to the myriad details in the report submitted by a committee headed by scientist K Kasturirangan. The report, which runs into 480-odd pages, amounts to a wholesale restructuring of the country's school, higher education and technical education systems, in keeping with the lofty aim set out in 2017 of making India a "knowledge superpower". How far the reforms set out in this exhaustive and well-meaning report can be implemented is an open question. Reiterating the urgency for India to invest in Early Childhood Care and Education (ECCE) — the report says a ₹1 investment yields an expected return of ₹10 — it takes an all-encompassing view that includes infant and maternal nutrition. To this end, it says the state's ECCE investment should start when the child is three years old, and suggests restructuring the school curriculum for 15 years of schooling.

Within the current system of delivering pre-school learning through anganwadis and private play schools, the report sets out a detailed framework that draws on "the numerous rich traditions of India over millennia involving art, stories, poetry, gathering of relatives" and other traditional resources to create a curricular and pedagogical framework. This is certainly an imaginative solution but it may run into practical difficulties. For instance, would anganwadis have the trained staff and resources to do this? Besides, not all families may be able to cope with the demand that three-year-olds be taken to play school as a matter of policy.

Although the committee's intentions are admirable in suggesting a significant expansion of pre-school education, it would have been more practical had it focused on enabling the government to concentrate on delivering better-quality schooling within the current 12-year system, which Annual Status of Education Reports have shown to be critically sub-standard. That section of the report does suggest some useful improvements in teaching routines to improve foundational literacy and numeracy — a prescribed minimum daily and weekly focus on language and maths and a connect with real-life learning. But the crisis assailing public primary education in India today is teacher absenteeism and poor teaching quality. The report addresses these problems by suggesting the mobilisation of a large-scale volunteer programme and a refocus of the teacher-training programme both in content and structure by integrating them into a new system of centralised teaching institutions. Oddly, there is minimal focus on distance-learning technologies, which could deliver some measure of quality education to India's more remote areas.

The micro-recommendations for pre-school education offer a flavour of the treatment the Kasturirangan report has accorded to higher and technical education. Overall, the report reflects a sincere effort to mobilise innovative solutions to the vexed problem of India's education and, at the same time, take on board the opinion of all its members (why else would it include a suggestion to set up a school for Persian and other Oriental languages). It has also addressed the "how to" element of its recommendations by setting out a comprehensive set of new regulatory and monitoring institutions — including renaming the ministry of human resource development the ministry of education. Any government that wants to enable a better educated India will find many teachable moments in this report. For one that wants to refashion education for specific political purposes, it may come up short.

ILLUSTRATION: BINAY SINHA

The stimulus should be monetary, not fiscal

Fight against the last vestiges of inflation threatens to undo significant policy gains of recent years

TESSELLATUM

NEELKANTH MISHRA

It is rare for consensus to emerge among hundreds of millions of humans. When it does, like it did in the recent general elections, it is natural for expectations of significant economic change to rise. As prescriptions and hopes turn into predictions, a clamor has arisen for the government to "do something" to address the ongoing economic slowdown.

One must be careful what one wishes for. While there clearly are measures the government can take, a significant fiscal stimulus would be ill-advised, and the solution is monetary.

For several decades now, reports analysing India's weak manufacturing competitiveness have, in addition to the oft-quoted complaints of regulatory hurdles, weak infrastructure and poor worker skills, lamented high interest rates. If Indian manufacturers borrow at, say 12 per cent, and the Chinese at, say 6 per cent, and it takes much longer to set up factories in India (so the higher rates get compounded), how can factories in India produce competitively? So the argument went. With chronically high inflation (CPI has averaged 7.5 per cent since 1960), and persistently high fiscal deficits that forced the Reserve Bank of India (RBI) to monetise them, interest rates could not have come down.

Thus, to get rates to fall, both inflation and the fiscal deficit needed to fall. Given that the two are also related, with higher fiscal deficits often associated with higher inflation, fiscal improvement needed to occur first, but a surplus in food production was necessary too.

And corrected they have: Inflation has averaged 3.5 per cent over the past three years, and the average over the past four years is below 4 per cent. The fiscal deficit ratio is the third lowest in India's history even though it is still high compared to other nations. Once adjusted for the pay commission cycle (the decadal pay hikes for government servants can boost the salary and pension bill by up to 2.5 per cent of GDP; the seventh pay commission implementation just got over), it is perhaps the lowest in India's history. Votaries of higher interest rates make much of extra-budgetary spending by state and central governments. This is undoubtedly an issue of lack of transparency, but this spend is not abnormally high, is productive, and cannot justify the really high interest rates for borrowers in the economy, in our view.

Despite these remarkable achievements, and nominal growth slowing, the prevailing interest rate environment remains excessively tight for borrowers. Revenue growth for firms may have slowed in the low inflation environment, but their interest costs have not: Not only does this hurt the bottom line and thus investible capital, it also reduces risk appetite. All three components of interest rates other than inflation: The real repo rate, the term premium (difference between the 10-year government bond yield and the repo rate) and credit spreads have been at elevated levels.

So, the economy has seen the negative effect of low food inflation: Weak farm incomes as the transfer from the rich to the poor through higher food prices was stalled; but no benefits, as the cost of borrowing has not fallen commensurately. Similarly, the consumption stimulus in the form of a large pay commission handout to government employees was much weaker than usual in the seventh pay commission. Unlike in the sixth commission, where a large stimulus took several years to run through the system, the growth boost from the seventh has already faded. And yet, there are no parallel gains, with the term premium unchanged.

Not surprisingly, then, even before the non-banking finance companies (NBFCs) braked sharply starting September last year, economic growth had started to weaken. That it has been mostly below the 8 per cent a year target clearly has several important drivers, but a fiscal pullback without a parallel relaxation of borrowing rates is one of them.

There is no doubt that the risk of inflation flaring up again remains, and one needs to stay on guard: The recent hike in milk prices after a hiatus of two years, and a possible spike in fruits inflation (mangoes, for example, due to weather disruptions) need to be monitored carefully, for example. However, one must also be cognizant of political economy considerations and the risks they pose. If growth remains tepid for too long, and the significant interest rate reductions that are possible do not happen (for the borrower, not just in the repo rate), political pressure could push the government back to a high fiscal deficit regime (and possibly high inflation too), undoing the policy gains of the last several years. Inflation being high and volatile for most of India's independent history was perhaps because it was politically necessary: Real output growth in agriculture averaged 2.5 per cent a year since 1960, and yet the agriculture workforce grew at 1.6 per cent a year. Without high food prices that engineered income transfers from the rich to the poor, this would have created significant social stress.

The process of interest rate correction appears to have started, with government bond yields falling by nearly 40 basis points in the last few weeks. This appears to be in anticipation of a repo rate cut on June 6, but likely also reflects relief among bond investors that the elections did not force a change at the Centre, and that the political alternative would have meant a step up in government spending.

This has a long way to go. As explained in last month's column (*https://bit.ly/2V5r2LZ*), borrowing rates can be up to 2 percentage points lower if the real repo rate, the term premium and credit spreads all just fall back to normal levels. Even if the Indian economy is not as rate sensitive as some others are, this scale of rate reduction can be stimulatory. If for argument's sake mortgage rates were to fall by two percentage points, for example, it would help ease the logjam in the real estate segment a bit.

To get rates down by this extent would necessitate not just a normalisation of real repo rates, but better signaling, as well as improvement in financial system capacity. These steps need to be on the policy agenda, and not any pressure to increase consumption-boosting spending by the government.

The writer is co-head of Asia-Pacific Strategy and India Strategist for Credit Suisse

Achieving a fiscal miracle

NEW DELHI DIARY

A K BHATTACHARYA

The Union government's net tax revenue for the full year of 2018-19 is now estimated at ₹13.17 trillion, according to the latest numbers released by the Controller General of Accounts (CGA). This represents a shortfall of ₹1.67 trillion over the revised estimates presented just four months ago in the government's interim Budget presented to Parliament. This is a huge shortfall equivalent to about 0.9 per cent of India's gross domestic product (GDP). And yet, the government has managed to keep the fiscal deficit for 2018-19 within 3.4 per cent of GDP, the revised estimates figure mentioned in the interim Budget. How did the government achieve this miracle?

The figures released by the CGA provide some explanation. The government managed to recover more by way of loan repayments and increase its disinvestment receipts over and above what was mentioned in the revised estimates. Thus, total non-debt capital receipts for the government during 2018-19 came to about ₹1.03 trillion, instead of ₹0.93 trillion given in the revised estimates. That reduced the tax revenue shortfall by ₹10,000 crore. A small increase of ₹1,000 crore in non-tax revenue brought down the shortfall in total revenues to ₹1.56 trillion.

The remaining task of reducing the shortfall was still huge. So, the government began axing its expenditure. First, it began with squeezing the capital expenditure — by around ₹13,000 crore. The shortfall was reduced to ₹1.43 trillion. And then the government sought recourse to what is popularly called off-Budget borrowings or transferring its own expenditure to state-owned entities and asking them to borrow from various sources including the National Small Savings Fund and meet the expenditure that actually should have been incurred by the exchequer. As explained by Prasanta Sahu in *Financial Express*, the government leaned on state-owned organisations such as the Food Corporation of India (FCI), Housing and Urban Development Corporation (Hudco), National Housing Bank (NHB), National Bank for Agriculture and Rural Development (Nabard) and Rural Electrification Corporation (REC) for such off-Budget borrowings to meet its expenditure on account of food subsidies, affordable housing schemes, irrigation, rural housing and rural electrification. And the amount of such off-Budget borrowing was as huge as ₹1.32 trillion.

The CGA figures do not refer to off-Budget borrowings but provide an indication of such clever expenditure management tactics. For instance, the government's food subsidies bill for 2018-19 is now estimated at ₹1.02 trillion, a reduction of over ₹69,000 crore compared to the revised estimates of ₹1.71 trillion, mentioned in the interim Budget. How did the government cut its food subsidies bill by 40 per cent? Well, by simply asking the FCI to borrow and meet the expenditure. Similarly, expenditure compression of another ₹63,000 crore was achieved by transferring the load of various schemes for housing, irrigation and rural electrification to other entities like Nabard, Hudco, NHB and REC.

The shortfall was now reduced to only ₹11,000 crore. Thus, the government's borrowing requirement or the fiscal deficit went up from ₹6.34 trillion to ₹6.45 trillion. But this slippage was hardly a problem. The nominal size of GDP for 2018-19 had been revised upwards from ₹188.41 trillion to ₹190.1 trillion. The expanded GDP base helped retain the gross fiscal deficit at 3.4 per cent of GDP.

Though the fiscal deficit target in the revised estimates for 2018-19 was met, the manner in which it was achieved raised a few disturbing questions. One, why was the finance ministry so wide of the mark in projecting its tax revenue numbers for 2018-19? To have got its revised estimates on tax revenues completely wrong, resulting in a slippage of 11 per cent, is nothing but a shame.

The advancement of the Budget presentation by about four weeks may have speeded up the rollout of expenditure on various schemes right from the start of the new year, but the government's ability to estimate its tax revenues for the full year has suffered hugely. The damage it does to the credibility and achievability of revenue targets for the next year is even worse.

For instance, with a 11 per cent drop in its actual net tax revenues compared to the revised estimates for 2018-19, the task of achieving the targets for 2019-20 will become even more formidable. Instead of a growth rate of 15 per cent, the required growth rate now will be steeper at 29 per cent. The challenge of fiscal consolidation in 2019-20 thus is already very daunting.

A related question pertains to how the borrowings of the state-owned entities would be settled and how these would be treated in the accounts of the following years. These borrowings by public sector entities should strictly reflect in the government's account. For instance, the government's actual fiscal deficit would have ballooned to 4.1 per cent of GDP if it had itself made the borrowings.

Burdening the public sector with the government's borrowings is a travesty of the government's stated commitment to the goals of public sector autonomy and reforms. Such recourse to off-Budget borrowings also underlines the need for maintaining a stricter vigil on overall public sector borrowing of the government in order to gauge its actual fiscal consolidation efforts.

Worse is the recent move by the Reserve Bank of India to exempt public sector entities from single-account exposure limits for banks. This will allow public sector companies to borrow from banks without worrying about the single-account exposure limit of 20 per cent of the bank's available eligible capital base at all times. Is this relaxation aimed at allowing public sector entities to borrow freely from banks to meet expenditure that should ideally have been borne by the exchequer?

Finally, such off-Budget borrowings provide additional relief to the government by helping the economy achieve a better economic growth number. If the government had indeed cut its expenditure by ₹1.45 trillion in the last quarter of 2018-19, this squeeze would have reflected in the government consumption numbers in last year's fourth-quarter GDP estimate.

True, the capex cut of ₹13,000 crore was real. But the remaining cut of ₹1.32 trillion was not real — this expenditure burden was shifted to public sector entities through their borrowings. Unsurprisingly, government consumption grew by over 13 per cent in the last quarter of 2018-19. If the government had really cut its expenditure, government consumption growth would not have been so high and the January-March 2019 GDP growth numbers could have been lower than 5.8 per cent.

Without doubt, the miracle of achieving the fiscal deficit target in 2018-19 has many features that are deeply troubling.

Governance and power

BOOK REVIEW

C M VASUDEV

A recently released book *Challenges of Governance* by B K Chaturvedi, a former cabinet secretary, is a compelling addition to the growing collection of memoirs written by retired civil servants. Since Mr Chaturvedi had worked at the helm of bureaucracy, his memoirs promised to be more revealing by providing insights into governance challenges at the higher echelons of government and interplay of forces between the professional bureaucracy and the political executive. Indeed, the book has achieved this in ample measure. In the preface, Mr Chaturvedi says he felt inhibited to talk about issues where decisions were taken in complete confidence and trust. This is somewhat of a dampener. He would have been privy to many sensitive decisions and revealing their context, barring official secrets, would have enriched this account. He has perhaps been overcautious in this matter.

The book covers a wide breadth of issues starting from challenges in district administration to state and central government administration and takes in the erstwhile Planning Commission. Mr Chaturvedi occupied pivotal positions in these organisations and he has deftly laced the policy dimensions of subjects with specific issues with which he dealt. His thoughts provide a storehouse of knowledge to budding civil servants and others interested in public policy formulation and public administration. At the same time, a book of 200 pages or so is not enough to do justice to the wide range of subjects that he has sought to cover. It provides a fleeting glimpse of governance challenges, which only whets the appetite of the reader and leaves him wanting more.

The most interesting section is the one concerning coalition conundrums and governance model under the first United Progressive Alliance (UPA I). Mr Chaturvedi was cabinet secretary during that period. His account of governance problems because of the jostling of power between coalition partners and the undermining of the prime minister's position because of dual centres of power contains many interesting anecdotes. He has abeen critical of the role of the National Advisory Council headed by Sonia Gandhi as a parallel centre of power. These ad hoc institutional arrangements posed many governance challenges. One offshoot was setting up many Groups of Ministers (GoMs) to resolve contentious issues. The GoMs took a lot of time to resolve conflicts and perhaps led to sub-optimal compromises. The process also delayed decision-making and weakened the position of the prime minister. The unique governance model evolved during UPA I is perhaps an example of the pitfalls of coalition governments. In the author's words, "This position did not give the impression of a government that was fully united. It adversely affected its public image."

Mr Chaturvedi has been more forthcoming when he writes about overreach by different organs of the state, especially the judiciary and the Comptroller & Auditor General (CAG). He has reserved his harshest comments for the encroachment by the CAG and judiciary into the domain of policy-making in telecom and coal, and explains how this made civil servants increasingly more risk averse. He has also put up a stout defence of civil servants who have been charged with criminal offences for administrative lapses. His analysis is a grim reminder, especially in an era of judicial activism, of the need for different institutions to confine their respective roles to those envisaged in the Constitution.

The portions in the book concerning the Planning Commission, Finance Commission and centre-state relations makes interesting reading. He has provided an insider views on how the Planning Commission was able to usher in reforms in the states as part of annual plan discussions. His defence of the resource allocation role of the erstwhile Planning Commission and his description of renaming the body Niti Aayog as a knee-jerk reaction seems to be overstated, however. There were perhaps good reasons to rename the Planning Commission so that its name and role reflects the current market-driven growth model that the country has adopted. The Planning Commission was a relic of the period when our growth model was public sector led with centralised planning. Also, the Planning Commission's resource allocation role was not in tune with our evolving federal structure under which discretionary grants (which central assistance for state plans were) from the centre to the states need to be minimised. Today 46 per cent of central taxes are given to the states in a non-discretionary manner. Niti Aayog with a redefined role of a think tank of government perhaps better reflects the change in our growth paradigm.

The last section contains Mr Chaturvedi's thoughts on future governance reforms. He has ticked many of the right boxes. He has offered wide-ranging suggestions for strengthening governance institutions and for electoral reforms. Having seen the functioning of coalition governments from close quarters he has argued for banning post-election defections. Our party-based parliamentary democracy has many shortcomings. But it is a moot point if these can be corrected by legislative action such as banning defections. Banning defections can also cut at the root of freedom of speech. Ultimately it is for the voters to punish unscrupulous defectors.

All in all, however, *Challenges of Governance* is a treat to read. There is a lot in it for public policy practitioners, policy makers and thinkers.

The reviewer is former Finance Secretary

CHALLENGES OF GOVERNANCE: An Insider's View
BK Chaturvedi
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