Talking Points

CENTRAL VIGILANCE COMMISSION,
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State and Market in India

Dear Chairman of the Commission Mr. Chowdary, Members of the Commission, Mr. Nilam Sawhney, and friends,

I am thankful to the Central Vigilance Commission for giving me this opportunity to participate in the Lecture Series of CVC.

Introduction

- When we studied Economics, we learnt that Adam Smith identified three duties of a Sovereign State. (We use State, Sovereign and Government inter-changeably). These are:

  a) Protection from external aggression (say conduct of defence and external affairs).

  b) Protection of the members of a society from oppression by other members of society (say of police force and judicial system).

  c) Taking up activities and the establishment of organisations which are essential to the society where private individuals or institutions may not be able to take them up.

- There can be market failures and the state should involve itself only to correct them in the public interest.
- This is the foundation of capitalism.

- Role of State in Depression, Second World War, liberalism and beliefs of Development Economics diluted the rigour of the Adam Smith's capitalism, or minimalist State.
- Some of us believed that capitalism would die, but that did not happen. It has been adapting and saving itself, by diluting and reinterpreting item (c) above.
- <u>We started our Republic by defining the role of State and Market in the context of Planning</u> as a dominant ideology and we inherited wartime controls as operational tools.
- <u>Planning was more or less a national consensus</u> even during the independence movement. There were two streams of thoughts. One is Bombay Plan and the second National Plan. National Plan gave greater role to the Government.
- We started Planning in 1950; I taught Planning in Osmania University in 1963, and worked in Planning from 1969 till 1976, and again between 1983 and 1985.
- In 2014 as Chairman, Fourteenth Finance Commission, I oversaw the distinction between Plan and non-Plan being put an end to.

<u>1963-64</u> (Teaching)

- Planning and Public Enterprises were two optional subjects for post-graduates doing M.Com in Osmania University.
- I took these two classes. We proceeded on the assumption that Planning is rationalist in approach and interventionist in operation. We believed that the

government represents the interests of the people. We thought we had enough data and skills to discharge our role.

- The financial resources were mobilised and utilised as per the Plan priorities.
- Public Enterprises also became important instruments of the Government for Planning purpose except that they were performing commercial or semi-commercial functions. RBI and financial sector were a sort of mechanism to subserve goals of planning. In brief, the State dominated, particularly because the markets were not well developed.
- It was in thing to be good planner.

<u>1969-76</u> (Working)

- Plan Holiday (1966-67 to 1968-69) and Raj Krishna's comment on Hindu Rate of Growth: and each Five Year Plan being a new edition of the same Plan showed some disappointment. So, we went ahead with more and not less of Planning. For most of this period, I was Deputy Secretary (Planning). We concentrated on use of public investments as a means of economic development, which has been described as "disjoined incrementalism".
- But, we in Andhra Pradesh had special place for Planning. Locational aspects became important because we had regional tensions and were dealing with Regional Planning. So, I became sort of 'expert'. In fact, I went to Tanzania to advise them on Regional Planning. The United Nations even developed a manual on Sub-national Planning with which I was associated.
- Planned approach meant that the State should take initiative in creating facilities and institutions that contribute to development. Necessary resources have to be obtained through taxation, through borrowing and, if necessary,

through printing money for financing the development. (Example of Minhas) & (Raj Krishna).

- Mixed Economy was acceptable to many but unidirectional in role of state approach was not. The approach to efficiency was to nationalise, expand public enterprise and centralise, and no attention was paid to outcome.
- With Emergency in 1975-77, balance shifted somewhat in favour of State.
- It was good to be a planner, but some doubted.

<u>1978-83</u> (Relearning)

- I moved to the World Bank in 1978 and worked for five years. I found that many countries were emphasising export oriented strategy.
- We were continuing with self-reliance. We felt that as a large country, we need not depend on export and, in any case, the rest of the world cannot absorb our exports. Some of the developing countries started thinking differently. Many Governments were giving more scope for private sector, but the State control and guidance continued. In other words, State was promoting business or private sector (example of Korea).
- In a way, private sector or business was encouraged by the State. They were business friendly, which is not necessarily market friendly.
- I also noticed that China and Russia joined the World Bank. They were becoming more and more business friendly.
- Advanced economies, especially USA and U.K. also tended towards market orientation. This is evident from the popularity of Reagenomics and Thacherism.

- World was changing, but we in India did not change much in terms of policies. However, there was some rethinking about the controls. A number of reports by Government Committees were submitted to rebalancing role of the State and the Government and the private sector.

1983-85 (Working)

- In this period, I was Secretary (Planning) in Andhra Pradesh. The State expanded and I actually participated in the Plan discussions. I led planning process; wrote books. By this time, I felt that the way we are approaching the developmental process depending heavily on the role of the Government was not working well. New Economic Policy of Rajiv Gandhi was a definitive break in thinking. Modernisation was the key, Legacy of planning persisted, but with greater autonomy for Public enterprises. I felt that, we in India were missing something good that was found elsewhere.

1985-88 (Study)

- I, therefore, took leave to study the State and the Market and also Public Enterprises and Private Sector. The later required, in particular, study of the experience of U.K.
- In this period, I learnt many important lessons, and published my thoughts. What were they?

State Failures

- The idea that the State or the Government can make up for failure of the Market is not entirely correct. The State also has failures. So, it is necessary to weigh the strengths and weaknesses of State and Market, and then define the boundaries of the State on that basis.

- Why do the State failures happen? State or Governments may be serving a group interest and not public interest. Even in democracy, they may nurture specific constituencies (Karunanidhi).
- Bureaucracy operates to maximise the budget of individual departments apart from their prospects and perks.
- Regulation may be serving the interest of the regulated due to regulatory capture.
- No incentive towards efficiency.
- Inflation, power of Unions and fiscal stress led to a worldwide review of role of States.

Why Rebalancing Role of State?

a) Reinterpretation of what constitutes public goods; (roads)

b) Unbundling of natural monopolies.

c) Using of private sector for providing public goods through competitive mechanisms, but funding by Government; (Passport issue)

d) Merit goods can have a combination of funding and provision by public and private sector.

e) Technology makes it difficult to get a "fix" on the product, its use etc. and hence 'control'.

f) What constitutes monopoly has been redefined, unbundling all natural monopolies.

g) Assessing relative efficiency of regulated private monopoly and State owned monopoly.

h) In regard to externalities, whether externalities have been over stated; whether they can be measured, and if they cannot be measured, how can bureaucrats administer it?

<u>1988-90</u> (Practicing and Preaching)

- More important, we in Andhra Pradesh put into practice the idea of dynamic mix of State and Market. We sold unit (Mahindra), tried to sell A.P. Scooters, and we started new ones for e-governance (ARTS) and Venture Capital (APIDC). Issue was how to get the desired output, in-house or outsource?

<u>1990-93:</u> (Managing Crisis and planning Reform)

- The crisis was triggered by Gulf War, but we were vulnerable to crisis. The State has failed to manage prudently by half-hearted policies! Borrowed time, money and short-termism as illustrated (Exports-Imports) or free entry, no exit.
- We reformed gold policy and got rid of single largest source of smuggling, Hawala and Black Money.
- <u>We reformed external sector.</u>
- The legal framework was provided for compounding also, not just punishment.
- We ignored stock of forex for normal management and focused on flows. Left it to banker who has inferments on the client.
- Discretion was confined to capital account management. Reporting requirements were improved. Monitoring strengthened.
- The impact could be seen not only in the broad policy parameters, but the availability of goods and services to the people.
- Leave it to Market, but simple rules monitor and be effective.

<u>1996 – 2002</u> (Putting limits to State Power)

- Limits to access to printing press were put (Ways and Means Advance).
- Support to Government borrowing by RBI through markets and at market related rates (FRBM).
- Direct funding of development by RBI stopped and balance sheet integrity restored.
- <u>Distance money creation from spending.</u>

<u>2002-2003</u> (State, Market and Globalisation)

- <u>Lessons from IMF in one year.</u>fs
- State is the ultimate risk bearer.
- Stability in finance can be given only by State.
- Global financial architecture inadequate.
- Wrote articles about IMF as a lender of last resort.

<u>2003 – 08</u> (Stability as Public Good)

- RBI provided what no market can provide namely external sector stability; provide legal institutional, technological infrastructure for development of markets (including Self Regulatory Organisations);
- Look at leverage and balance sheets (Households, government, corporates, finance, and national).
- Did less of directed lending.

<u>2013-14</u> (End of Planning)

- Plan – Non Plan distinction ignored;

- Introduced principle of "Nudge", (i.e.), Public policy will make choice till individual makes a choice. It is not that government chooses or you choose. Provide default option.

Asking Right Questions

- What has been our experience with two of the important legislations that we got rid of, namely, on Gold and on Foreign Exchange.
- What are the capabilities of State / government relative to market?
- Indian state may be business friendly, but is it market friendly?
- Is the issue State with Market or State versus Market? Examples:

a) Parliamentarian and Businessman

b) Public-Private Partnership

c) Education and Health funding by govt. and provision by private parties.

d) Natural resources exploitation.

- Two I's - Ideology and Investments were driving the relatives roles of State and Market in 50's & 60's, but it is different now.
- Two I's to be replaced by Five I's.
    1. Interests
    2. Incentives
    3. Information
    4. Innovations
    5. Institutions

Economic Theory of Criminal Behaviour

The economic theory of criminal behavior holds that rational criminals compare the benefits of crime with the expected punishment imposed by the criminal justice system.

The economic theory of crime offers a predictive model of criminal behaviour and a clear goal for criminal law. The predictive model of criminal behaviour could be based upon a theory of the rational choice to commit. The goal for criminal law and policy: should be to minimize the social cost of crimes. Optimal policies should ideally be computed on this basis.

Economic theory of optimal punishment suggests that the goal should be the sum of the social harm caused by crime and the cost of deterring it. There are alternate ways to deter crime, say fines or imprisonment. The optimal level of deterrence and optimal allocation of society's resources among alternative ways to deter crime can also be determined. In other words, the amount of resources that a society or government can afford to spend on punishment as a deterrent is not unlimited. No doubt, it is not appropriate to reduce every aspect of life to costs and benefits, but then one cannot entirely ignore opportunity costs, merely because of strong feelings.

Governance and Markets

Markets will not succeed unless they are supported by adequate governance institutions. Most economic activities and interactions share several properties that together create the demand for an institutional infrastructure of governance. Conventional economic theory recognises the importance of law for governance, but it takes the existence of a well-functioning law and legal system for granted. It assumes that the state has a monopoly over the use of coercion. It also assumes that the state designs and enforces laws with the objective of maximizing social welfare. The usual implicit assumption is that the law operates costlessly. About forty years ago, economists realised that these assumptions are not valid since there are transactions costs, information asymmetries, principal-agent problems and incentives.

In the economist's ideal picture, the government supplies legal institutions that are guided solely by concern for social welfare and such institutions operate at low cost in the sense they are too small to matter. In reality, the apparatus of law could be costly, slow, weak, and even biased.

What happens if transaction costs are high and legal system too slow or weak? Economic activity does not grind to a halt because the government cannot or does not provide an adequate underpinning of law. For many people, too much potential value would go unrealized. Therefore, individuals, groups and societies create alternative institutions, instruments and practices, to provide the necessary economic governance. For instance, it is widely recognised that it is difficult to have smooth business transactions without recourse to use of black money either directly or indirectly (say through input suppliers or liaison officers).

It is easier to grow from a low level of income per head to a middle level than it is to remain as a middle income country and reach to a high level. In the first phase of the growth or transition, economic activity is on a small scale, trade is localized, and economic transactions involve a relatively small group of people. In such a setting, networks of information flows, norms of behavior, and sanctions for deviants may already be present from the social environment, or can develop quickly as people interact economically among themselves. Therefore, self-enforcing governance is feasible. But for a sustained growth, ruled based governance must prevail over relation based ones.

Relation-based and rule-based systems are conceptual pure categories that mix in different ways in practice. In some situations, the diminishing returns of a relation-based system can be countered without going to a fully centralized rule-based alternative.

The processes of creating the institutions and the apparatus of state law, and of improving them to the point where rule based governance dominates and functions well, can be slow and costly.

The fixed costs of rule-based governance are a public investment; therefore society must solve a collective-action problem to put such a system in place. This is not automatic; there are the usual problems of free riding, under-estimation of the benefits to future generations in today's political process, and the veto power held by those who stand to lose from the change.

Even when the public investment for a rule-based system has been made, people used to the relation-based system who want to switch must make some private investments to learn the rules and their operation. Their benefit from the switch will depend on how many others make the switch. This positive feedback externality can lead to too few switchers, or even a lock-in that keeps the old system in use. In turn, the expectation of this can reduce the social benefits of the changeover and therefore delay or deter the initial public investment.

The benefits of the new system may be unequally distributed, and some participants may even lose. The system of rules and their enforcement itself must at first establish a reputation for integrity and efficacy. This takes a long time and strict supervision even given much good will.

Last or Lasting Question

Let me conclude by saying that corruption is not merely an issue of committing crime and imposing punishment. It is manifestation of a bigger problem of governance. In countries that are moving from relation based systems to rule based systems, there are challenges. In dealing with this issue, we cannot take a simplistic view of a benevolent state versus a manovelent market participant. It is interesting that people urge severe actions by government precisely in those countries where governments are reputed to be weak in governance systems. If corruption is a consequence of weak governance, how could empowering precisely the same governance systems solve the problem on a firm footing?