

Governance Matters in Economic Reform

By

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“If the kings be deprived of the rules of governance, the trinity of Brahma, Vishnu and Shiva is sunk like a boat without its pilot, hence all rules of conduct perish.”

**-- from Bhishma’s words of advice to
Yudhishtira in the *Mahabharata***

Different meanings of the term “governance”

As for “economic reform”, the preoccupation is with deregulation, trade policy, fiscal policy, privatization, corporate finance, and capital account convertibility. Very little serious work or discussion on the modalities and details of governance reform.

I believe the unpopularity of economic reform in India has much to do with our dysfunctional governance.

Many economists and columnists in the financial press are not aware how unpopular, rightly or wrongly, the reforms introduced since 1991 are with the general public.

Many of them think that reforms would be popular but for the obfuscation by the ignorant and ideologically blinkered Left.

National Election Survey data of 2004 (on the basis of a sample of about 27000 respondents) suggest otherwise.

We'll first briefly consider issues of

- **Administrative Reform**
- **Judicial Reform**
- **Regulatory Reform**
- **Reform in the Delivery Infrastructure of Social and Economic Services**

We'll then take up two of the major analytical issues which I think are important for governance problems in India:

- ***Commitment vs. accountability* as a central dilemma of governance institutions.**

- ***Collective action problems*** in reaching a new governance equilibrium. In this connection we'll particularly focus on the relationship between heterogeneity and inequality among social agents and collective action.

Administrative Reform

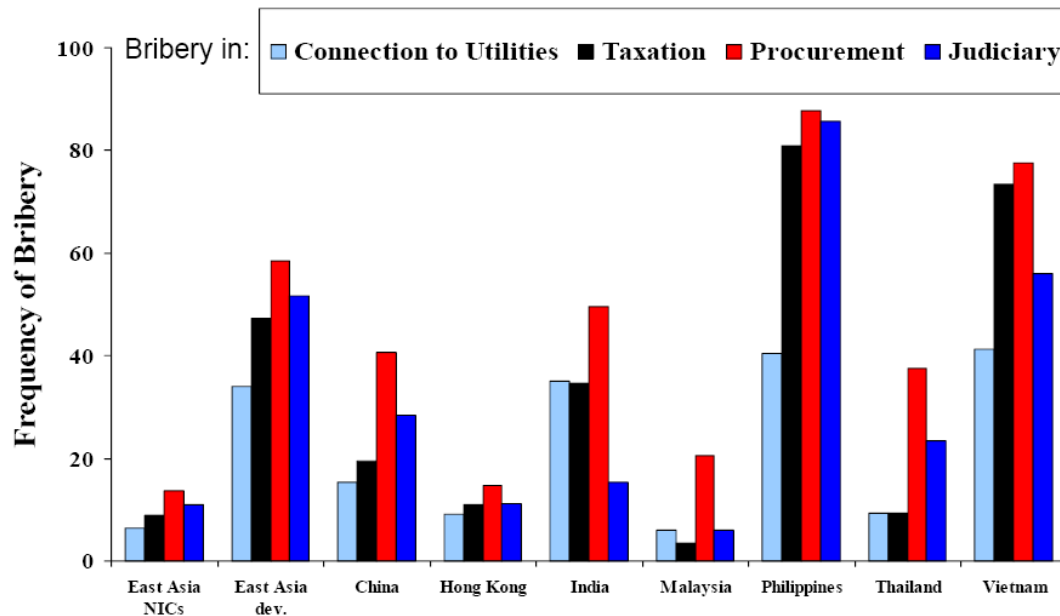
- **Monopoly power of officials.** Citizens have to approach them as supplicants for services they are entitled to. Bribes are monopoly prices charged for these services, and extortions for averting undue harassment. More competition among officials, overlapping jurisdictions, more competition with private suppliers, etc. are among the usual administrative reforms suggested. (Not feasible for all transactions). Recent attempts at backtracking on the Right to Information Act, if successful, will make the bureaucratic process more opaque.

- **Citizens are complicit when the briber and the bribee collude, when the latter is paid to look the other way (as in cases of customs or tax evasion). Overlapping jurisdictions, adequate incentives for ‘whistle-blowing’ by third parties, etc. can help.**

Comparative data on different arenas of corruption in India

Unbundling Corruption: Different types of Bribery (responses by firms 2005)

% Firm Report High Bribery (1-3)



Source: EOS firm survey, WEF2005 – 117 countries. Question: In your industry, how commonly firms make undocumented extra payments or bribes connected with permits / utilities / taxation / awarding of public contracts / judiciary? (common...never occurs).

There are many aspects of administrative reform meant primarily to improve efficiency, not just to control corruption.

Examples:

Civil Service Reform

- **Issue of lateral entry by outside experts (as in New Zealand) in the higher echelons of service. Main block: powerful organizations like the IAS Officers' Association. A package deal of substantially higher salary for upper-end civil servants (in alignment with private sector salaries) along with increased latitude for more lateral entry may be negotiated.**

- **Transfer and promotion (In UP between 1992 and 1998 on an average *every* year about 420 of the less than 500 people in the IAS cadre were transferred). ‘Transfers and postings’ major activity of a minister (generating large opportunities for illicit income) in any state secretariat on a given day. In Karnataka there have been experiments with interesting programmes to discipline and control transfers.**

Reform of Tax Administration

- **As part of economic reform there has been significant rationalization of the tax structure over the last decade or so, but very little of reform in the tax administration**
- **As the study by Dasgupta and Mookherjee shows, there is a great deal of**

- scope for incentive reforms (multi-pronged reforms required to serve typically multiple goals), to be accompanied by wider reforms in the internal organization of the bureaucracy, including changes in information systems, organizational structure, budgeting and accounting systems, task assignments and staffing policies**
- **Much to learn from the experiences of incentive reforms of tax auditors and administrators carried out in Mexico and Brazil in the late 80's and early 90's**

Reform of Public Health Administration

- **Most of funds are for medical care (discussed below in the context of social service delivery)**
- **Public health and sanitation not a major priority in a country with infectious disease burden (measured crudely in terms of DALY's per capita) of staggering**

- proportions—7 times that of China, according to WHO data**
- **In continuation of colonial practice, the administration is geared to taking action (though usually with delay) when a major epidemic breaks out, but not to the systematic following of routine procedures and sustained policy measures of public health and sanitation that you expect in any decent society**

Police reform

- **The British colonial administration chose for India the ‘adversarial’ Irish constabulary model of police administration (which was different from the one in operation at that time in England). After Independence our rulers have continued with the same model, instead of devising a model more in harmony with local communities**
- **The multi-volume reports of the National Police Commission of the early 80’s,**

- containing many excellent suggestions for police reform, continue to gather dust in the shelves of the Home Ministry
- Politicization of the police administration is the major problem in most states. The police are reluctant to touch criminals who are in cahoots with (or are important members of) the ruling political parties.
 - Rule of law only sporadic in India. For common people much of the time politicians are *above* law in practice. Politicians as ‘elected godfathers’, who distribute favours and protection.

Judicial Reform

Data on congestion in lower courts. But there is, of course, a selection bias in the data, as many cases do not reach the courts at all in anticipation of delay.

- The 2003 Justice Malimath Committee Report emphasized slowness in filling judge vacancies, which is important, but for an economist the more important

issue is that of the warped incentive system in place: lawyers and judges have little incentive to reduce delay. Many defendants also have vested interest in delay.

- **For 60% of cases the government is one of the litigant parties, and in such cases appeal is automatic, leading to over-litigation. In many cases one government department is the plaintiff, and another department the defendant, unnecessarily clogging the courts.**

Regulatory Administration

Comparative data on regulatory effectiveness

Regulatory Effectiveness

	India	China
<i>Starting a Business (days)</i>	71	48
<i>Registering Property (days)</i>	67	32
<i>Complying with Licensing and Permit Requirements for Ongoing Operations (days)</i>	270	363
<i>Exporting a Standardized Shipment of Goods (days)</i>	36	20
<i>Enforcing Debt Contracts (days)</i>	425	241
<i>Closing an Insolvent Business (years)</i>	10	2.4

Source: *Doing Business in 2006*, World Bank

Congestion in Lower Courts in 1995-99

	Average Number of Cases Older Than A Year Per Judge
Andhra Pradesh	746
Assam	383

Bihar	559
Gujarat	4,205
Haryana	1,284
Himachal Pradesh	895
Jammu and Kashmir	191
Karnataka	1,547
Kerala	631
Madhya Pradesh	1,044
Maharashtra	1,934
Orissa	1,052
Punjab	565
Rajasthan	1,021
Tamil Nadu	558
Uttar Pradesh	1,261
West Bengal	1,798
Mean for 27 states and Union territories	889
	(s.d. 869)

Source: Data from Ministry of Law, Justice and Company Affairs, Government of India, as reported in M.B. Micevska and A.K. Hazra, "The Problem of Court Congestion: Evidence from Indian Lower Courts", ZEF Discussion Paper no. 88, Bonn, July 2004

- **In the US much of the discussion of regulatory bodies is about ‘capture’ of those bodies by interests they are supposed to regulate. India has additional problems:**
- **At a time when commercial regulations involve increasingly complex issues, many**

- of our regulatory bodies are manned by retired civil servants (often as a sinecure), not by active professionals, who could pose the questions and provide the relevant information on the details in an accessible way and make regulatory hearings more meaningful for the customers
- Most importantly, politicians regularly violate the principle of autonomy of regulators, and take arbitrary decisions on tariffs of regulated public utilities to placate vocal members in their constituency, riding roughshod over established tariff-setting procedures. As a result these vocal members bypass the regulatory hearings, and whenever they have some grievances directly go to the street and organize demonstrations to put pressure on politicians.

Reform in the Delivery Infrastructure of Social and Economic Services

Education (and Health)

- **Rampant teacher (and health clinic official) absenteeism (the World Bank-Harvard study suggests higher pay for teachers, etc. is not nearly enough, accountability is often the key issue)**
- **Poor school infrastructure (including things like toilets for girls which influence their attendance)**
- **Pupil-teacher ratio very high, particularly in the first few grades; majority of rural schools have 2 teachers or less; only 45% of rural schools have any female teacher (parents are more likely to send their daughters to schools with female teachers); even in 5th grade, about one-third of the children cannot read or write, etc.
[see Pratham's Annual Status of Education Report]**

- **Quality of teachers and appropriateness of course content**

The state failure in delivering education sometimes drives children in poor areas to sectarian schools (RSS schools or madrasas).

Similar failures of the state in medical care drive poor people to quacks and crooks for help at great cost.

There is scope for effective community monitoring by public service recipients (led and mediated by NGO's)—as is suggested by a random evaluation study of public health services in about 300 villages in Uganda (Svensson 2006)

But as the studies by Banerjee and Duflo (2006) suggest, community monitoring is often not enough. In other words, problems are not just on the supply side of delivery,

there are also problems on the demand side (on the part of parents and medical care seekers). Through low expectations there is a kind of Say's law in operation: (lack of) supply creates its own (lack of) demand.

Demand-side interventions have apparently been quite successful on a large scale in some Latin American countries (Oportunidades /Progresa programme in Mexico, Bolsa Familia programme in Brazil, etc.) Such contingent transfers are more rare in India.

Vocal sections of economists and columnists of the financial press regularly complain about the large wastage in most transfer programmes for the poor. They often consider them as a colossal waste, which only lines the pockets of corrupt officials and intermediaries involved in these programmes.

First of all, there are interesting ways in which information technology has been used in Mexico and Brazil to identify the beneficiaries and monitor the implementation

which can reduce the extent of corruption (one does not hear about big stories of corruption in these large transfer programmes in those countries). It should be within the capacity of a country like India, which takes pride in exporting software services to the world, to devise efficient technologies for keeping theft to a minimum.

Secondly, we should not forget that Indians live in a welfare state for the rich. According to the NIPFP estimates for a Ministry of Finance White Paper in 1997, the central and state governments together gave out in the middle 90's about 10 per cent of GDP in the form of explicit or implicit budgetary subsidies for "non-merit" goods and services (largely accruing to those who are relatively rich). Some new large anti-poverty programmes are estimated to cost a much lower fraction of GDP. There should be some sense of proportion before we work ourselves into frenzy about the (undoubtedly large and regrettable) waste and theft in the anti-poverty programmes.

There are also differential degrees of public vigilance over (or effectiveness of) different types of anti-poverty programmes, as Dilip Mookherjee and I have found in our study of the nature of leakage from anti-poverty programmes in West Bengal villages under the *panchayat* administration:

- In general in our statistical analysis of the panel data for 89 villages spread out over the whole of West Bengal we found that in the government distribution of ‘private’ goods like IRDP credit or agricultural ‘minikits’ of inputs, targeting was on average substantially pro-poor, and the leakages small.**
- But in the use of more ‘public’ fiscal grants there is evidence of significant local elite capture (both in intra-village and inter-village allocations) and some effect of local political competition.**
- Olken’s similar findings in road projects in Indonesia**

In the delivery of infrastructural services the government programmes (like roads or dams or mining projects) regularly uproot and disrupt the lives and livelihoods of many poor people (often *adivasis*), which catches fleeting public attention from time to time (particularly when celebrities take up the cause).

The record of resettlement and rehabilitation of these displaced poor people is absolutely dismal in India, and our recent history of infrastructural projects is littered with arbitrary land acquisitions, defrauding by contractors, and renegeing of promises to these poor people. It is high time that we institute adequate *on-going* governance mechanisms for involving all the affected people in the decision process right from the beginning, work out appropriate compensation programmes and see through their implementation, instead of waiting for sporadic judicial interventions and lurching from one crisis to another.

We now turn to the two analytical issues of governance I want to focus on.

The first is a central dilemma of governance institutions in a poor country: *a trade-off between commitment and accountability.*

On the one hand.....

One needs institutions of credible commitment to insulate the system from marauding special interest groups and partisan or faction politics. We have already cited many instances of short-sighted political intervention in economic decisions.

In particular, long-term investment projects or economic policy decisions that have consequences over a prolonged period will

not get off the ground without such commitment. (A major example is the lack of political commitment to implement adequate user charges, hurting long-term investment, domestic or foreign, in our power sector).

Even outside the economic sphere rule of law requires the system to display some degree of commitment that civil servants and the police are not at the mercy of ruling politicians.

In the macro-economics literature the credible commitment problem is usually emphasized in the context of central bank independence, but the problem is much wider and deeper.

On the other hand.....

Too much insulation often means too little accountability. This leads to high-handed arbitrary governance, leading to abuses and waste.

Even when the administration is benevolent, large-scale development projects directed from above by an insulated modernizing elite are often

- inappropriate technologically or environmentally**
- far removed from or insensitive to local community needs and concerns**
- failing to tap the large reservoir of local information, initiative, and ingenuity**

These projects often treat poor people as *objects* of the development process, and end up primarily serving as conduits of largesse for middlemen and contractors, and also encourage widespread parasitism on the state.

In a country like ours where much of the economy is in the vast informal sector and dispersed in far-flung villages and small towns, the accountability mechanisms are

particularly important at the local community level.

In some sense the dilemma of *commitment vs. accountability* is best resolved at the local level. If commitment is necessary for long-term projects, it may be easier to persuade the local people to make sacrifices for projects that are to benefit them in the long run.

- more transparency of benefits
- possibly more trust and peer monitoring
- resisting populist pressures may be easier to coordinate

In contrast, individuals and groups may perceive more uncertainty in the trickle-down from future growth arising out of large-scale centrally administered projects, and they may instead opt for the 'bird-in-hand' of current subsidies and short-term benefits (an example: tubewell groups in West Bengal)

Accountability is also more direct at the local level, if the local democratic processes work.

More local vigilance on issues where more local stake is involved (“it’s our money you are wasting or stealing”). Electoral sanctions are more effective at the local level, than at the central level where multi-dimensionality of electoral issues dilutes responsibility.

Decentralization of governance in the sense of devolution of power to local governments was constitutionally adopted in India around the same time as economic reforms. But this particular governance reform as yet remains largely on paper, except in 3 or 4 states.

A large number of local governments do not simply have adequate funds, or the appropriate delegated functions or competent functionaries to do the job properly, sometimes giving decentralization a bad name. Yet there have been some localized success stories.

Again, there is a major trade-off here.

Against the advantages of better local information and more local involvement, there are several problems decentralization has to grapple with

- local capture, as collusion of local elite groups or sectarian interests may be easier than at the central level**
- sometimes more corruption**
- because of agglomeration, more scarcity of administrative talent and technical expertise**

But, hopefully, there is also learning by doing in local democratic processes.

Much, of course, depends on the initial levels of inequality (both social and economic), and how lop-sided the nature of political competition is at the local level.

More empirical studies are called for in finding some pattern in the general

determinants of how the trade-offs work out under different socio-political environments.

Also, most of the case studies so far relate to rural *panchayats*; there is very little work on urban municipalities

- **Anecdotal accounts like the better handling of monsoon flooding in Chennai compared to Mumbai, with the former city having more power devolved to locally elected representatives**
- **Rating of urban services by the Public Affairs Centre in Bangalore apparently quite effective, etc.**

Finally, I shall comment upon the **collective action problem in moving to a new governance equilibrium.**

For many years I have considered the overarching social and political problem in India to be one of collective action:

even when we know what is to be done, we somehow cannot get our act together.

There are two kinds of collective action problems involved:

- **one is the well-known free-rider problem about sharing the costs of bringing about change**
- **the other is a bargaining problem where disputes about sharing the potential benefits from the change may lead to a breakdown of the necessary coordination.**

The collective action problem has been discussed in the political economy literature, both in the micro and macro context.

In the micro context there is a substantial literature on the determinants of successful collective action in management of

environmental resources (forests, fisheries, irrigation, etc.)

In the macro context there is a literature on the public fisc as a common pool, where the grabbing hands of special interest groups lead to fiscal crisis as a kind of ‘tragedy of the commons’.

What is under-researched in this literature is the relationship between heterogeneity and inequality on the one hand and collective action on the other.

For several years now I have been working in this area, both on theoretical and empirical aspects.

Digression: on why I believe India is one of the world’s most heterogeneous and unequal societies.

And this may have affected our ability to resolve the acute collective action problems in changing the governance institutions.

Our limited ability to persuade the general population to bear the short-run costs of long-run economic reform has much to do with the prevailing social heterogeneity and economic inequality, which makes cooperative problem-solving efforts difficult.

The severe educational inequality in India, for example, makes the absorption of shocks in the industrial labour market more difficult, to the extent that education and training provide some means of flexibility in readjustment. As a result the resistance to the competitive process that market reform entails is that much stiffer in India, than in some other countries.

That collective action problems in orchestrating institutional change from a low-level to a higher-level equilibrium are rendered particularly difficult by distributive

conflicts are now slowly being recognized in both the macro and microeconomic literature.

In macroeconomic comparisons of East Asia and Latin America in the last quarter of the twentieth century the point has been made that when wealth distribution is relatively egalitarian, as in large parts of East Asia (particularly through land reforms and widespread expansion of education and basic health services), it has been somewhat easier to enlist the support of most social groups (and isolate the extreme political wings of the labor movement) in making short-run sacrifices at times of macroeconomic crises and coordinating on stabilization and growth-promoting institutions and policies

Below the aggregative or macro level there are many local self-governing institutions, e.g.

- elected local government bodies in charge of delivering local public goods (like roads, extension**

service, and public health and sanitation)

- **rural community organizations in charge of management of local environmental resources (like watershed management groups, *pani panchayats* or *van panchayats*)**
- **urban neighbourhood or *mahalla* associations (in charge of crime-watch or cultural-cum-social solidarity promoting activities)**

In many of these cases distributive conflicts lead to governance failures. In areas of high social and economic inequality the problem of ‘capture’ of even elected local government bodies by the local elite can be severe, and the poor and the weaker sections of the population may be left grievously exposed to their mercies and their malfeasance.

In other cases, the problem of elite capture may be less, but that of elite ‘exit’ is quite serious in causing the erosion of political support from the provision of local public goods. When, for example, the rich do not send their children to local public schools and do not use the local health services, the public provision structure often crumbles as is familiar in both rich and poor countries.

Similar problems, arising from inequality, may afflict local non-government, often informal, community organizations in developing countries.

For a brief survey of the theoretical and empirical literature on the relationship between inequality and collective action (both in the sense of participation in a regulatory group organization and that of contributing to provision or conservation of some common resource), see Baland and Platteau (forthcoming).

Here let us generally note that there are many cases where the net benefits of coordination for each individual may be structured in such a way that in situations of marked inequality some individuals may not participate or contribute to the cost of collective action, and the resulting outcome may be more inefficient than in the case with greater equality.

Inequality may also lead to bargaining disputes arising from the distribution of benefits of collective action, as we have mentioned before.

Besides, the negotiation and enforcement costs for some cooperative arrangements may go up with inequality. In such situations collective governance structures and opportunities for cooperative problem-solving may be foregone by societies that are sharply divided along social and economic lines.

So our governance problems are in some sense deeply implicated in the distributive conflicts in our society

This suggests that efficiency (in governance) and equity may sometimes go together.