

## The Challenge of Governance in India Today

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# The Challenge of Governance in India Today

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## Abstract

This paper attempts to delineate the possible role of governance oriented reform in India today. We raise conceptual and historical difficulties with the notion that sees governance failure as the cause of poor economic performance. We discuss why there are certain regularities in the occurrence of good governance, distinguishing the same from 'functional governance' which aids and abets industrialisation. Next we go on to discuss the interlinkages between institutions, economic development and governance in India, and why internal attempts at reform thus far have failed.. Finally we bring out the current failures in governance that are actionable and suggest that they are largely corrected by changes in economic policy and some institutional initiatives. Attention to governance as such is warranted only to build organisations and initiatives for commercialisation and privatisation, and for appropriate changes in the law and in the development of frameworks for regulation and contracting out.

## INTRODUCTION

The tendency to ascribe to bad or inadequate governance the failure of development policy, has become nearly universal. It seems development finance institutions (DFIs), multilateral agencies (MLAs) like the World Bank and the Asian Development Bank, and policy makers have all come to the 'conclusion' that 'poor governance', like a multiplicative factor, reduces even the best policy and prescription to naught. One can dispute this contention in many ways. Since all acts of omission and commission, poor design of institutions, their improper working can be considered as governance failure, the contention is neither an explanation of development failure in a causal sense, nor particularly useful from the point of bringing about change in economic performance (or even of governance). The notion of governance failure has to be narrowed down and carefully understood. As a truism it has the danger of masking our inadequate understanding of societies and economies, or even our unwillingness to understand the specific features of particular societies. Talking about poor governance without worrying deeply about the conditions that engender the same may also hide an unwillingness to examine the policies and development approaches, critically. In this paper we finally come to the conclusion that the leverage point for correcting governance failure lie in policy and politics. In a more restricted sense of being able to set up the correct institutional arrangements, rules and incentives for economic behaviour, actions focussed on governance has a special autonomy and a more limited role.

This paper attempts to delineate that role today in India. In the introduction we raise the conceptual and historical difficulties with the notion that sees governance failure as the cause of poor economic performance. Next we discuss why there are certain

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### **Governance - Cause or Effect**

Governance through the system (of government and its parastatals) is more often than not, not the 'leverage' point for change, but has to be effected by simultaneous changes in other dimensions of society - economic policy, politics, and law. The contrary position only begs the question since how does one bring about better governance than by appeal to 'political will' a much abused term?

It is important and of utmost relevance that the 19th Century despite no MLAs or DFIs saw many more countries making their industrial transformation<sup>2</sup>, than the Twentieth. Indeed, the only successful independent transformations that can be said to have begun unambiguously in the Twentieth Century are those of the East Asian Tigers (South Korea, Taiwan, China, Vietnam, Thailand and possibly Malaysia), where the role of MLAs was marginal at best. The Soviet industrialisation which was successful has now fallen and is in the process of acquiring a more sustainable capitalist character. These facts should open the minds of policy makers to the possibility that DFI's and MLAs may have been quite wrong in their approach to development. Certainly the hope that with actions at the international level, development can be engineered faster than otherwise has been dashed. Otherwise the twentieth century should have seen nearly all countries (except perhaps the African) to being well on their way to the industrial transformation. It is important to note that good governance as conventionally understood - fair, transparent and accountable - was not a necessary characteristic of successful countries at every point in their history.

### **Corrupt Societies Have Also Transformed**

The US in the twenties or earlier was a very corrupt society. So is China today. Despite that it grows very fast. So have many other societies been during some part of their history<sup>3</sup>.

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<sup>2</sup> The industrial transformation, the second major social revolution after man emerged is fundamentally so<sup>7</sup> and without it no society (other than through rents and transfers) can aspire to high and increasing incomes. There is nothing like sidestepping industrialisation for a society of any decent size despite the opportunity to leap frog and avoid particular industries, that the emergence of the services sector as one in its own right brings about.

<sup>3</sup> We know that industrialisation is a messy process; and good governance, as we understand it today was neither a necessary nor a sufficient condition. Indeed, the early

Corruption in societies does present a pattern of sorts. With a critical level of development it seems to fall, sometimes very dramatically. Corruption came down rather suddenly in the US after the Twenties. The jailing of Al Capone in 1932 may have been the turning point in the change in the US to a relatively corruption free society. Today, China is putting down corruption with a firm hand<sup>4</sup>. Taiwan and Korea today value cleanliness in public life far more than they did in their immediate past. The early years of industrialisation do seem to be more corruption ridden and prone to governance failures than the post-transformation phase. So is it the case that the importance or otherwise of governance, and possibly of its dysfunctionality (or otherwise) an aspect of the phase of development? And so negating a priori, any universally valid relationship between 'good governance' and development?

### **Another Word for State Failure?**

The Gerschenkron notion that the later a country industrialises the 'greater' has been the role of the state (Gerschenkron, Alexander, 1966), is again a historical regularity that has held up to date. So far there has not been a single violation of this regularity. Therefore, is the insistence on good governance as a pre-condition to the efficacy of development policy a round about (and confusing) way of admitting the Gerschenkron theses by main stream economists? When the insistence on governance is so intense as it is today, then logically the state of which it is an aspect<sup>5</sup> ought to be at the centre stage. The debate on state and market failure has led to deep insights into the factors of success in East Asia, and failure elsewhere. State failure has been cogently developed in the literature, wherein the class base of the society, the particular orientation of the bureaucracy, and the policies pursued, and the appropriateness of economic instruments of control have been related to present cogent stories. We draw much from this literature.

### **Prosperity Inequality and Governance**

Today the 'causation' is assumed to be from governance to development. It may, and often does, run the other way too, as numerous examples from history will show. China after going thorough a phase of high corruption, poor (but nevertheless functional) governance is now cracking down on corruption. Is it that with 'middle incomes' the value of good governance has gone up? And hence its pursuit? Similarly, was the sudden change away from corruption in the US during the 1920s the result of economic compulsions arising out of the high and wide spread growth of the 'roaring twenties'.

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period of industrial transformation has typically been one of contests, and class struggles, wherein 'rent' or plunder are barely distinguishable from capital.

<sup>4</sup> Over a few thousand corrupt officials and people have been jailed or sentenced to die during the last few years in China, on charges of corruption. See Box on Corruption in China. See also Zhao Dengju (2000).

<sup>5</sup> Even corporate governance is determined through frameworks, policies and actions of the state.

As incomes rise for all with the industrial transformation, and when the bulk of the people cross a certain level of income (and are satiated in a basic sense), their ability to be concerned about immediate 'non-economic' aspects of life - relationships, orderliness, access to public facilities and fairness improves. Whereas below this level the struggle is for survival. With a decent living people's ability to resist the 'unfairness' and waste in public bodies improves. In China and South Korea with very little inequality of incomes such a phase has come very suddenly.

In South Asia and Latin America with pronounced income inequalities even when the rich are well beyond that threshold level of income most others are not, so that there is no point in time when a sudden change is discernable. Visible poverty coexists with affluence. Ghettos, a vast services sector, urban sprawls and slums along with isolated and protected private clean spaces result. 'Good governance' in such situations of extreme deprivation may then merely mean states and public institutions being responsible to the rich and the upper classes, and so may be highly oppressive on the poor, who are in the majority. Standard notions of the dimensions of good governance - participatory, transparent, and accountable - may be limiting. Only propertied citizens, (but not to people in general)<sup>6</sup> may be able to take advantage of such good governance. The aspect of class is of particular concern in India because of the extreme inequality of incomes. It brings in a whole new dimension to governance. It makes any meaningful characterisation of governance inseparable from the nature of the state and its class basis. Even in democracies where theoretically the poor have the same political rights and privileges as the rich, the economic rules to corrupt and distort, to ritualise many political processes like participation. Stability, to such discordant societies is provided by an 'escape route' for sections of the politically ambitious (climbers) even among the poor. Thus, powerful 'big-men' in democratic Kenya, India or Bangladesh quickly amass wealth by controlling the levers of power. And this small window that allows a few (outside the elite) to convert political power into wealth has been well recognised as a characteristic feature of such societies<sup>7</sup>. That process, an important aspect of which is corruption of public offices is very visible, attracts media attention and is much discussed. And derided and felt to be a blot and a shame on society. It is actually a process important to the survival and continuation of the elites' hold over a vastly in-egalitarian society. This kind of politics cannot be corrected by urging politicians not to be corrupt. As law makers it is easy for them to create laws with loopholes that make the space for them to indulge in corruption. The cure actually lies in growth and development, which in taking people above a certain level of income quickly would create the right atmosphere and basis to stand against corruption.<sup>8</sup>

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<sup>6</sup> Our contention is that, therefore growth which takes all people above that survival level of income has to have primacy over all else in capitalist society, as the goal of policy and practice in all poor countries.

<sup>7</sup> Mamdani, Mahmood (1976), Leys, Colin (1975), Shivji, Issa (1976)

<sup>8</sup> One may ask: How can growth take place when such politicians stand in the way of good policy and its implementation? While there is no doubt some influence of this corrupt behaviour on the policy and economic management, our contention is that at this juncture, all that the corrupt politician demand is an 'illegal' share. It is possible for wise policy to result in high growth, so that the costs of accomodation can be borne. The 'rents' that they would collect while no doubt unfair and possibly illegal would if invested make this 'outside' politician a capitalist. The resulting governance and state

Meaningful good governance is very difficult in such discordant societies. In such societies which is also truly democratic (like India) (a rarity since discordance is usually managed by authoritarian regimes), the fact of political corruption and anomie, should not lead to the policy maker losing hope. The point really is to look beyond corruption, to the leverage points for change in society. These lie principally in getting the initial conditions right - a population with all having some (minimum) endowments, so that he can participate as both a producer and a consumer. Today that would mean land reform or security of tenure. It would also mean appropriate macroeconomic policy that gives primacy to growth. In short policy and politics become the drivers. In a more limited sense though institutional change, design of better organisations and rules are an opportunity today in India, since there is a broad consensus that reforms should continue. Only with a more egalitarian income distribution can governance hope to be both functional and good.

## **INSTITUTIONS ECONOMIC DEVELOPMENT AND GOVERNANCE IN INDIA**

### **Prior Institutional Development in India**

India which started out with nearly all the institutions (largely inherited from the British) current in advanced societies, but limited to serve only a miniscule proportion of its population, failed in the apparently 'easy task of simply extending the domain and access' of these institutions to the whole of society. Today we know that in India such extension has been more formal than real. In contrast, East Asian societies starting out without the 'institutional benefit' of the 'colonial yoke', was able to create institutions as they went along and as the need arose. This raises the question: Can the early existence and growth of institutions, much before their 'need' in an economic sense, prove premature and reduce the prospects of the transformation. Possibly yes, if the history of South Asia in the second half of the 20<sup>th</sup> Century is any indication.

### **The Failure of India**

India had all the ingredients by way of 'rules', institutions and organisations in spheres such as law, politics, participation, administration and governance, which few other non-industrial countries had. It also opted for universal franchise and a 'fair and true' democracy, which meant that most of the inherited institutions and more had to be extended to cover the entire population. Did the costs of such extension prove backbreaking for the immature economy? Could these have in any case been avoided? We must recognise the massive bureaucratic overburden that has resulted, with the economy having to support an extensive state apparatus that in form is concerned with institutional development<sup>9</sup>.

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system would be functional but not fare. Thus we would caution those who want to change governance to work through the economic.

<sup>9</sup> Yet, there is no denying that had economic growth been as rapid and broad based as was envisaged by the planners and the founding fathers of the nation, then this burden may perhaps have been not as onerous as it is today. Could the prior institutional development then have then been an asset? Perhaps so, and in that case India may

India because of its 'failed' economy cannot in reality (although in form the claim can be made) of being successful even in the political front. The political and social institutions tend to show the form of success and correctness but not the content and substance: "Constitutionally provided" decentralisation but negated by government rules, orders processes and controls, and overstaffing; caste equality enshrined in the constitution but violated every hour in some corner of the country. Equality of opportunity, but poor children out of school, and others not so poor exploited in Bihar and UP by a 'rapacious' private sector because public schooling has all but collapsed. Indeed, an entire enterprise has evolved within and outside government whose task is to manage the contradictions between the formal political and social development on the one hand, and slow economic development on the other, and the resulting non-realisation of political and social development in substance. Thus for the state it is important to tell the intelligensia and the middle classes that it (the government) is doing something about poverty and the environment; that it provides scholarships; that it has hundreds of special and targeted programmes, that there are many thousands of NGOs working in the villages and elsewhere, and that there are free hospitals; free water supply; and that all are equal before the law. In truth though despite all these efforts India has very slow growth in per capita income barely doubling over a thirty year period. (And not because of a high population growth as many believe to be). It also has one of the worst records with respect to the environment. Bright young boys and girls are systematically excluded from good education given its highly elitist character (despite the activities of charitable and religious organisations). The leakages from government programmes are so large, ranging from a minimum of 30% to as high as 98%, that such programmes are more usefully (and correctly) seen as programmes that serve to buy up potential dissent among the excluded and deprived. Despite the 'free' hospitals people even the poor spend vast sums on medical care, the health status and morbidity of the Indian is among the worst in the world. We have tragically (and shamefully) the highest incidences of avoidable diseases like blindness and mental retardation due to vitamin deficiencies (!), leprosy, TB, typhoid, malaria, rheumatic heart injuries to name just a few. Suspects (when they have no contacts within the police bureaucracy or higher up) are regularly beaten black and blue, since the Indian police is unaware of any other method than 'confession as the queen of evidence', while drunken driving by rich brats resulting in deaths go unpunished. The cops themselves help in erasing evidence!

The institutional school would explain economic performance in terms of institutional inadequacies or their lack. It is true that the two are intertwined. And any snapshot picture of the situation of poor economic performance would reveal inadequate and missing institutions. But this does not mean that institutional failure was a cause of poor economic performance. In fact poor economic performance, which made competing groups and interests focus their attention on how the 'cake was to be divided' i.e. on redistribution rather than growth and transformation, lead to the populist politics and the corruption that has now virtually destroyed many institutions. We will examine how given the mess, the attempts to correct the same through

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well have been able to complete both its economic, and social and political transformations simultaneously! Today East Asia (including China with its economic transformation just round the corner) await their political and social transformations with a very good chance of completing both.

'institutional efforts' have usually failed in the past. Nevertheless in a limited sense, and because of reform having made significant progress, it has created the space for institutional change and governance improvements to be succeed. With time if nothing is done, that window of opportunity would close.

## **FAILURE OF ENDOGENOUS ATTEMPTS IN INDIA**

Thus the first Administrative Reforms Committee under LK Jha made very valuable recommendations even though in the light of present day understanding of the bureaucracy they look rather staid. They have the limitation of being purely an administrative approach to improve administration, rather than any major shift such as bringing in an increased role for the market. Nevertheless most of the recommendations were not taken up and the few that were, were ritualised to a point where no real difference was made. Similarly there is a Department of Administrative Reforms and Public Grievencies. What they do is hardly known to citizens or even to most government officials.

Similarly other administrative and organisational reform has been attempted many times in India without much success, pointing to the entrenched nature of the dysfunctionalities, and their basis in the nature of the state, and the overriding dominance of the bureaucracy without a concomitant accountability<sup>10</sup>. The measures recommended for change, whatever the intentions or assumptions of their original designers, mutated and got ritualised to end up reinforcing the mess that was sought to be overcome. MoUs (Memoranda of Understanding signed between Public Sector Undertakings (PSUs) and government, the mechanism of the holding company as a buffer between PSUs and government were all instituted to reduce dysfunctional interference of the government in PSUs, and thereby to give managers the requisite autonomy and accountability for performance improvement. They worked elsewhere, notably in France, but in India they got ritualised and continue to exist on paper with no real effect whatsoever in distancing PSUs from government. See Box: Institutional Efforts for PSU Management Fail.

### **Political Economy of Design Failure**

Many other 'fine institutions', well crafted have deteriorated. Examples would be the state schools education machinery, health 'delivery' systems and government purchase (including defense purchases<sup>11</sup>). Why? Deficiency in design is only a part, probably a small part of the explanation<sup>12</sup>. It is more likely that the overall environment of corruption and rent seeking, very little need for accountability given the nature of defined government processes and rules, the politics of displacement between authority

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<sup>10</sup> The lack of accountability resulting from the structure of the bureaucracy, the civil servants significant power, and their relationship with the political executive is well understood. We cover some of this when we discuss the failure of the Panchayats later.

<sup>11</sup> This is not based on Tehelka, but on the author's own professional study of the system of purchases for the armed forces of such things as uniforms, tentage etc.

<sup>12</sup> The solution though may still be in correction of these deficiencies when there is a strong motivation (pressure and now) and willingness to change!



and responsibility are the underlying root causes. Also the open invitation to corruption as in 'lowest cost tender', without feedback and punishment of errant bidders, no processes to blacklist such vendors have been responsible for heinous crimes being committed in public hospitals. This has been brought out by the Lentin Commission Report. Correcting such "bloomers" in design involve change at the core of government processes, hardly possible without a movement, and strong economic and political pressures to correct them.

### **Dysfunctionalities of Worthy Institutions**

Similarly, in the context of public management we do have the institution of the Controller & Auditor General (CAG) whose job is to selectively audit the use of public money, i.e. inter alia perform 'CAG' audit of PSUs<sup>13</sup>. Its functioning has rarely brought out cases of the big misappropriations and corruption. But most managers would generally agree that it has restricted entrepreneurial initiatives in PSUs, to the point of rendering managers impotent. Despite audit, the corrupt can always get away by covering their tracks. Today Vigilance has emerged as a major constraint to entrepreneurial initiative in the PSUs. It is not so much the case that the institutions of the Controller & Auditor General and the Chief Vigilance Officer (CVO) and the roles they play are per se dysfunctional in a democracy. But given the failure of the other systems, that have resulted in pervasive governments' interference at the operational and managerial levels in PSUs. Neither audit nor vigilance is able to work without at the same time creating large costs within the system.

The general point is that mere institutional forms, even the best forms, without underlying change in the politics and in the environment of the organisations whose improvement is sought, is of no avail. To be effective the very existence of the organisation and the status quo has to be threatened<sup>14</sup>. So in a policy sense addressing governance directly without at the same time creating the political and economic conditions is pointless and a mere ritual. (We will argue that unlike in the past, some sectors today those conditions exist or are just about to be realised, so that worrying about governance and design at this juncture is useful. Thus liberalisation, the budgetary squeeze on state owned enterprise all create the right conditions for correcting design errors).

### **MODE OF SUBSIDISATION AND CORRUPTION**

The reform process thus far has eliminated the vast rents that were generated through licenses, controls and shortages. This does not mean that rents are not generated today. Poor administration of subsidies, contracts not in the public interest, and residual shortages especially in infrastructural services continue to remain feeding corruption and governance failure. We conclude the section arguing that only with the policies that

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<sup>13</sup> This is in addition to commercial audit under Company Law (statutory audit).

<sup>14</sup> This is a fairly universal phenomenon. Large organisations public and private (when not run by a small group or an individual), or in other words, bureaucratic organisations have rarely responded to opportunity. It is 'threats' that have had success in bringing about organisational change. The detailed case study of the Imperial Chemical Industries (ICI), U.K. brings out all the nuances (Pettigrew, Andrew .....).

removes the scope for rents and with the correct modes of delivery of subsidies can governance improve.

Today subsidies are under attack, and there is much consciousness among reformers that they need to go. I had argued that more than sharp reduction in subsidies a "stepping stone solution is called for." In shifting from the existing modes of subsidisation to direct subsidisation not only can the leakages be plugged and the condition for governance improvements be realised, but reform can become decoupled from the bind of subsidies. Herein we take the case of electricity and argue the point already made, in greater detail.

The discussion on the oil sector (Box: Creating Governance Failure in the Oil Sector) brings out the mess that has come out of the current mode of diesel and kerosene subsidisation. In moving from current modes to direct subsidies, there would be much support for politicians who truly represent the interests of farmers. It is in the realm of political possibility. Nothing could help major infrastructural areas like electricity, water and irrigation then direct subsidisation.

### **'Agency Failure' Due to Different Prices**

The current mode of subsidisation (financing the deficit of SEBs by transfers or simply allowing them to mount) creates an 'invitation to corruption that is surprisingly not universally recognised. Thus the SEB managers report high T&D losses when a large part, usually more than half, is theft or leakage, where the manager himself is involved in under the table sales to usually small industrial consumers, and rich households using air conditioners as in Delhi. Similarly, SEBs over report auxiliary consumption. Perhaps more importantly the manager over reports sales to the subsidised sectors when in reality he would have sold to industrial consumers, and created rent equal to the quantity so sold times the price difference<sup>15</sup>. This is a situation of rents with losses (Pandey, Ajay 2001). The leakages that so result are very large. Thus, in Gujarat in 1995, had the leakages been plugged, the GEB should have shown a profit of +20% on equity rather than a loss of 20% on equity! In other words unlike the belief of many consultants, the problem with electricity prices is not that on the average they are very low, but of irrational pricing. A pricing which creates the 'open invitation to corruption' in the delivery systems. Both irrationality in the price structure and the leakages can be stopped with direct subsidisation.

### **Direct Subsidy and Reform**

With direct subsidisation the electricity company (SEB or its inheritor) sees uniform prices (regulated or part determined in the market for wholesale power), since the subsidised customers would pay with coupons (encashable) and with cash above their entitlements. All zones or circles except the very remote and sparse ones would become viable for private investment, and reform could take off overnight in various ways - reform by mere corporatisation of SEBs, by privatisation of distribution-cum-generating companies, or through markets for wholesale power. The company, within the ceiling imposed by the regulator, could offer differential prices based on the need to maximise

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<sup>15</sup> These were brought out in detail in Morris, S. (2000), Chapter 6.2 in the Morris, S. (2000).

his profit. Possible outcomes are low prices for agriculturists since many of them would not mind consuming electricity at off-peak hours. Similarly industrial customers with the ability to shift demands to off-peak hours could get electricity at very low prices.

### **Invitation to governance failure and corruption**

In the IIR2001 I had argued that reform in the electricity sector has to start with direct subsidisation of the farmer and other subsidised sections. Direct subsidisation was expounded as a system whereby farmers and others once identified could be regularly issued coupons through banks and post offices equal to their fixed entitlements, allowing them to purchase electricity from distribution companies. As a result, it is possible to separate the subsidisation and reform of the sector (otherwise caught in a Catch 22 situation), and address both issues independently. Politically it makes sense on the part of reformers to not ask for a removal of subsidies - always very difficult - but to attempt to right target subsidies. Such a change in strategy would bring the politically mighty farmers on the side of reform. And the vast gains out of reform would allow the burden of subsidies to actually go down. It was argued that such a move is not only desirable but also necessary for reform to make progress. The current proposals to directly make good the subsidy claims of State Electricity Boards (SEBs) or their inheritor organisations obviously creates an incentive to over claim and over report subsidies, which finance departments or regulators can hardly cross check. This motive would remain even for private companies, even if they have a motive to reduce and plug leakages. The difference would be that leakages would have been internalised. Additionally, such subsidisation removes or minimises the distortions in the use of electricity. And we had also argued that if all farm subsidies are bundled and made available for various inputs, with the farmer exercising choice, then the vast distortions in the cropping pattern, in input use and especially in misuse of scarce water and land would be reduced or eliminated. The gain to the economy would be stupendous, and to my knowledge has not been adequately addressed by agricultural economists.

### **'Arbitrage' Opportunity**

With such a large 'arbitrage opportunity available to SEB managers, why should they not succumb to the temptation? Indeed if a few take advantage of the opportunity, with little or declining risks of getting caught, such corruption spreads like wild fire to become the dominant pattern, to appear almost like a characteristic or a propensity. 'Indians are corrupt' or 'all government officials are corrupt', when indeed the problem is one of the system rather than at the individual level. No is the problem that of culture. So-called cultural 'explanation' to<sup>16</sup> many things economic, is cultural in most cases vacuous, and cannot lead to a solution.

### **Rents in Other Subsidies**

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<sup>16</sup> A 'cultural explanation' of corruption or governance failure can only lead to the impotent position of 'changing the culture', something practically impossible. As a process cultures change much after the economic has changed - rewards and punishments incentives information and control.

Besides these cases of electricity and oil retailing (See Box), there are many others of policy failure that have now resulted in powerful vested interests. Among them are food-subsidies through the so-called 'public distribution system', fertiliser subsidy, irrigation pricing. In all these it is not the desire to subsidise or provide the incentive per se that is the big problem, as much as the way it was done, i.e. of design. The failure is therefore intellectual rather than one of implementation, and as such the policy makers, or rather the detailers who are to be blamed. And here the responsibility falls squarely on the upper rungs of the bureaucracy. The politician in India has been forced to carry a lot more of the blame for the current mess, than is legitimately attributable to him. The bureaucrat and policy maker by their intellectual laziness bear responsibility for converting what would have been accommodation of various 'legitimate' interest groups, into opportunities for rent and graft. Where the future opportunities for rent and graft anticipated and hence provided for as some would claim? Not really such a position would give too much foresight to the bureaucracy of the day. Talking to senior and now retired civil servants who were intimately involved in the electricity and fuel sectors, the mistakes were genuine. Correction though has now come up against the wall of vested interests.

### **Distortions Don't Cancel**

This tendency to overcome rather than correct a past mistake, with another measure (which would therefore in due course become another mistake), is rampant to policy making in India. In fact, the system values officers within the bureaucracy who can provide such 'compensating solutions', a point I had made in the last IIR (p 9, 2001). This trap of 'overcoming' one distortion with another is so ingrained in our minds that we are not even conscious of the real options. Even the media is unable to step out of that paradigm. The intellectual architects of the mess of electricity pricing or fuel pricing now after their retirement continue to be very 'successful' advisers of reform creating further mess, (but sweeping them under the carpet) as they go along. The trifurcation of SEBs on paper merely to get an ADB loan, the Orissa model of reform, the current CNG solution to pollution in Delhi, the 'coverage of subsidisation' and 'subventions' to the GEB (and other boards) by the state governments are all examples of application of this approach. As we go along we would suffer their consequences. Thus it is obvious today that if direct subsidisation or better subsidy administration were to come about there would be a quantum improvement in governance. Similarly, in a market economy, interventions that recognise the constraints (and the opportunities) in the market would also result in major positive changes in the environment for the improvement of governance.

### **SHORTAGES AND CORRUPTION**

Unlike in oil products or in electricity, the administered prices in other crucial products such as cement, paper, steel and non-ferrous materials were accompanied by control orders. Control orders served to manage the shortages that would be natural in non market prices. Thus 'approved' construction could hope to get steel and cement allotted at controlled prices, while the rest of the economy went either without these or had to pay ransom prices for these (other wise mundane) products. The resulting impact on the economy and society was dramatic. Governments had to develop the allocative machinery that was to do the job 'fairly' and also to appear to be 'fair'. The bureaucracies that came about to manage the shortages were very large. Thus in steel

allocations alone, a few thousand people may have been involved. More importantly in vitiating the controls or the rationing system rents were created. The marginal value of housing is considerable in situations of shortage, and the rents which cement and steel traders could extract out of the middle classes who could afford to build houses were considerable.

### **Licensed Shortages and License to Corrupt**

There was a time when nobody (other than institutions and public organisations) could get cement without a contact with someone in government, or by bribing officials. What was true of cement and steel was also true of many other basic materials like paper, furnace oil, many chemicals, which were administratively priced and allocated. In other goods and services which were also controlled (either on price or capacity or both), but where automatic rationing through queuing was possible, the scope for petty corruption was enormous. Numerous examples come to mind - scooters till the mid-eighties, railway tickets, food until 1972, movie tickets till the end of the seventies. Telephone connections till the liberalisation of the 90s, electricity connections even today in rural areas and small towns, water supply and sewerage services, bus services. Where the markets could adjust with fancy prices, such as in imported goods the damage to the society was perhaps limited to the rents that were generated out of a license awarded to a favoured few, or the returns to smuggling. It is where rationing or queuing was necessary that the greatest damage was done, since all people waiting in the queue would have an incentive to try and get some of the product by bribery if he could afford to. The administrative machinery would be able to extract rents since the cost of waiting or denial, to many, would be considerable. Such conditions when they continue long enough can corrupt practically all in society, except the 'stupidly' honest person. See Box: The Indian Experience

Most of us do what our neighbours do, which is why accents, trends and fashions are possible in society. If a person's probability to commit a corrupt act is a positive function of the number of his friends and neighbours who are corrupt, then in a situation with vast rent opportunity, long queues and shortages, it is only a matter of time before public moral standards fall and a so called 'corrupt culture' emerges. Nearly all Indians would have given a bribe to a train ticket examiner or a village talati. The connected elite of Delhi would not even think that they are doing something wrong when they fix up for a fee somebody's business with the government.

As the control and allocation raj gave way in most manufacturing sectors, the problem of shortages and denial has been overcome. The cement decontrol that happened in the mid-eighties overnight brought about massive expansion in output, lower prices and competition in the sector. Today, personal bank credit, which was officially completely denied (or one had to find an accommodating bank manager who would pass off the personal loan as a lending to the small scale industry), is now available for the asking.

### **Infrastructural Shortages and Denial Remain**

But in many infrastructural services, especially those consumed by the poor, the denial and shortages remain. It is easy to say that second class rail travel is under priced and hence there are shortages. But true costs of passenger travel may not be substantially higher than what it is at present. Even at double today's prices shortages would remain,

since much peak season travelling is need based. In railways, bus services etc, where downward price elasticities are low (upward, travel for pleasure, price elasticities may well be large). Some is true of drinking water. In such sectors the adjustments are made through inhuman overcrowding and congestion that the 'unreserved' traveler on railways and buses has to bear. Petty corruption naturally result since advance planning by definition cannot work for all when there is a shortage. Even more importantly in all municipal services but especially school education, water and sewerage, sanitation, street lighting, and roads denial and shortages continue, and result in corruption and neighbourhood competition. Many of these services being basic can therefore be exploited by the 'unscrupulous' (goons who organise slums, provide 'protection' and regulate water and toilet access) or touts in railway booking offices, to extract rents out of the poor and those denied. Price elasticities are very low over a certain range, so price adjustments when possible are very large, enough to have (negative) income effects on the poor. Thus water market prices in areas of cities denied with adequate municipal supplies, slums and the outskirts have prices almost close to the willingness to pay and often typically many times the cost of production of these services.

### **State Failure Compounds Market Failure**

Education, especially quality school education extracts large rents from all including the poor and the lower middle classes. A small shortage of a good 'english teaching' schooling makes parents run from pillar to post and victims of donation taking and high fees in the 'new' schools. An earlier era of 'chauvinistic', rather than need based expansion of public schools, and near total state failure on this aspect in Bihar and much of UP has ensured such a state of affairs.

### **Creating the 'Culturally' Corrupt Society**

Unlike the high corruption of the contracts variety - a la Bofors or Tehelka - the corruption that an economy of shortages and administrative (non-transparent allocation) breeds is widespread and becomes almost universal. Even children are not free from experience of corruption, as when a tiny tot realises that her parents had to give a hefty donation to the headmistress, or use her big uncle's influence to get her to the school. In society this petty corruption is often used to justify more dastardly acts of corruption. Thus an IPS officer when after a few years of struggle to keep himself above the morass, finally gives up, he would use the argument that even his upright brother had to depend upon him to get that railway ticket or that ration card. MLAs and MPs have quotas for gas and petrol bunk allocations, and earlier for telephone connection. There are 'VIP' quotas on trains, quotas for certain worthy categories of citizens like doctors and shopkeepers. And higher level employees of organisations providing services have their own quotas to allocate. When these are priced and sold for a fee as in the case of gas connections, then the damage to the moral and social fabric of the society is less, than when administrative discretion is actually used. Imagine a mother desperate to visit her ill son in a distant part of the country having no option but to cringe before a politician or a bureaucrat to get that emergency quota released. Such processes only reinforce the notion that only 'contacts and administrative and political power' matter in society, and therefore not one's work and rights. The notion of rights gets therefore muted, in all meaningful spaces of one's ordinary existence. The pent up denial of rights can sometimes spill over on to the symbolic and political levels in a much destructive manner. This is not healthy for any democracy. It allows demagogues

and charlatans to symbolically (rather than in substance) address the problems of the people. Thus Indian politics in caught in the rhetoric of symbolism, and in the complex web of contacts (the actual reality that cuts across party lines). A sustainable but expensive democracy results, were (harsh) realities do not matter because they are actively kept 'hidden', or ritualised to create sympathy rather than anger, reportage rather than analyses, and protest rather than revolution.

## **CONTRACTS REGULATION AND GOVERNANCE**

### **Inappropriate Contracts**

The archetypal story here is that of Enron which had been dealt with in the last IIR and is also covered in this report. But our argument and that of several others including that of Sant, Dixit & Wagle (1995) and Abhay Mehta (1881) who perhaps were the first to highlight the same, is that the IPP framework (despite the aspect of competitive bidding after a few 'fast track projects were pushed through) has been flawed. In the last IIR and in the Infranet Conference December 2000 we had called for an immediate ban on all further IPPs and a withdrawal of all negotiations then on to bring potential IPPs to closure. Instead, we had argued for a true reform based on open access to the transmission network and reform of the subsidisation. The details of the governance failure in the Enron saga have been brought out in its lurid details by Abhay Mehta (1997) whose facts have not been remotely contested even today despite the fact that his book has been in circulation for several years now, Subodh Wagle in IIR2002 (Chapter 6.6) brings out the implications for governance that arise out of the same. Here we are interested in drawing attention to a more general phenomenon within government of refusing to right staff key organisations and institutions of governance causing failure, as a result, and then shrugging away the whole thing as the cost of learning. Today lack of professionalism in key regulatory functions obstruct reform. See Box The tragedy of Indian Adminsitration.

### **Specialised Skills**

Besides the SEBI, many of the departments of the RBI, the Dept of Banking, the Power Ministry, the DFIs and investment banks all need highly specialised knowledge and expertise that cannot be brought in by bureaucrats on the move, however clever and committed they are<sup>17</sup>. The problem of policy making and administration in a phase of transition to a liberal economy is perhaps most demanding and crucial. Once a successful liberal society has been ushered in the challenge of governance perhaps reduces, but till then it is heightened by the need of governments to create and right equip the new institutions, create enabling frameworks, such as BOT laws, nudge consumer and other watch dog organisations into existence and activity. This entirely avoidable failure of government inter alia now threatens the continuation of reforms. There have been notable successes such as telecom reform, where the powerful force of technology was irresistible and so forgave regulatory mistakes. Ports again have not done badly in this regard. Power sector reform has perhaps been the worst victim of this kind of failure.

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<sup>17</sup> For governance failures arising inter alia out of lack of specific knowledge and skills see Chapter 6.6 by Barua, S.K, IIR2002

Private infrastructure could need credit enhancements, and elaborate agreements with the state. In some cases such contracts can be used to generate resources for the state without hurting the prospects for market development, and the interest of the consumer. In other cases such as that of the natural monopoly with little contestability and average growth prospects, it would be right for the state to grant subsidies and credit enhancements. There is no getting away from the specialised skills - including knowledge of the sector - of the law relating to contracts, and technology, as the basis for the correct decision making. Where what is desirable and suitable is not easily decided.

'Hiring consultants' or 'bidding as a solution' does always work. Consultants' knowledge can be very limited, and their best effort would not come forth unless the client is knowledgeable and well prepared.<sup>18</sup> Bidding can result in optimal results only if the bid process is right structured, and that is not easy. It is not a generalist skill either. There are limits to using consultants to right structure bids without a basic knowledge of bids and the industry in government departments/authorities. Similarly, decontrol of highly regulated sectors is a skill demanding activity, if the creation of vast rents has to be avoided.

### **Distancing from Government**

Additionally, as much as the skills and the knowledge, crucial to good governance is 'distancing' of such regulation, contract designing and policy formulation from the day to day affairs of the government. To illustrate the point: The formulation of a draft agreement for building sections of highways needs to be carefully done, widely circulated and commented upon, cross checked and fully refined before it becomes official. But a specific agreement becomes a day to day aspect. There is much potential at the design stage to bring about better risk allocation, incentive compatibility, lower monitoring costs, and transparency and hence reduce the scope for rents. If the prototype of the agreement itself is shoddy then there is the possibility of certain developers using the same to their advantage to create rents. Most PPAs and the IPP framework have been flawed in this sense.

### **Distancing Privatisation from Government**

Privatisation is one activity though, where the scope for rents is enormous. Rents could take many forms and only if the correct counterfactual is posed can the situation be recognised as having created rents. Thus delays, interdepartmental wrangling and uncertainties, restrictive presale conditions including insistence upon golden shares can reduce bid values considerably. Then, after sale, if the new owner is able to get rid of government interference, neutralise or do away with the golden share, the rents can be large, though this is not evident. The current low values of the stock of PSUs are in part a result of confusion with regard to disinvestment. If these are corrected after sale,

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<sup>18</sup> I have been witness to some entirely shoddy work done by consultants of international repute, since they knew that their client was ill-equipped to question them, and was not familiar with the task and the questions given to the consultants. The consultants had been covering up their poor work with jargon until the meeting in which a few better-informed people (all outside the government) could call off the bluff.



then large value transfers could be said to have taken place even though with reference to the market, there may not be even 'abnormal' gain to the purchasing party. In the Indian context disinvestment would have to be distanced if not separated from the government. We had argued in the last IIR for a constitutional or distanced authority for disinvestment. This is because the credibility of the government (irrespective of which party rules) to carry out disinvestment in a fair and corruption free manner is low if not non-existent. This has happened because of 'state-failure' in India, in many of its efforts to direct economic activity, and competitive politics with one feeding the other. Neither can the route of transparency be an answer, since every aspect of the disinvestment process cannot be disclosed. Disinvestment even when by a competent body and headed by persons whose credentials are not in doubt, but within government, does not carry much credibility. Valuations can always be questioned, and no political party, would let an opportunity to question values, go unexploited.

### **A Core within Government**

The tasks of governance and institutional change as we have outlined above require that at least some section within the government, for some time, is motivated, corruption free, and skillful. Economic reform has the great advantage that it does not require all of government to be 'good' all the time. That is why reform can be put together from within the system if adequate pressure to do so exists. (Such was the case in the immediate aftermath of the crisis of 1990-91). As such the general 'impotence of the administrative machinery', or the 'system failure' while real, and a valid explanation for the ineffectiveness of well meaning officers and politicians<sup>19</sup>, need not actually stand in the way of reform. More of the correct reforms such as direct subsidies, legal changes that for BOT type participation, freedom of information laws, growth oriented macroeconomic policies, the less is the bind of the administration. The growth and development effects of reform would in turn, through larger processes, bring about changes in governance through the system as a whole. See Box The Tragedy of Indian Administration.

For such small groups within government, or for regulatory institutions trying to work a new sector development, or put together a framework for public private partnership, or writing contracts for the same, or worrying about new frameworks for land acquisition, the key to success would be accept compromise solution only when that makes sense. Thus whether one chooses cost plus or incentive regulation or 'created' markets for generation is not something that is negotiable. The choice should emerge out of the 'strategy for change for the country as a whole', that is being pursued. If for instance the strategy is largely one of deregulation the understanding that ownership changes alone are not adequate ought to follow. And that industry structure and the nature of environment for profits is important and the probability of regulatory capture

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<sup>19</sup> Some may contest this and claim that 'system failure' is an excuse to hide one's lack of initiative and poor performance. This is no doubt true, but then the implicit reference for comparison is that only very dynamic and politically savvy manager or officer can get things done. Why should the system demand such enterprise out the officer. That only confirms that the system has constraints. It is important to realise that this very fact - that only great leaders like V.Krishnamurthy could succeed in Indian PSUs is proof of the systemic mess.

is high. In such a situation then only created markets wherever feasible and incentive elsewhere would be the choice. Cost plus regulation has no place at all. What could possibly be negotiated, is the pace of change towards that new industry structure, and the treatment of 'stranded assets'. It goes without saying that such key groups and institutions have the right skills and the freedom. One of the challenges today is really to open up administration to lateral entry of experts so that one does not have to wait for the learning with the cadres of the bureaucracy. Lateral recruitment merely for advisory capacity does not help much.

Another attribute of success would have to be the originality to contextualise reform to the Indian situation. I had argued for inventive and original solutions. The need to deeply understand our own problems, to contextualise our approach (like deregulation) even if they are derived from elsewhere had been emphasised. No models that worked elsewhere, can on that count alone, be grafted on to the situation here. Experts, including transnational consultants may not have all the answers. (Their answers can in any case be only as good as the background work done by the 'clients'.) Thus, there is need to go beyond the beaten circuits. Thus, 'right structuring' the ownership of difficult to regulate business like transmission, the need to be particularly bothered about the mode of subsidy administration, to be particularly worried about incentive compatibility in proposals for change, to be able to distinguish between political considerations and others that are 'politicised' or only a mask for rents, wastage and theft, to recognise the limits of government administration and to be alert enough to take advantage of the few opportunities for political entrepreneurship, are all integral to getting the 'Second Stage' of reforms correct. The special characteristics imposed by late-industrialisation, low incomes, income inequality, the opportunities in access subsidisation, rather than use-subsidisation, in postponing regulation when high growth and expansionary phase of the network obtain are other sensitivities of the successful reformers.

## **CONCLUSION**

We discussed governance, but argued that the 'leverage point for change' to improve governance would generally lie not in attempting governance improvements in government as a whole, but in policies that engender faster growth and development, in the removal of restrictions, and in correctly deregulating the economy. The basis for the arguments were conceptual, historical and empirical.

Today the economy is constrained by conservative monetary (and fiscal) policies and a tame pricing of the Indian rupee. Given the large buffer stocks of food, and the very high responsiveness of exports to the exchange rate there is scope to raise the growth rates substantially. That should be the first task. This point was not argued in this paper but mentioned by reference to my paper on the topic (Morris, 1997) which had anticipated the current industrial recession and its nature. Many economists have misunderstood East Asia's success to inter alia lie in *laissez faire*. This is incorrect. It lies in export-promotion, the simultaneous promotion of both exports and import substitution, possible in a more realistic three commodity model of world trade. The fear of inflation and the fiscal deficit getting out of hand is greatly exaggerated. A longer term strategy for which there may be political difficulties is land reform which has the potential to unlock the constrain of the home market for the industrialisation of the country.

The second task is really to right structure the subsidy administration in critical areas : electricity, water and petroleum sectors where reform is caught in the bind of subsidisation modes. Removal of subsidies would not be the answer since that would require prior reform and would be political hara-kiri. In any case that is not necessary since the true value of subsidies (in terms of actually delivered benefits to the the targetted sector) is quite manageable. The replacement of current modes that generate vast rents and have created vested interests through direct subsidisation is possible. In subsidised groups being able to pay with coupons developers and providers of the service /product would see uniform prices. Developments in IT, in database management and in communication and identification allow the easy identification of citizens for the basis of correct administration of subsidies. The task of coupon distribution given the entitlement and identification is trivial Even if there are mistakes in identification, they are containable, and can be reduced over a period. Most importantly mistakes in identification do not affect reform and the management of infrastructural sectors. They can then be reformed quickly. Political support for direct subsidisation is likely to be overwhelmingly large, to counter any possible role of vested interests. The need today is to urgently drive towards direct subsidisation in electricity, kerosene, irrigation water, fertilisers and chemicals.

The third task is more narrowly that of governance and institutional development: The economic reforms thus far, have created the space for some governance oriented reform to have important impact on the economy. If the second task can be simultaneously addressed, then the scope of the changes possible within government are very large. Once the source of nourishment of corruption can be destroyed, the business of improvements in the performance of government as a whole can be addressed. Even before that, in a more limited way, governance can improve if small groups within government and regulators can take upon themselves the task of doing things the right way: developing drafts for framework legislation like the BOT law, setting up of key organisations like the IDECK or GIDB in Karnataka and Gujarat respectively, developing the right formats for contracting, creating the space for people to directly interact with providers of public services, brining in markets and commercialisation wherever possible, and working towards privatisation when state owned enterprises are severely constrained by their dysfunctional interface with government. The need to right man and professionalise the new bodies including regulatory commissions is obvious. Society has paid too high a price in the poor performance of regulatory institutions set up during the nineties.

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## **BOX: INSTITUTIONAL EFFORTS FOR PSU MANAGEMENT FAIL**

### **MOUs Fail**

In the area of public sector management, (which is recognised as a major aspect requiring governance related assistance, by the World Bank and others), measures such as the 'holding company' or the 'MoU' (Memorandum of Understanding) got entirely ritualised<sup>20</sup>. They ended up becoming an added expense and a distraction and did not in any way reduce government's dysfunctional interference in companies (the original purpose of the MoU). The reasons for such a pass are well known: Until the budgetary squeeze on the PSUs, there was little need for any of those in positions of decision making to change. The dysfunctional interface allowed displacement of responsibility, provided for 'hidden budgets' for the politician to use, reduced the challenge for senior managers, allowed workers high wages and security with very little work, and to even translate their vast bargaining power into idle time. And the private industries that benefited out of the relatively low prices of PSU products could not complain. The MoU over the late eighties and early nineties had got reduced to a 'complex document' crafted by the 'Adhoc Committee' within the Department of Public Enterprise, in consultation with the enterprise and low level functionaries of the administrative ministries. They were evaluated by a "High Powered Committee", which could never have had the time. The entire exercise was purely formal. The essential seriousness attached to an important contract was not there. They were seen more as an academic exercise than as a binding contract. No rewards and punishments were attached to either performance or adherence, or to their lack. It was not in any way negotiated. Soft targeting was rampant. And it is doubtful if any of the administrative ministries thought of themselves as being constrained by the MoUs. Yet MoUs spread like wild fire and nearly all PSUs today go through a MoU annually. We have, what the French have most effectively used, viz the contract form to distance the PSUs from government, but sadly only on paper.

### **So do Holding Companies**

Earlier we had started with another form the 'holding company' to create behemoths like the Steel Authority of India Limited (SAIL), Bharat Bari Udyog Limited (BBUL). SAIL was the creation of the late Mohan Kumaramangalam, the dynamic young steel minister who, in being close to the Prime Minister Ms Gandhi could cut through red tape. He was particularly enamoured by Fabian socialism and the Italian holding companies. During his leadership SAIL did manage some autonomy, but since his death, SAIL has been a curious and tragic mix of a bureaucracy and a 'managerial hierarchy', that is parasitic on the steel plants at Bhilai, Bokaro and elsewhere. The reform of SAIL would mean that not only government gets off the back of the steel plants, but even the top heavy SAIL head office is wound up. SAIL had the ridiculous distinction of employing 220 thousand people to produce some 8 million tonnes of steel, when Pohang Steel of South Korea (POSCO) could produce the same with just 13000 people, PIB a Millstone!

Similarly, in a still earlier period organisations like the Project Implementation Board (PIB) set up within the Planning Commission to coordinate the investment decisions of the PSUs, ended up to become a millstone round their necks. In its own direct actions the PIB may have been responsible for much of the delays and cost overruns in public sector projects. The Planning Commission itself is an organisation that ritually plans, when government itself hardly takes these plans seriously.

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<sup>20</sup> This is now well accepted. For a discussion on why MoUs (as also holding companies) were failing when they were being actively implemented see Morris, S. (1990).

## **BOX: THE INDIAN EXPERIENCE**

There have been significant improvements in well being since Independence though nowhere near the progress made by East Asia and China. When the British left us our average life expectancy was just 37 years. (Habib, Irfan, 1975) for the country as a whole. This means that vast numbers of the very poor (peasants) in Bengal, Bihar, Orissa, Eastern UP and Telengana would have had life expectancies no more than 25 years! A figure lower than that of Neanderthal man. Today life expectancy is nearly 60 years in some states.

### **What has been the Source of this Progress?**

Much of it has come from technological developments in vaccines (vaccine programmes can be administered even in situations of state failure), in antibiotics (especially cheap), and in some improvements in diet especially on account of the milk, vegetables and eggs revolutions. Per head grain intake has gone up very little or has remained static if some of our food statisticians have to be believed. Even accounting for increased calorific intake due to potatoes in eastern India, it is unlikely that food intake has shown anywhere near the kind of improvement (from a better base) that East Asia has shown. That marginal improvement in food intake (without any imports) would not have been possible without the HYV revolution, again largely technological and amenable to programme mode of extension without major demands on design of organisations, is worth noting. Public services continue to remain of abysmal quality and poor coverage, and may even have shown an overall deterioration in quality as these were over ambitiously sought to be spread.

Similarly, social movements have had durable effects on the society and the economy. These include the 'Non-Brahmin' movements of Southern India, including the Ezahava Rebellion in Kerala, the movement for the upliftment for lower castes and women by people like Jyotiba Phule and Ambedkar in Maharashtra, and 'sankritisation' processes in so far as they lead to lower castes valuing education.

### **Micro-intervention of State has Failed**

Microeconomic efforts at redistribution<sup>21</sup>, by the state, began with vehemence since the stagnation of the mid-sixties, and has continued with increased emphasis ever since. This 'massive' redistributive effort has colored and determined the very functioning of the government and the bureaucracy. Income distribution though has remained as skewed as ever. The proportion of the people below the poverty line is still explained best by the rate of growth in the preceding years, especially of agriculture. Action and organisation for redistribution on the part of the state has become an end in itself with the result being of no consequence. Thus all these programmes spew out impressive 'results' which are defined in terms of expenditures (input measures) rather than effects

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<sup>21</sup> See adjoining box for a brief review of India's growth experience thus far.

(output measures<sup>22</sup>). Their real purpose we had mentioned earlier was to 'buy up dissent' and create the space for an expanding bureaucracy. Vast rents were no doubt generated in the leakages. We have already seen that those economies that carried out a one shot (and economy wide) redistribution of productive assets through land reforms (essentially a political and macro process) have avoided altogether any continual redistribution on the part of the state. Thereby, they have been able to keep their state apparatus relatively lean and focussed on the task of industrial development.

### **Macro Programmes**

In contrast to micro intervention for redistribution, productively oriented public investments, especially in irrigation, but also in the HYV programme, in higher education and in primary education (to the extent this could be sustained) have had important effects. Similarly successful mega-programmes such as operation flood, and macro efforts such as price support for food production (given the demand constraint for food) and subsidies (despite the waste) have had measurable impacts. Subsidies have also dysfunctionally helped to create rents, which have over a period taken the form of 'directly unproductive activities'<sup>23</sup>. We will return to the rents created by subsidies, more correctly to the mode of administration of subsidies, shortly.

The criticality of the growth of agriculture to the growth of the rest of the economy is not adequately appreciated. Agriculture and exports explain best the non-agricultural private sector GDP in comparative studies (Morris, 1997). More importantly today (since the mid-seventies) agricultural growth is constrained by inadequate demand requiring therefore a vast 'buffer' stocking. The only way the demand can come is by the poor peasant being unshackled enough to increase his output so that in producing he automatically creates demand. Only this can lead to a quick relaxation of the home market contract for manufacturers.

Thus land reform, major income redistribution through massive food for work programmes in the Indian context today are the key issues that need resolution<sup>24</sup>. To discard the present (conservative) regime of macro-economic management for another more ambitious and expansionary is a live issue. The potential benefits in aggressive pricing of the currency and in interest rate targeting, if carefully managed are many. The high growth that it can bring, possibility in excess of 9%, would be exhilarating. It would be the only way, not only to grow out of the current recession and the fiscal mess, but also to give the economy and society a fair chance to make its industrial transformation, and to therefore create the space and the pressure for governance improvements.

### **BOX: THE TRAGEDY OF INDIAN ADMINISTRATION**

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<sup>22</sup> For a brief review of such programmes see Das, K. in Chapter 7.1 in IIR2002.

<sup>23</sup> A term due to Jagdish Bhagwati.

<sup>24</sup> Those are not excluded given the class basis of society, and of the state today. Land reforms as a capitalist strategy that enhances the home market, and embeds the institution of private property are feasible, if the Indian bourgeoisie can 'think big' to ensure its long term interests.

There is no civil service training programme that I have yet conducted without the civil servant blaming the politician. My standard argument against the futility and error in such blame which has never failed to enliven the debate is to show the 'intellectual' failure in many policies such as the export pessimism of Mahalanobis, in the mode of subsidisation in many areas, in Indian reformers having read export led growth as laissez faire under World Bank tutelage, etc. so as to open the civil servants' mind to failures other than that due to vested interests or the 'politician'. And then to argue how many of the politicians and the dysfunctional interests they represent are very much the creation of past policy failure. Allied to these arguments I bring out the vacuousness of the often made statement "good policy but poorly implemented", to argue as in IIR2001, why that is a contradiction in terms - a good policy implements itself.

### **Mixed Up Powers**

I go on to then argue why the Indian system is most failure prone: It is well known to a student of government that when executive decisions are the sole preserve of either a 'bureaucracy' (career bureaucrats in office), or that of elected politicians with clear demarcation responsibilities, of roles and then the outcomes in terms of governance and economic administration, have been far better than when both are together involved. The details of the Indian system are worth recounting from the bottom up. The lowest and perhaps most crucial levels of government (from the point of view of economic services provision) are the urban local bodies (nagarpallikas) and the village (gram) panchayats. They were always there but could never function effectively. It was hoped in a manner similar to that between the centre and the states, if the state could legislate the powers of the local bodies then things would begin to move in the direction of effective decentralisation and hence effective local administration. Much hope was placed on the 73<sup>rd</sup> and 74<sup>th</sup> Constitutional Amendments that legislated the powers and functions of the rural and urban local bodies respectively. But that, it was soon realised, made no difference, since in any case local bodies had little fiscal resources of their own and depended much on the state government for much of their funds (see Mathur (2001)). It was again hoped that with financial devolution as laid out by the state financial commissions would result in autonomy and meaningful responsibility for local public services to local bodies. In many states the devolution has yet to be notified. What is more interesting is that even where they have been, the results are not encouraging. The local bodies continue much as before, superceded for all practical purposes by state governments, officials and departments that work locally (Nanavati, A. (2000)). This has happened because the bureaucracy in India is a true hierarchically ordered tree with no breaks to accommodate elected executives. Thus the talati and other clerks and junior officers view their senior officers at the district and state levels and not the panchayat president as their masters. Had the link in the chain of command been broken at all levels where elected representatives were in executive positions, the embedding of responsibility would have been possible. Organisationally, most functionaries are being asked to serve two 'masters', when only one (the higher ranked official) is far more real, especially at the local level.

Strangely in having the IAS and other central services as a national cadre, the bureaucratic chain is not broken even at the level of the state, thereby denying the states (through the organisational aspect), much of the powers (and independence) they ought to possess under the Constitution. But the problem is far more serious at the



level of local governments, where there is much displacement of responsibility: The elected representatives cannot be held accountable since they have no power over the officers and staff of the local body, and the bind of processes and rules can reduce them to impotence. The little financial autonomy they have compounds the problem further. The government employees on the other hand can hardly be made answerable to people. Elected representatives are at best able to influence the selection of beneficiaries of programmes pre-decided at the central or state levels. Or be able to chose the site of a bore well given that the state government or its parastatals have a bore well programme. Design, and planning which start with the local problems of nagarpallikas is hardly possible. Local elections are highly politicised. This is entirely dysfunctional because local issues dominate the world of the citizen especially rural and small town. The politicisation then becomes the excuse to tie the hands of the elected representatives in a maze of processes and rules. Similarly, the fear that panchayats may not adequately represent vulnerable castes, becomes an excuse to effectively bypass them in all targetted economic programmes<sup>25</sup>. In that situation it is natural that the elected representatives turn to nepotism and graft. The scope for building political capital through good performance of the local bodies they head or are elected to is therefore limited. So what else can they do? The bureaucracy arranges for the graft, partakes in the same, and the system continues to exist and thrive at the cost of the people as a whole. So what systemic functionality do local bodies have? The expenditure on local bodies is not inconsiderable, and salaries and related administrative expenses could absorb the bulk of their total expenditure. Therefore local governments of all but the larger towns may be nothing more than job creation by an expanding bureaucracy. And election of representatives in politicising local opinion, deflects them from economic failure, by giving local leadership some participation in the 'spoils' of governance. Their potential to do good though is high if the local bureaucracy can be made entirely answerable to the local elected representatives. Costs could go down dramatically, employment could then be more need and local requirement based rather than being derived from the rule book, and elected members would be empowered to be responsible. They and others would not be able to pass the buck.

### **Colonial Origins of the 'System'**

The origins of such a debilitating design lie in colonial rule. The reality of (British) Indian administration and governance was the governor general and the administrative bureaucracy that he commanded. The last authority in this hierarchy was the talati. As the pressures for popular government emerged (the reason for the freedom struggle) the British as early as in 1935 created legislatures at the provincial level with ministers and other elected officials, headed by Pt. Jawaharlal Nehru. This is no substantial way diluted the powers of the governors and governor general. In such crucial dimensions of administration as the police, or district administration they retained complete control. With independence while power over policy and law making shifted to the elected representatives, at the state and central levels the executive power is still shared

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<sup>25</sup> In many parts of the country but especially in the South and the West, which have seen as neodicum of development, lower castes can no longer be systematically excluded by panchayats. In most situations that require the village as a whole to have an opinion, as in issues relating to displacement, natural disasters, road building, representative groups that include all castes have begun to emerge.

between career bureaucrats, and elected officials. Only those politicians with great leadership skills and a natural flair for administration have typically been able to exercise their power in a positive manner. At the local level, where there is no legislative role, and little or no policy making, executive power is the key, which is certainly not in the hands of the elected representatives. It may possibly also not effectively be with the local officials since they could in turn be constrained by their own deep hierarchy, rule orientation, and also by the dysfunctional role of the elected representatives. The collector remains the key authority at the district level and certain changes in the law such as the 73<sup>rd</sup> Amendment and the Land Acquisition Bill have only increased his powers. Such structures which obfuscate, and cannot allow for responsibility assignment can therefore hardly be transparent or held accountable. Poor governance is therefore one of design but has its base in history. And its continues because of elitist character of administration and society.

### **Of 'Knights in Shining Armour'**

Many capable bureaucrats (probably the best of the lot) revel in fixing problems. They are the means by which a minimum functionality of the system is ensured. They are its 'knights in shining armour'. They need the problems, as much as the vested interests who gain from the governance failures. They are shifted around when their activities become 'too hot' for the system. They are also sent in when things go awfully wrong (revealed as such) and have to be fixed or set right. They are usually incorruptible, clever, highly motivated individuals, with boundless energy. Unlike the 'impotently honest' bureaucrat they are able to take things forward by attacking 'solvable problems'. They have a particular knack for finding such problems, however uninteresting their posting. They also have a tolerance for very large and very small failures. Thus, they are not reduced to impotence within the corrupt system. They are also able to get lower down functionaries, even corrupt ones, to work to their own plans. They may even look the other way in the face of petty corruption of their subordinates, for overcoming the larger problem. They see every problem as something that must be actively corrected. They are incapable of admitting systemic limitations. To them the solution to all problems is for many more to be like them. That the system can have properties other than that of its individuals (holistic aspects or in a more limited way the idea of the fallacy of composition), has no place in their minds. They express a truism that if all were like themselves then there would not be any failure. To some of them, who have an extreme action orientation, all change follows from things that have to be got done. "Implementation (because people like them are scarce) failure is the key." Notions of incentive compatibility, functionality of the systems of rewards and punishments are an anathema for their kind of minds. Change as arising out of social movements is also alien to them. Some of them though may see the general solution to lie in 'reforms of education' inculcating values, and such other homilies. Change to them is what they and other energetic officers (and possibly some politicians) like them bring about. When they leave (or as is more likely are asked to leave), their good work inevitably collapses, or degrades after a while. Their stories of success when narrated at the dinner table can be very inspiring to all present, and may well lull us into the belief that with such knights, even if very few, around, things could not go really wrong. A few may even be able to get into the limelight to become 'icons' for the mass media and the middle class.

### **And 'Alchemists'**

Yet, the more durable change can come from the 'alchemist' who understands the system and sees his role as not that of a doer but as one who needs to release or allow pent up forces to act. Such a bureaucrat or a politician (more usually the latter) sees policy not as something that needs to be implemented but implements itself. He would have no action stories to tell, probably only 'boring' stuff about a particular rule or law, and may appear to be too academic. Unfortunately, his tribe is rarer than that of the knights. Such 'alchemists' would have less romantic notions of their own roles and class, see themselves as ordinary individuals in a situation, where the best explanation (in the average sense) for the bureaucrat's (or politician's) behaviour is the situation he is placed in. Most bureaucrats who blame the system are not necessarily able to articulate the problem and put their fingers to the leverage point for change, be it a law, a rule that requires change, or a price distortion that needs to be removed. The time to ponder and arrive at such deeper understanding is denied to them. In order to be not too far away from the career path even those who sense the systemic nature of the problem are forced to live in the day to day. Over a period they come to assume that it is 'committees and expert groups' (and today consultants) who should do the thinking. As such open thinking within the system is itself muted.

### **And Yet Impotence**

A few of the 'alchemists' who are able to find time to think may also end up being 'incapacitated'. Freeing them is today, an important aspect of change. Armed with a degree (sometimes even a Ph.D.) in disciplines like economics, management of government from good universities they monopolise the entire thinking within the government. Their skills in being able to put out the first draft for any paper gives them the advantage over the 'knights in armour'. Their importance is particularly enhanced when 'reform is on' since that is the time for these papers, framework documents, drafts and white papers. Unfortunately, exceptions apart, their knowledge and understanding while very expansive may not be deep enough and may only be what is the current fashion in a school or an institution abroad. There is little dialogue among them, since they are only the last leaves of the intellectual enterprise whose roots, and big branches are in the west. In areas which require specialised knowledge - electricity reform, revamping financial markets, monitoring banks, macro management of the economy, privatising PSUs, generalist knowledge would not be enough.

### **Inappropriate Consensus**

Even that inadequacy may not be the main problem of the system. The process of consensus building around the draft that goes on, usually kills the functionality of the final version that goes on to become the policy or the law. The 'coherence' of a particular approach is then lost. This, is akin to the foolish couple who spend the evening on the road in their car because they could not decide one way or the other - whether to go to the theatre or to stay at home. Such 'compromise' papers are usually fatally flawed, and yet get pushed with the vigour that arises out of the bureaucratic and political processes that they would have gone through<sup>26</sup>. And then to kill that bad

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<sup>26</sup> Practically, every major initiative, the BOT laws of state governments, the modifications to the Electricity Acts that created the regulators, the TRAI, the now pending Draft 2001 Bill on Electricity have been victims of this tendency. It was only the

idea becomes a tough task for those than come in a little later and have to own up to the dysfunctionalities created by the very same policy or law<sup>27</sup>. So even the 'alchemists' who could have been agents of remain constrained.

Had the process of consensus building or compromise been in situations where compromise is possible (where for instance continuously varying solutions on some relevant dimension exists), and had the process been truly reflective of the interests of different segments of society, there would still have been some progress. To give an example: the mode of subsidisation of electricity is not something that is to be decided on the basis of 'bargaining' or consensus. That has to be a 'technical' decision. To assume that it can be negotiated is to presume that thieves and rent seekers are sections of the interest groups. On the other hand the criteria for identification of the amount of entitlement (i.e. whether it ought to be largely a production, or an income subsidy), or the amount of entitlement itself, can be negotiated.

## **BOX : CREATING GOVERNANCE FAILURE IN THE OIL SECTOR**

### **Subsidisation and Adulteration**

In 1979, after the second oil shock, retail prices of petroleum products were increased through the imposition of heavy duties. The need to cushion the shock on diesel and kerosene arose. Farmers were important users of diesel, and many poor households used kerosene. Soon enough, the tax demands on the sector and the cross subsidisation within the sector grew. By the late eighties the final price of petrol was way above that of other fuels. Till recently the price ratio between petrol and diesel was as high as 3:1, that between petrol and naphtha perhaps higher, and that with kerosene in the range of 4:1. Even a 10% adulteration of petrol with naphtha or certain solvents including benzenes generates stupendous 'profits' in relation to the 'contract' profits in the retailing business. The government pushes contracts (on paper) on to retail oil dealers that are so finely calculated that returns (for honest dealers) higher than about 16% on assets are not possible<sup>28</sup>. But 'honest' dealers are a rarity today.

### **Dealer Selection Board**

Companies never have had the autonomy in the selection of dealers. Even today they do not have this freedom. There is a "Dealer Selection Board" whose criteria for selection of dealers has nothing to do with the potential to perform well in the retail business. The Board itself is highly politicised. Why should a business that can give only modest profits be so much in demand? Most dealers are politically connected; some

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great technological dynamism of the telecom market, that was able to force changes to overcome the debilitating provisions of the earlier TRAI Act. See Jain, Rekha (2000) in the last IIR. Varma, Jayanth (2001) in Chapter 6.1 IIR2002 brings out the fatal flaws in this 'half way house', in private financing.

<sup>27</sup> Thus today reformers would have to 'kill the IPP provisions', the idea of subvertions, extra charges on transmission usage as a cross subsidisation devices.

<sup>28</sup> Are margins purposefully kept low to keep out good people? Many managers claim that this is indeed so!

may be only a front for small time politicians. Dealerships are seen as payoffs at the lower levels of the political system. There are of course the usual reservations for ex-soldiers, handicapped people, depressed castes, freedom fighters, and other worthy citizens. But barring a few, most such allottees are merely 'fronts' for the real operators. Such operators control many outlets. Corruption is rampant and the marketing departments of oil companies cannot avoid being involved. The extent of corruption varies much across regions. It is generally believed that petrol on highways, and more generally in the north and in Gujarat the extent of adulteration/short selling is more.

### **'Innovations' in Adulteration**

Benzenes, naphtha, other solvents, and certain additives to keep the anti-knocking properties of the fuel within the range required for IC-engines with ignition, are used. 'R&D' takes place in the small scale industry to develop such additives.

Even in the lubricants trade there is major adulteration of oils especially 2T oils with improperly recycled oil. A licensed small industry has come up to extract the base oil from used lubricants. But instead of doing just that, they manufacture lubricants with improper additives. Even the extraction processes are not good enough to completely remove the metal residues in used lubricants. But there is a ready and lucrative market for such oils in the unscrupulous retail outlets and road side garages that service two wheelers. Branded pouches introduced by the oil companies have not restored any confidence. The informal sector has responded with their pouches that often copy those of the oil companies. Since the freeing of lubricants from the administered price mechanism, specialist lubricant 'super markets' located all over and (significantly) away from fuel outlets have come up. They do a roaring business because nobody trusts retail outlets to sell clean lubricants, and the advertisements of the oil companies may have helped to build the scare and the consciousness.

### **Created Negative 'Externality'**

The consumer of petroleum products due to adulteration and short measuring bear large private costs. Loss of engine power and life, more frequent maintenance and considerable drop in mileage are obvious effects. The social costs are enormous. When kerosene and solvents are used, the amount of unburnt residues and monoxide in the exhaust are at least an order of magnitude more than when clean petrol is used. Many of the solvents and benzenes being hetero-cyclical are highly carcinogenic. It is quite likely that in cities like Ahmedabad, where benzenes and kerosene levels in the air are high enough to be actually smelt, the risk of cancer that the people bear is alarming and higher than in exposed industrial places. Mere reporting of SO<sub>2</sub> levels, as is done by the media in their pollution watch, completely misses this pollution. Despite MPFI, Euro -II and all that, all cities continue to be highly polluted due to adulteration. Indeed so rampant is the adulteration that a special 'auto-fuel' is available on the streets of Ahmedabad, at a fraction of the price of regular petrol. This is a mixture of petrol, benzene and possibly naphtha that makes each autorickshaw a pollution bomb. The tragedy is that this pollution is not an externality, of some other activity that is adding

positive benefits elsewhere. It is crime that results in negative value addition<sup>29</sup>. It is entirely avoidable. It is a direct result of ham-handed policy.

### **Why Companies Cannot do Much**

The government thinks that the oil companies are responsible and advise them to police the retail distribution business. The oil companies throw up their hands, since they have no control over the dealers. Dealers would never admit to adulteration. They have a strong association, and when individual cases of adulteration are taken up occasionally by the oil companies, nothing finally happens. After a great deal of effort in proving adulteration or short measuring the fine/punishment is too small. Based on the numbers of dealers actually caught adulterating or short measuring, the lowest estimate of the numbers of retail outlets involved is at least a third, in the best of the nationalised oil companies. In the others it is probably much worse. So what do the managers in the marketing departments really do? The rookies try to do something, fail, and ask for different postings.

I am told an interesting story by one such 'rookie', who is today a senior manager, who finally opted out of marketing because he could not bear to be impotent in the face of this systematic assault on the consumer, and on the interest of the company. In one South Indian city, where citizen awareness of the ill effects of adulterated fuel is somewhat greater than elsewhere, he launched a campaign, following two cases of adulteration and short measuring that was discovered by the company. The action against the two outlets was the severest possible under the rules. Their license was suspended for a while, and citizens were told, why the retail outlets were closed, and also informed about the campaign against adulteration. The local company officials were able to withstand all political pressures, but the sales of the company went down, because now consumers knew for certain that petrol had been and therefore probably was bad from that company. But other companies who had equally bad if not worse

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<sup>29</sup> In highly corrupt and poorly coordinated societies like India the notions of 'rent' and 'directly unproductive activities' may not be adequate to understand the economic effects of certain activities. Thus, when as a result of corruption in government purchase, the official earns rents then it is only in a static, *ceteris paribus* sense that we may see it as unintended redistribution. Other effects that follow are the second order effects in the rents having contributed to raising the 'effective price' of the product being purchased. Now if the official and his establishment work hard to obfuscate, to create processes that are responsibility displacing, (where attribution of blame is difficult), then all that work instead of being directly unproductive (wasteful) is actually 'negative'. The feed back effects of the same on the system can be enormous. So-called vigilance agencies then have to work harder. They could over a period of time have developed processes to give the semblance of being active (putting out a few cases of anti-corruption) while letting most others go. Their role then becomes one of keeping the system of rents getting out of hand. Thus it adds negative value to the economy, rather than being merely unproductive. In the last IIR (Gupta, Amita and Sebastian Morris, Chapter 5.5) brought out the case of wanton deterioration that creates the scope for further maintenance activity on public roads. When railway projects are delayed, resulting in earthworks being washed away with the monsoon and have to be done all over again, the processes that delay may be seen as cause resulting in 'negative value addition'.

retail outlets benefited out of the demand shift. Petrol quality is not easily measured at the retail level.

### **'Managing' Corruption**

Most get 'wiser' and though not necessarily personally corrupt, get around to 'managing' the corruption rather than stamping out the same. They help to keep the adulteration to 'within limits', open new (suboptimal from a national or company point of view) 'company outlets' to check adulteration. How have consumers responded? In the case where the rents have been in part passed on to the consumers (as in the case of auto owners in Ahmedabad), they too benefit but create huge social costs. Motorists, especially those with high performance modern engines go through that awful experience of adulterated petrol, talk to others with experience and get around to finding the one dealer who does not adulterate, and hopefully there would be at least one in every city. Variation in the sales between dealers can be very high. Thus in Ahmedabad the one outlet in the city that does not adulterate (besides company pumps that are not conveniently located) sells as much petrol as 25% of the total sales of petrol in the city by all outlets of the same oil company! Consumers with incomplete information are subject to great stress. Others journey long distance to inappropriately located outlets where they think they can get good petrol.

Today, we have reached a situation of an outlet every few score kilometres on the highways, and every other street corner in the city, and still there is no good fuel to be had! Yet, all these outlets, some of them with sales as low as 80 klpm apparently make money since so much bribe is paid or influence used to get these outlets. Marketing jobs ('dipstick mending') in oil companies as it used to be called then) in the mid-eighties, used to be prized jobs. The reasons then, were the potential to make a little 'extra' through the temperature and other variances. (They are probably prized jobs now since they oversee points of huge rent generation.) So change cannot come from within the system. Consumers as usual do not have the necessary 'leadership institutions' to argue their case. Oil companies pin their hopes on the abolition of the dealer selection board, in the post Administered Price Mechanism (APM) scenario. That may help in the selection of new dealers. But already the retail business is overcrowded, and in any conceivable rational reorganisation of the same, many would have to be closed as competitive margins and pricing emerges. (Unless adulteration and short measuring continues which for the business has the effect of upping the margins and creating over entry).

So how can one control and manage a set of dealers who have been reared in corruption? Would establishment of private sector oil distributing companies (or privatisation of the oil sector) help? In a limited way they could if the private companies are allowed to use price to signal quality. Then the consumer would have to pay high prices, the difference between the price of good petrol and bad petrol being a return to asymmetric information for the oil company. Socially, this is suboptimal. The oil company too bears an unnecessary cost of managing two different types of outlets, and ensuring that 'adulteration' does not occur in the 'high priced' segment of the business. Unlike the public company it would have a motivation to internalise the benefits of adulteration, and sometimes to stop the same if the company's reputation is directly linked to its behaviour. But the 'temptation to adulterate once a name has been established may also exist. The essential difference though may well be that the

punitive measures by the government or a regulator are likely to become credible against a private company, than a public one, since any displacement of responsibility has necessarily to be contained within the private company.

### **Distortions Breed Further Distortions**

Privatisation or not, no real solution is not possible, unless the vast differences in prices are eliminated. In the current situation of vast differences in prices, only very heavy punitive measures, with a large probability of getting caught would help. (If one is small the other has to high). Thus, something close to ten years imprisonment may perhaps work. But that alas would do violence to all that we know and derive from our Judeo-Christian notions of jurisprudence. (Even though in any social cost benefit analysis such measures would be amply justified). Any attempt to 'solve' the problem without correcting the price difference in the first place, (unless of the stiff punitive type mentioned above) would only compound the problem and create other unanticipated problems or distortions. The 'solution' of a company owned and operated outlet that is currently being pursued could add to the costs of distribution, if the employees of the 'labour contractor' were to successfully put pressure for regular employment within the company, and get the courts on their side. It also adds to an already overextended retail outlet network. Elaborate testing machines to ensure quality also add to cost.<sup>30</sup> Besides testing equipments, tamper proofing comes at a high capital cost usually not justified given the Indian factor price ratios. In any case if tests are not going to be used to punish, they become mere rituals or irritants, as the current PUC (Pollution Under Control) certificates in most cities have become. Value creation at retail outlets through groceries and medicines dispensation is no compensation and would not work if the core product remains a problem.

### **Created Vested Interests**

A little over a year back, there was what seemed like an effort to correct the mess. The so called 'Solvent Scam' surfaced, to reveal that vast quantities of 'solvents' including benzene and naphtha ostensibly supplied for industrial use were diverted to adulterate petrol. What were remarkable was the huge quantities involved, and the wide extent of the operations that spanned over five states. The kingpin was a Guarat based 'entrepreneur' who had organised the entire business, and had the backing of highly placed politicians, excise officials and possibly managers in the petrochemical plants. The evidence against him was very strong, and well built up by the Oil Company that was keen to make a serious effort to stop the mess of adulteration. The usual methods of destroying and falsifying evidence somehow did not work in this case. But the business had its supporters among the political bigwigs. A 'counter-case' against the Company was filed. Police brought forth evidence that diesel meant for industrial application (which had a lower price) was being diverted for use in the transport sector. Oil company officials were quickly arrested and jailed. Bails were denied and the personal harassment of the officials began. The best efforts of the company to get the officials released were of no avail. The company's argument, which had much logic, was that they had been selling diesel to firms who had been granted licenses for lower

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<sup>30</sup> Absolute assurance of non-adulteration is possible only with the installation of octane, and cetane testers for petrol and diesel respectively and other instruments, which are very expensive.



priced diesel by the Excise Department. Was the Excise Department working hand in glove with these 'benami' firms to take advantage of the price difference? Then there was little that company officials could have done. They (the company) claimed that they were neither an investigating agency nor the police. The final outcome is not known. Was a 'deal' finally forced on the Company? We would never know.

### **Bigger Mess**

In Delhi, when confronted with pollution even after Euro-II norms were introduced for car engines<sup>31</sup>, a large part of it being due to adulterated fuel use, instead of going for low sulphur diesel in combination with modern diesel engines, 4-stroke engines for two wheelers and autos, we picked CNG<sup>32</sup>. One of the reasons cited by the environmental pressure groups is that, being gaseous, it cannot be adulterated. In other words implicit admission that nothing can be done about rampant adulteration! If CNG really goes ahead in a big way we would have imposed a huge and avoidable cost on the economy. The correct solution would have been as stated above and to overcome the problem of adulteration through removal of the incentive in the price distortions for adulterating, with stiff punitive measures. (Allowing the oil companies to do so). The matter of subsidisation of those who use diesel and kerosene could have been easily covered through direct subsidisation, not too different from the direct subsidisation in the case of electricity. To us it is amazing that none of the actors, the government, the politician representing farmers, the oil companies, nor citizen's groups have actively argued for the case of direct subsidisation.

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<sup>31</sup> Which in itself was a success, See Pundir (2000).

<sup>32</sup> See BP Pundir's article in IIR2002 Chapter 5.6.