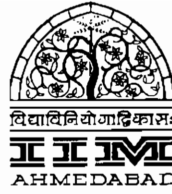

Working Paper

MARKET REFORMS AND THE CRITICALITY OF INSTITUTIONS: A FEW ISSUES IN THE INDIAN CONTEXT

By

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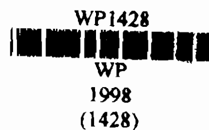
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Market Reforms and the Criticality of Institutions : A Few Issues in the Indian Context.

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Abstract:

This paper brings out a few issues on how prevailing institutional conditions are inadequate for an efficient functioning of markets, and on the role of government policy in the transition period in the Indian context. We approach the issue of market institutions from the new institutional economics perspective. The basic argument of the paper is that the prevailing institutional conditions are not totally consistent and are inadequate with the spirit of free market economy and the approach of the reforms has been lopsided. To put it in the words of Williamson (1994), the approach of the reforms should be not just getting *the prices right* but getting *the institutions right*: to get the prices right one has to get the institutions right.

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I. Introduction

Economic reforms and globalization have been the two major buzz words of the late eighties and nineties. Economic reforms generally refer to the movement of several developing economies and the East European countries towards a capitalistic system after decades of pursuing highly state interventionist economic models. Globalization of economies is referred to increasing volume of world trade, foreign direct investment and short term international capital flows (facilitated by the implementation of the Gatt agreement). Economic reforms and increasing integration of world economies do provide great opportunities for achieving rapid economic growth for economies such as India which have achieved a certain degree of industrialisation and economic development. And at the same time, this could result in high costs in the short and medium term, because of absence of several markets and necessary institutions for efficient functioning of a free market economy. This paper brings out a few issues on how prevailing institutional conditions are inadequate for an efficient functioning of markets, and on the role of government policy in the transition period in the Indian context. We approach the issue of market institutions from the new institutional economics perspective. The basic argument of the paper is that the prevailing institutional conditions are not totally consistent and are inadequate with the spirit of free market economy and the approach of the reforms has been lopsided. To put it in the words of Williamson (1994), one can get the *the prices right* only by getting *the institutions right.*

Free market economies function on the basis of institutions that facilitate *fair* and *efficient* voluntary exchange of goods and services : fair exchange implies the price realised by each agent in exchange of a good or service reflects its true value (opportunity cost) determined by costs incurred in producing it (transformatión of inputs into output) and demand and supply for the good or service. Efficient exchange implies that agents of transaction do not incur high costs in the transaction itself. In an economy, as we

know, there are millions of exchanges involved. The absence of necessary institutions or presence of sub-optimal institutions of market exchange results in economic and distributional inefficiency and consequently lower economic growth. The new institutional economics examines the institutional aspects of capitalist societies from the issue of property rights and market transaction costs (North, 1990, Williamson, 1985).

Douglas North (1990) observes, 'Institutions provide basic structure by which human beings throughout history have created order and attempted to reduce uncertainty in exchange. Together with the technology employed, they determine transaction and transformation costs and hence profitability and feasibility of engaging in economic activity.' Transformation costs refer to the costs of transforming inputs into output: the inputs are generally taken as land, labour and capital. Transaction costs refer to costs incurred in exchange of output and inputs. The prevailing institutional structures that define and enforce property rights, and contract formulation and enforcement, and information perfectedness determine the transaction costs of exchange mechanism. In the modern market economies, as technological change reduces transformation costs, increasing complexity of economic activity (exchange) requires strong and effective institutional mechanism that minimises transaction costs. Institutional conditions provide a structure (or platform) for economic agents to compete and cooperate in the markets based on well defined and enforced rules and norms. The rules and norms of exchange are practised on the basis of institutions of governance (the political system, government regulation, the legal framework) and institutional environment that sets (evolved) norms of exchange (Williamson, 1994).[2] When these institutional

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[2] Every exchange requires minimum trust among agents (both anonymous and small group transactions): trust in exchange is important as all contracts of exchange are incomplete and it is impossible to enforce a contract in totality through the legal framework. Kenneth Arrow (1974) observes, 'societies in their evolution have developed implicit agreements to certain kinds of regard for others.... (agreements that) contribute greatly to the efficiency of its working. It has been observed, for example, that among the properties of many societies whose economic development is backward is a lack of trust.'

conditions are weak. high market transaction costs not only lead to lower economic activity (low economic growth) and have distributional implications i.e., benefiting some groups at the cost of others.

The following section 2 brings out the conceptual framework of the new institutional economics. In section 3, I briefly discuss the economic reforms and apply the conceptual framework to Indian conditions in the context of reforms and bring out some of the possible costs of institutional inadequacies and policy implications. Section 4 brings out a few elements of required institutional conditions in the present context.

2. The Conceptual Framework of the Institutional Economics

For a long time, the mainstream economics has looked at economic activity in terms of transformation activity taking the exchange mechanism purely as a mechanism of price formation and market clearing. The economic reforms that had been implemented in India and Eastern Europe under the structural adjustment and stabilisation philosophy of IMF and World Bank are based on the mainstream approach of getting the prices right ignoring (or taking them for granted of) the institutional conditions. One can not get the prices right without getting institutional conditions right. The importance and relevance of the institutional economics, especially in the context of economic reforms in developing economies, has been recognised after the Russian and East European experience (debacle). Russia followed the communist model for more than seventy years (since the 1917). The market reforms in Russia were implemented in the absence of institutions of private property rights and the institutional framework for contract formulation and enforcement and in absence of evolved norms of market exchange mechanism (private agents in Russia operated under the communist system for a long time which means they did not know the basic premises of market mechanism for example what do savings and interest rate mean at the time of the reforms). The consequence of this approach is that the Russian economy crashed although it is considered one of the richest countries in terms of physical and human capital and natural resources. Secondly, it led to high degree of distributional inefficiency by causing emergence of a small section of super rich and high incidence of poverty in Russia. The absence of property rights led to emergence of the

Russian Mafia in a big way. We elaborate on the basic concepts of institutional economics framework in the following.

Information:

A major part of market transaction is collection and processing of information and there are costs associated with it. Incomplete information and informational asymmetry can take place because the prevailing institutions do not facilitate transparency and allows some private agents to deliberately engineer misinformation and there are high costs to collection of information which small players can not invest in. When the information is incomplete or asymmetric across agents it leads to the outcomes of: bounded rationality, moral hazard and adverse selection. Bounded rationality implies that decisions based on incomplete information will be sub-optimal and one of the agents of the exchange loses value in exchange. Moral hazard refers to the principal and agency problem: by taking the stock market example- the investors are the principals and the managers are the agents (similarly the case of the banking sector). The principal gives his (her) money (savings) to the agent for its investment and getting a return on it by paying a commission to the agent. If the principal does not have the information about how the agent is functioning, the agent could misuse the money as it is not his (her) money: the agent could use the resources for personal gaols and also may take high risks which the agent would not (an example is the Banking sector behaviour in East Asia leading to the crisis). Adverse selection refers to sub-optimal selection of projects because of incomplete information deliberately engineered by one of the agents of transaction. The example can be drawn from the stock markets again- if investors are given incomplete or wrong information, they may invest in inefficient (or dubious) projects.

Contracts:

An important aspect of institutions of a market economy is the conditions that facilitate efficient formulation and enforcement of contracts among various economic agents. Efficient contractual arrangements require effective institutions of governance and institutional environment. For example, the legal system with defined rules and laws and the mechanism of enforcement is only a subset of the framework because of incompleteness of contracts and also imperfect information about the possible state

of nature (the time difference between contract formulation and execution). This is based on the view that it is extremely difficult to formulate contracts that incorporate all possible contingencies of nature. In this context, an important source of efficient contractual arrangements is the institutional environment of evolved norms and trust. The norms evolve through history of repeated transactions towards generating co-operative behaviour for avoiding outcomes that are detrimental for the society as a whole. In other words, a system of contractual arrangements and enforcement is a result of complex historical, political, cultural, social and economic processes.

One simple example of transactions costs associated with contract enforcement is opportunistic behaviour by agents when contracts are incomplete. Opportunistic behaviour of re-negotiation of a contract or violation of a contract by an agent arises because of incompleteness of contracts and high costs of enforcing contracts. The costs of opportunistic behaviour are high when there is *asset-specificity*. Let us take the example of a joint venture between an MNC firm A and a domestic firm B to produce a specific product, X. A and B gets into a contract to produce the good X. Firm B invests in a specific asset k with an agreement that A provides an asset p (technology). X can be produced only with a combination of k and p. Once B invests in k, firm A knowing B is locked-in may try to renegotiate the contract. Since B has invested in a specific asset which can not be employed productively elsewhere, may agree to new terms of contracts (it could happen both ways). Similarly, if the state of the nature changes in favour of one of the parties, opportunistic behaviour takes place. The incidence of opportunistic behaviour will be more, if costs of enforcing even the basic elements of contracts is high which is highly relevant to the Indian conditions. Apart from this, asymmetric information between agents may result in one of the agents to provide incomplete information to formulate contract in his (her) favour which, in turn, results in breaking off contracts (for example the failing joint ventures in India).

Because of inherent incompleteness of contracts, the new institutional economics rejects the control role of the legal system posited by the mainstream economics but it maintains that the legal system plays a larger indirect role in governing exchange. In the context of the limitations of the legal system, private

order institutions may emerge to govern exchange- examples are farmers in the South Indian villages managing the irrigation systems. and the Indian diamond merchants transacting with millions of rupees without any explicit legal contracts, etc. The private order institutions could be both in a positive and also negative terms. If the legal system does not provide a minimum basic ground and establish and enforce private property rights, Mafia may emerge in controlling property rights: a good example is the Mafia controlling real estate in Mumbai and Delhi because of the rent control act. This is where the role of the state becomes important in building the institutions of governance that provide the basic structure for efficient contract formulation and enforcement with minimum transaction costs. The absence of these institutions reduces economic activity by discouraging investment and consequently result in low economic growth.

The private order institutions, generating a positive institutional environment, as mentioned before, emerge through co-operation among the private agents arising out of repeated transactions (history)- repeated cheating of contracts may result in a worse state for everyone. In order to avoid the collective bad outcomes, norms of co-operation and trust may evolve. In other words, institutional environment of exchange norms and minimum trust evolve through time for avoiding socially adverse outcomes (the prisoners dilemma outcomes). The issue for policy in the context of economic reforms in India is setting up of certain initial (organisational) conditions for the evolution of institutions of governance and institutional environment in the right direction. One has to keep in mind that all kinds of cooperative behaviour is not necessarily for collective good. For example, the collusion among the politicians and industrialists and bureaucrats for using public policy for vested interests could result in sub-optmal institutinal conditions. Another example can be drawn from the recent East Asian experience. The state guarntees to the banks led to lending by banking to highly risky projects and consequently the crash of the banking system. Under this type of cooperation (or collusion), if one or a few groups turn out be more powerful than others, it leads to rent seeking.

Property Rights:

Capitalist economies function on the basis of establishment and enforcement of well defined private property rights. The underlying philosophy is that well assigned private property rights result in efficient use of resources (which is supposed to avoid the *tragedy of commons* outcome of common property resources: people may not invest in efficient management of common resources as no single individual has a stake).[3] A well defined property rights system reflects a set of entitlements that define the owners privileges and obligations for use of a resource. It is expected to have the following general features: 1). Comprehensively assigned: All resources are either collectively or privately owned and all entitlements are known and enforced. 2). Exclusive: Owners internalise all benefits and costs from the use of a resource. 3). Transferable: All property rights should be transferable in a voluntary exchange with minimum transaction costs. 4) Secure: Property rights should be secure from involuntary seizure or encroachment by other private agents and the government.

An imperfect specification and high transaction costs of enforcing of property rights result in wrong prices, inefficient use of resources and under-investment which stunt economic growth. The major feature of countries such as India is poor specification of property rights, vague definition of the rules of both private and common property resources, high costs of transfer and high market transaction costs of enforcing the property rights.

The issue of property rights encompasses the previous issues of contractual arrangements: for example an investor buying a stock in a company is a property right. The transaction costs of asymmetric information and contract formulation and enforcement involve the issue of enforcing property rights. Shleifer (1994) observes that establishing property rights means enforcing the contracts through which economic agents

[3] But there are examples of societies managing common property resources efficiently without any assigned private property rights: for example the fisherman on the South Indian coastal conserving fish in the sea by not over-fishing; the native Americans managing the natural resources before the entry of the Europeans to the American continent.

try to arrive at more efficient control structures themselves or finding ways to improve the efficiency of control rights. This is highly relevant to Indian conditions as the control rights, right from the stock markets, to publicly owned lands, the public sector to the real estate, are poorly defined (in several instances deliberately by the politicians and bureaucrats for increasing their powers). A good example is the rent control act in India, which led to under-investment and under capacity utilisation of real estate in cities such as Mumbai and the land scams where the politicians and bureaucrats distribute the public land to their patronage groups at throw away prices There has to be clearly defined property rights by taking into account the finer distinction between the private property and common property elements of resources (Patibandla, 1997b). In absence of this, the excessive control rights of politicians and bureaucrats cause under-investment by private agents by generating uncertainty.

Most of the private property resources have common property elements. A simple example is: I own a piece of land but the ground water of the land is a common property which means I do not have the total rights to exploit the ground water as I wish. The institutions of governance and institutional environment should be able to distinguish these finer elements of the property rights. When they fail in this respect, it results in misutilization and mismanagement of resources resulting in collective bad (a good example is the water mismanagement in the Indian cities). A major source of environmental mismanagement in India is a result of the failure of the prevailing institutions bringing out well defined rules and mechanisms of enforcement of the property rights The institutions of governance have to recognise these distinctions and set well defined rights and mechanisms of enforcement with low transaction costs.[4]

Several common property resources are managed by private order institutions (with social norms) without any explicit legal conditions. As mentioned before, social norms evolve, especially in smaller groups or societies where agents are not anonymous to each other, through history (of repeated transaction costs)

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[4] For example, in the U.S., the land owners are not allowed to dig bore wells to exploit ground water as ground water is considered a common property. I am thankful to Prem Pangotra for this point.

for avoiding collective bad outcomes. In the context of reforms in India, introducing private capital into the common property resources in absence of effective rules and their enforcement, results in over-exploitation of resources and loss of employment [5] A good example is the introduction of large fishing trawlers owned by multinationals led to over-fishing and erosion of livelihood of fisherman, who managed the resource of centuries on socially agreed norms, in the Tamil Nadu and Kerala coast.

Organisations and Institutions

By applying the above concepts, North (1990) distinguishes between organisations (forms) and institutions (substance) which is essential in understanding the institutions of capitalism. This is germane for understanding enforcement of defined rules and regulations by the government organisations. While organisations, say the constitution, the legal courts etc., with defined rules and regulations can be engineered,[6] the institutional conditions of enforcing the rules have to evolve. Effective functioning of organisations requires institutional conditions which involve numerous entities like economic, social and political attitudes and norms which can not be engineered overnight.[7] Institutions evolve by the interaction among these entities and prevailing organisational conditions.

[5] The introduction of Tradable Pollution Permits by the U.S. government for controlling polluting industries is one of the ways of (attempting at) assigning private property elements to common property resources.

[6] For example, a major part of our constitution is copied from the British. The British have the house of commons and the house of lords and we have the Lok sabha and Rajya sabha.

[7] A good example for distinguishing between organisations and institutions is: India has a very large number of environmental protection laws and the record of enforcing them can be observed to be one of the weakest in the world. On the other hand, the U.S., has a fewer and simpler laws of environmental protection, but the mechanism of monitoring and enforcing the laws is very effective.

To illustrate the above observation, when there is no transparency of the rights and obligations of the public and there is informational imperfectedness and asymmetry and high transaction costs in exercising the rights, a government official may end up exercising higher powers than he or she is assigned (for example, in small cities and villages in some states such as Bihar and U.P). Given the sub-optimal institutional conditions, the norms and belief of the public may evolve such way so as to institutionalise (legitimise) those extraordinary powers of the government officials. This in turn results in rent seeking and corruption by government officials which weakens the enforcement of the rules of the organisations. In other words, for the rules of governance to be enforced, there has to be strong accountability of the public agents. Accountability can prevail when there is transparency of the defined rights and obligations and low transaction costs of exercising them. Secondly, the possibility of opportunistic behaviour by the public agents will be lower when there is higher social interaction between the public and the government agents. This is based on the argument that in large groups where economic agents are anonymous to each other, there is no social stigma for cheating. In smaller societies, where each agent knows the other socially, cheating could be restrained by the fear of social stigma. This rationale is used for the decentralisation of the government organisations which is supposed to augment transparency of defined rules and higher accountability of government agents. For example, decentralisation of government organisations, along with increased literacy (which reduces informational imperfectedness), in states such as Maharastra, Andhra Pradesh, and West Bengal is supposed to have caused more effective functioning of government organisations.

3. Economic Reforms and the Institutional conditions in India

As mentioned before, economic reforms in India refer to movement from a highly state interventionist economic model to a more free market oriented economy. A major part of the reforms were introduced in 1990 on the basis of World Bank and IMF stabilisation and structural adjustment package. As mentioned before, the reforms are based on simplistic micro and macro economic theories ignoring the institutional aspect of market economies. Although, the Indian economy has been able to realise about 5 per cent

annual growth rate during the last five years, the negative consequence of this approach has been the high costs of institutional inadequacies, failures in the industrial and financial sectors, and political instability owing to the increased (opportunities for) corruption of the government agents (for example, the telecom and fodder scams). This, in turn, appears to retard the economic growth.

The costs of institutional failures can be seen by the functioning of financial markets in India. The important role of financial institutions (sector) is channelling savings into investment . This is done by the principal and agency relations with possible outcomes of moral hazard and adverse selection: a saver (the agent) gives his or her money to a borrower under a contract for the return of the money with interest . If the lender does not have full information about the borrower's economic worth it results in adverse selection (the borrower could deliberately engineer wrong information). The moral hazard outcome could be in terms of misuse of the savings of the principal by the agents and also if the lender (the principal) is not able to effectively monitor the manner of use of money there arises less than precautionary behaviour on part of the borrower. Banks and other capital market intermediaries function as *the agents* and if the institutional conditions are weak they cause moral hazard and adverse selection outcomes. In market economies, quite a few organisations take up the agency role.

Efficiently functioning financial sector institutions channel capital into the most productive sectors which, in turn, generates economic growth. Development economists look at savings rate and capital accumulation (apart from technological progress) as a critical source of economic growth. An economy with a high saving rate, such as India has been, may realise low economic growth because financial sector inefficiency causes misuse or inefficient use of accumulated capital. The institutional failures of the Indian financial sector were quite dominant before and after the reforms: the only difference is a slight shift from the misuse of capital by the government (the public sector with softbudget constraints, the nationalised banks, etc.) to private intermediaries in the post reforms period. The institutional failures on the financial sector front can be extremely costly and could result in undermining of the real economy (production of goods) which can be easily observed from the recent East Asian crisis. The weaker the financial

institutions, in terms of incomplete information and moral hazard problems, more prone they are to speculative attacks and redistribution of wealth, as it has been taking place in India and on a bigger scale in the East Asia. We do not go into the details of the Indian financial sector but provide a few examples of institutional inadequacies in the following.

In recent years, the adverse selection outcomes in the capital markets in India have resulted in redistribution of thousands of crores of rupees from small investors to speculators and dubious operators. This, in turn, destroyed savings of small investors and their confidence in the capital markets. Several promoters in the Indian stock markets are observed to engineer incomplete or wrong information with strategies such as inflating project costs, fixing high premia and raising money for which exist only on paper. This is observed to take place through the collusion of merchant bankers, underwriters, advertisers, financial weeklies and other sundry marketers under the very nose of regulatory bodies (Bhole, 1995). A consequence of destroying small investors saving's and confidence is increasing concentration in the capital markets and excessive dependence on FIIs (Foreign Institutional Investors) with some positive and several negative consequences. The result of destroying the confidence of small investors is the stock prices in the Indian capital markets depend so much on what the FIIs think about the market.

Adverse selection and moral hazard outcomes, as mentioned before, take place if there are high costs to information which causes incomplete and asymmetric information among the principals and agents. Since small investors can not afford to invest in high costs of information, they may depend on large players and free ride on them for information (externalities). The large player knowing this, may deliberately manipulate stock prices and cause a redistribution of wealth in his favour. An example is the stock market debacle engineered by brokers such as Harshad Mehta and others in the early nineties: Mehta had access to large sums of money from illegal deals with certain banks and used it to jack up certain stock prices which in turn induced millions of small players to invest in those stocks. Once the stock price was high, Mehta could sell off the stock and make huge gain in the market. This in turn caused redistribution of savings of small investors into the hands of the large brokers.

The other aspect of institutional failures is the corporate governance in India It is well known that the corporate governance in India is one of the most inefficient with poor disclosures; incomplete information by practice (with highly dubious accounting practices); deliberately engineered incomplete or fraud information through collusion of major players (the role of large share holders or the so called promoters); and significant presence of the public sector financial institutions in the capital market. High costs of moral hazard take place when the actions of the managers (the agents) can not be monitored by the stock holders and the regulatory bodies. One could speculate that the amount of capital misused or sub-optimally used by the Indian corporate sector could be phenomenal.

The prevailing corporate governance institutions assigning a larger role to the so called promoters and large share holders with a major chunk of capital provided by the public sector institutions is observed to be working against small investors. The main problem in the Indian corporate governance is not a conflict between management and owners but a conflict between dominant share holders and the minority share holders as the dominant share holders (or the promoters) are the managers. In other words, there is no clear distinction between the principals and the agents (the managers). This, in turn, results in manipulation of stock prices and transferring of wealth across different units by the promoters (the major shareholders) which appears to take place in the domestic corporate and the multinational subsidiaries (Verma, 1997). For example, in the case of MNCs, where the promoter is a foreign parent company, the local subsidiary could transfer wealth to the parent by overpricing the services rendered by the parent. In the case of the Indian business groups, the promoters capture the public sector finance companies which are basically passive partners with a high moral hazard behaviour (as the managers of these institutions deal with the public money). The government financial institutions which are passive partners do not discipline the promoters as they are prone to moral hazard behaviour and could be easily controlled by the promoters. The promoter in many cases is not even a large share holder because he is able to capture these public sector financial institutions. The promoter who has access to the savings of the small investors and the public sector financial institutions could misuse the capital for personal ends. Furthermore, the rating

agencies such as CRISIL (the Credit Rating and Information Services of India Ltd) are owned by the financial institutions themselves which means the collusion among these players could engineer wrong (information) signals for inducing adverse selection from investors.

On the positive side, the increasing presence of FIIs appears to bring in some disciplinary mechanism in the corporate governance. The large investors could invest in information and monitor the companies investment behaviour. Every time, a company tries to divert funds for non-productive uses, FIIs will withdraw causing a fall in the stock price of the company and thereby bringing about some disciplinary mechanisms. On the negative side, FIIs selling shares might have less to do with how healthy a company is, but more to do with return differentials across countries in the world market. Secondly, similar to the manipulation of the market by the domestic players in 1992 as discussed earlier, FIIs could manipulate the equity market with their vast resources to cause redistribution of wealth in their favour. FIIs could undertake price rigging as they operate simultaneously in the Indian market and in the overseas GDR market. It has been observed that by targeting some corporations they could sell en masse and then when the price has been pulled down enough, pick up the shares cheaply in the GDR market (Samal, 1997). In essence, the systematic institutional failures of the capital markets destroyed the savings and confidence of small investors which in turn made the Indian market depend on short run foreign capital which could be highly destabilising.

One of the aspects of the inadequacies of the prevailing institutional conditions can be observed on the industrial policy reforms front. One of the objectives of the reforms is to increase domestic competition by eliminating industrial licensing and liberalising entry of MNCs. This is only partial reform because of competitive markets are defined in terms of absence of any form of entry and exit barriers. In the absence of entry and exit barriers, a relatively inefficient incumbent can be contested by a more efficient unknown new entrant. But prevailing institutions which cause high market transaction costs, and the capital market imperfections function as a major source of entry barrier to unknown new entrants and a source of long run market power to incumbent firms (Patibandla, 1997a). In other words, the prevailing institutional

conditions dampen the exploitation of entrepreneurial talent and markets will remain to be dominated by dominant domestic and MNC firms. This, in turn, results in lower than the potential economic growth as the established firms with market power produce at sub-optimal scales. Apart from this the poor institutions of governance and institutional environment that does not facilitate efficient mechanisms of contract formulation and enforcement cause high incidence of opportunistic behaviour. This leads to lower investment and economic activity. The several failures of joint ventures among the Indian companies and MNCs is a good example. Furthermore, one can see institutional failures on the front of tax laws and their enforcement. The ambiguity in the tax laws allowed the Indian corporate sector to evade corporate taxes for a long time. In several instances, these laws and rules are made ambiguous by the government agents for increasing their discretionary powers.

The other aspect of the institutional failures is ill-defined and inefficient enforcement mechanism of property rights with a highly inefficient legal system. As mentioned before, the poorly defined property rights can not capture the finer elements of private and common property characteristics leading to mismanagement of resources and irreversible damage to environment. Secondly, the poorly defined property rights give excessive control rights to the government agents which in turn causes high uncertainty for investment and also loss value to private assets. Excessive control rights in the hands of government leads to excessive intervention by the government into the private economic activity for rent seeking by the government agents. The inefficiency of the legal system causes high transaction costs in enforcing property rights which in turn results in under-investment.

4. The Institutions of Government

In this section, we discuss what are the necessary organisational and institutional structures of government for a free market economy. I delineate the institutional requirements of governance into:

1. Supportive institutions and

2. Regulatory institutions

The organisational scope of the supportive state institutions is provision of social security, provision of primary education and basic health and provision of some basic public goods like water and creating an efficient legal system. The regulatory institutions are the establishment and enforcement of competition policy, financial sector regulation and environmental regulations which require the task of monitoring and restraining. The enforcement of some aspects of regulatory objectives can be done with a combination of command and controls and also by making use of market incentives. Secondly, the issue of regulation involves the trade off between ensuring of competitive functioning of markets and possible loss of value of assets through regulation. This involves the issue of scope of an optimum level of regulation because there is a negative side to too much regulation i.e., loss of value : the assets can be devalued by a variety of control mechanism- including taxation, input controls, operation requirements, reporting requirements, rate of return limitations (Williamson, 1994). If there are effective private order institutions in the right place, the regulation can be minimal which contributes positively to economic growth by minimising the value-loss of assets involved in regulation.

As mentioned before, the engineering of the organisations for the above tasks is the easier part: these can be copied from a developed country like the U.S. or U.K. But the more difficult job is how to enforce the rules effectively which implies the institutional conditions. To illustrate this, a regulatory institution has to be neutral as regulation hurts the interests of one party. This involves mechanisms of ensuring the neutrality of the organisation by not letting it be captured by vested interest groups. Similarly, the supportive organisations could be captured by powerful groups to appropriate the goods: for example the Public Distribution System (PDS) benefiting the well off but not the poor in India.

One of the conditions for ensuring the enforcement of the defined rules effectively is by getting the organisational conditions right : clearly defined rules and the scope of the organisations, transparency of the rules (without any discretionary powers), decentralisation within the organisations and taking the organisations to the people (political and economic decentralisation), adopting incentive compatible

systems for the public agents. At the broader level, combining decentralisation with increasing investment in primary education reduces informational asymmetry and transparency of the rights and obligations.

Competition Policy

We take the example of competition policy for illustrating the regulatory aspect of institutions. The primary organisational aspect is defining what is fair competition, what is the objective and scope of the policy and what are the necessary organisational structures for enforcing it. Any behaviour of producers that is harmful to consumer welfare can be treated as anti-competitive behaviour- increase in price far above marginal costs, and spurious information (spurious advertising), etc A firm's or a group of firms ability to raise prices above average costs depends on market power which arises because of presence of entry and exit barriers and explicit and implicit collusion. First the policy has to ensure at the micro and macro level, elimination of any form of entry and exit barriers. Secondly, it has to monitor the behaviour of prices and restrain their positive deviation from long run average costs. Any conduct of firms that harms the competition, both prevailing and potential, can be treated as anti-competitive- predatory pricing by dominant producers, imposition of entry barriers for potential new entrants, etc. Horizontal and vertical mergers, if observed to cause any anti-competitive outcome have to be monitored and regulated. Secondly, a major part of competition policy is regulating natural monopolies for the provision of certain public goods like electricity. This may require government getting into contracts with private producers for production and distribution. For an efficient contract formulation and enforcement, there has to be competitive bidding for the projects and absolute transparency in contract formulation. For example, the recent telecom scandal in India is a result of not having these conditions.[8] For the enforcement of the policy it requires effective monitoring and restraining with the later task involving the legal system. The

[8] With rapid changes in technology, industries such as electricity generation and telecommunications are losing the natural monopoly characteristics which facilitate market based regulatory policies. For example, in the power industry there are three major components: generation, transmission and marketing. Changes in technology have made possible a competitive market in generation facilitating large number of private firm to compete effectively (Stiglitz, 1997).

enforcement requires an autonomous body that undertakes research and monitoring and legal litigation. Research is necessary not only to monitor any form of anti-competitive behaviour but also to keep track of fast changing technological, product and market conditions which have implications on the definition of a competitive structure (examples are software industry, telecommunications and power sectors).

In the present context, an effective competition policy is extremely necessary especially when private capital is being introduced into the public goods such as power, increasing presence of multinationals with large purses (which could result in predatory pricing by MNCs to eliminate domestic producers) and increasing horizontal and vertical mergers. At present, an ineffective job is performed by two separate bodies: the consumer courts and MRTP commission. MRTP commission is still stuck with a (conceptually) badly defined restrictive trade practices while consumer courts function as a separate entity. These organisations are not rightly set because they do not even have a conceptually well defined system of what is a competitive market and what is anti-competitive conduct. In case of capital market regulation, the effectiveness of SEBI has been minimal. As mentioned before, the primary market has been killed by the unscrupulous promoters and the mushrooming merchant banks. SEBI continues not to have powers to impose punitive damages for capital market violations. In other words, even the necessary organisational structures for implementation of a regulatory policy are missing.

Institutional Requirements of the Transition Period

In this section, I argue that the role of government is a lot more complex and demanding in the transition period of reforms than in the case of a matured capitalist economies such as the U.S. This is because it requires: 1) managing the transition by minimising short run costs of the reforms and making credible commitments and 2) setting the conditions for evolution of necessary institutions in the right direction.

The market reforms implies movement from a highly interventionist state to a more free market economy which has important distributional implications. The interventionist policies benefited some groups at the cost of others. For example, the highly protectionist policies benefited the domestic industrialists at the

cost of consumers. The opening up of the Indian economy to MNCs and to imports will cause a decline in the prices and profits of the protected industries. Secondly, the agriculture sector was subjected to price controls in the past and the removal of price controls and restrictions on exports may increase prices of food, hurting the low income groups in the short run. The labour market reforms will hurt the organised labour. Secondly, introduction of free market economy on the basis of expost distribution of assets and information, benefits the people who could participate in the market and leaves the others behind. The previous policies led to emergence of powerful vested interest groups (for example, removal of the reservation policies for the small sector has become extremely difficult because of the existence of politically powerful vested interest groups). Furthermore, the privatisation of public sector and introduction of private capital into industries such as power and telecommunications, in the absence of appropriate institutional mechanisms, provides opportunities for high degree of corruption by the government agents.[9]

The government should be able handle the complex implications of the transition by minimising short run costs, build up political consensus and make credible commitments. For example, freeing up of agriculture prices and implementation of exit policies which causes displacement of labour requires strengthening of the public distribution system of essential commodities and implementation of effective compensatory benefits to labour displaced by the reforms. A consensus for the reforms can be built up only by making a credible commitment of minimising the short run distributional costs of the weaker sections.

In the case of setting up of the initial conditions for evolution of institutions, right kind of organisational structures have to be set up as quickly as possible before new coalition and vested interest groups emerge which could thwart the evolution of institutions. For example, the privatisation of the city bus service in Delhi without getting a proper regulatory mechanism in place, has caused emergence of a strong

[9] For example, the privatisation of public sector in Mexico led to emergence of quite a few billionaires through dubious deals.

organised Mafia controlling the operation of the bus services. The setting up of the required organisational structures has to be combined with the policies of social sectors such as making the primary education as universal which, in turn, can reduce informational asymmetry and may facilitate effective norms of exchange mechanism. At present in India, the policy have not got even the organisational conditions right which will result in emergence of new coalition and vested interested groups seeking rent. This in turn will thwart evolution of right kind of institutions.

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