Working Paper

ECONOMIC REFORMS AND INSTITUTIONS: A FEW ISSUES AND POLICY IMPLICATIONS FOR INDIA

By

Murali Patibandla

W.P. No.1360
March 1997

WP1360

WP
1997
(1360)

The main objective of the working paper series of the IIMA is to help faculty members to test out their research findings at the pre-publication stage.

INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD - 380 015
INDIA

PURCHASED
APPROVAL
GRATIS/EXCHANGE
PRICE
ACC NO.
VIKRAM SARABHAI LIB
I. I. M. AHMEDABAD

Economic Reforms and Institutions : A Few Issues and Policy Implications for India

Murali Patibandla

Indian Institute of Management, Ahmedabad 380015, India

E-mail: muralip@iimahd.ernet.in

Abstract:

In the absence of necessary institutional conditions, market reforms in developing economies cause rent seeking and unequitable distribution of income. This, in turn, could stun economic growth and also thwart the emergence of right institutions. It is important for government policy not only to minimize the costs of institutional failures but also to set the initial conditions for the evolution of institutions in the right direction. This paper illustrates some of the costs of institutional failures and the policy implications in the present Indian context.

First Draft: March 1997

This research has been supported by a grant from Indian Institute of Management, Ahmedabad 380015, India

Economic Reforms and Institutions : A Few Issues and Policy Implications for India

Murali Patibandla

Indian Institute of Management, Ahmedabad 380015, India

E-mail: muralip@iimahd.ernet.in

I. Introduction

The sharp decline in the industrial growth in the recent times in India can be seen as a direct cost of institutional failures on several fronts especially the capital markets. In discussing the Russian experience of high costs of institutional inadequacies, Amsden et al (1996) observe, ``Instead of nurturing financial systems that successfully `intermediate' savings and investment flows among households, the public sector, and productive enterprises, the authorities have sanctioned unregulated financial speculation and pyramid schemes such as MMM whose crash destroyed the wealth of millions of shareholders and contributed nothing to capital formation.'' The observation is highly applicable to the Indian experience. During the last seven years, speculators, bogus corporations, and established corporations with bogus projects have been allowed to play havoc in the capital markets. This provides only one striking example of costs of institutional failures or inadequacy of prevalent institutions in context of market reforms.

The market reforms that have been implemented under the guiding philosophy of structural adjustment and stabilization policies of World Bank and International Monetary Fund have been simple standardized package deals (based on simplistic macro and micro economic theories) which are applied across developing economies ignoring economic and political institutional background of different countries. The example of Russian experience well exemplified by Amsden et al (1996) is a clear example of the high costs of this approach. This paper argues that the most important aspect of the reforms in the present juncture is setting initial conditions for evolution of necessary institutions in the right direction. Some of the arguments of this paper are extensions of the issues raised by this author in a previous paper (1994).

In addressing the question of why some countries are rich and others poor, 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." Taking that transactions and transformation (production) activity is done under a free market economy, absence of necessary political, social and economic institutions that facilitate efficient and fair process of this activity could be a source of economic stagnation. When we talk of market reforms and institutional conditions, we mean the transition economies that have undertaken a move towards a market economy after years of pursuing socialist or activist state model. The absence of necessary institutions in the context of reforms have to be traced from the history of different countries. For example, Russia and India have quite different institutional background. The package deal applied to these countries will result in highly diverse results. In terms of human and physical capital as also natural resources, Russia can be considered one of the richest countries. But this package deal approach to reforms reduced Russia to the bottom of the ladder.

Free market economies of developed countries function on the basis of institutions that have evolved through time and painstaking process. In the case of several developing countries and the eastern block, the sudden move towards free market economy from highly interventionist state implies that free market forces are expected to function on the basis of institutions inherited from past history, historically given social, political norms, attitudes and beliefs [1] and also absence of necessary organizational conditions. Under such conditions, the packaged deal approach of the market reforms could result in high costs in terms of highly unequitable distribution of income and rent seeking. The irony is that the rent seeking argument which was used to negate

[1] About year ago the following quote appeared in one of the Indian news papers. A rickshaw puller in Lucknow was supposed to have observed, " This minister who could not build a house for himself despite being in power for the last five years, what can he possibly do for us?." Under zero sum game politics, the political performance of a minister could be in terms of getting bigger piece of the pie under inter-group conflicts.

Market reforms imply lesser role of government intervention which means reduced power of politicians and bureaucrats. Irrespective policy changes on paper, the traditions that gave high degree of power and status to bureaucrats from top to bottom will restrain the change in their attitudes.

policy intervention (Krueger,1974, Bhagwati, 1982) appears to hold to the free market policies because of presence of sub-optimal institutional conditions: an example is the emergence of a small section of super rich in Russia after the reforms (see Scheflier, 1994, Amseden et al, 1996) and emergence of billionaires in Mexico through the privatization of public sector. Rent seeking is observed to take place when there is government policy intervention in terms of controls. A free market economy that reduces government policy intervention does not mean there would not be any control on the economic activity of private agents. Free market economies function on the basis of strong regulatory institutions that implement competition policy, minimization of negative externalities in production and consumption, and the public organizations that provide public goods through contracts with private producers. If these organizations are weak owing to absence of effective institutional conditions, they could be captured by vested interest groups which leads to rent seeking. In India's case, the recent examples are numerous: the controversy associated with the Enron deal, a few speculators vanishing with thousands of crores in the Indian capital markets and the several scams. These examples of costs of institutional failures of the present approach to reforms might be only a tip of the iceberg. In the context of the market reforms, the policy role is all the more important in setting up necessary conditions not only towards minimizing these costs but also towards evolution of institutional conditions in the right direction.

We take the work of Williamson (1985) and Douglas North (1990), which draws from Coasian theory of transaction costs and property rights as a reference point in discussing what we mean by institutions in a market economy. The literature of new institutional economics shows how various transaction costs are the main reasons why the impersonal large group competitive markets of the neo-classicals may not function effectively. The emergence of effective institutions facilitates fair exchange with minimum transaction costs. When institutions are weak or absent, exchange mechanism leads to unfair and unequitable outcomes which, in turn, stuns potential growth of a developing economy. By taking this framework, this paper brings out a few issues of costs of institutional failures and the policy implications.

II. What we mean by institutions

Transaction costs approach to institutions looks at institutional conditions in terms of costs of market transactions between economic agents under existing social, legal, economic and political conditions for formulating and executing contracts in exchange. The basis of transactions are on historically evolved social norms and beliefs and explicitly stated legal conditions. North (1990, p.27) defines transaction costs as "the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements." In this framework, the costs of transactions are the costs of collection and processing of information and those of formulating and executing contracts. Incomplete information and informational asymmetry across economic agents (which might be due to existing market conditions and also deliberately engineered by economic agents) lead to costs (in terms of bounded rationality) of moral hazard (the principal and agency problem) and adverse selection. Costs in formulating and executing contracts can be in terms of opportunistic behaviour by any one of the parties of exchange. We elaborate on and discuss these outcomes in the Indian context in what follow:

North distinguishes between institutions and organizations (substance and forms). Organizations can be engineered but not institutions. Functioning of organizations requires institutional conditions which involves numerous entities like economic, political and social attitudes and norms which can not be engineered overnight. Institutions evolve by the interaction between these entities and prevailing organizational conditions. In other words, while organizations with well defined rules and regulations can be engineered, institutions have to evolve and can not be engineered at will. For example, let us go by the approach that all contracts are incomplete because of all kinds of contingencies, and inherent complexity of nature. The nature and dimension of some of these transaction costs are determined by existing organizations, social norms and beliefs, and historical experiences. Certain social norms of exchange are relevant only to small societies where each agent knows the other socially. The close social interaction facilitates formulation and enforcement of economic contracts with lesser degree of cheating than in a large group setting with anonymous agents. For example, a pan shopkeeper may get into an understanding with a regular customer that she will pay the amount for regular purchases at the end of the month. The customer will be refrained from defaulting with a fear of social stigma of being known as a defaulter within the social group. In a large group context, where economic agents are anonymous

to each other, there will be no fear of social stigma and cheating could take place if there is no effective search and penalty mechanism and when contracts are highly incomplete. Therefore, a minimum level of trust among parties is required in respecting the contracts. Certain social norms in a country even in the larger group context that brings in the minimum trust and respectability of exchange may evolve through time of repeated transactions (history). Similarly, the anonymous nature of agents in a large group context facilitates certain transactions which may not take place in a small group. In other words, possibility of new markets emerging might be more in a larger group context than in a small group context. For example, an individual of a particular class doing certain jobs in a small village in some parts of India might be viewed as a social stigma. A good example of this is handloom weavers in several rural parts of India generally are unwilling to move on to other professions although they have not been able to make a living because of severe competition from the powerloom sector in the production of lower quality cloth. Private organized banks might not operate in small villages owing to economies of scale of larger transactions which, in turn, may cause non-existence of effective markets for savings and borrowing.

The arguments for decentralization of government bureaucracy for increasing accountability of public agents and for increasing transparency of defined rights of the public can be based on the above argument of closer social interaction between the government agents and the public which reduces possibility of cheating, opportunistic behaviour by the government agents. One example of this outcome is replacement of Taluks by Mundles in Andra Pradesh state. This is supposed to have increased the social interaction between the government officials and people at village level which, in turn, increased the accountability of government agents and also transparency of the legal rights of the public. In the present context, one of the initial conditions that can be set by the policy for facilitating evolution of institutions in the right direction is increasing the decentralization of the government bureaucracy.

The market reforms in the absence of effective underlying institutional conditions will cause high costs to certain groups and are doomed to fail. One good example of this possible outcome is the experience with privatization of city bus service in Delhi (Patibandla, 1994). In the crude sense of efficiency argument of a free market economy, the privatization is a success in terms of supply responding to demand. Prior to the privatization, any

commuter in Delhi could vouch for that travelling in the city bus service run by the government of Delhi required tremendous patience in terms of waiting hours for a bus and also gymnastic abilities for getting in and out of crowded buses. After the privatization, the supply of bus service increased significantly: increase in consumer welfare in terms of reduction in patience and gymnastic ability requirements. But the other side of the story is the costs of significant increase in fatal road accidents owing to institutional failure of the regulatory organization's inability to regulate the conduct of the private bus runners. In other words, there are regulatory organizations with well defined rules and regulations, but the institutional conditions are missing in enforcing the terms.

Defining the rules and regulations is the easier part of engineering organizations. But enforcing through effective institutions is the more difficult task which requires accountability of the public agents, transparency of information and minimum transaction costs. To illustrate this, one of the primary requirements for efficient functioning of a free market economy is implementation of an effective competition policy. Implementation of an effective competition policy requires good definition of anti-competitive behaviour of private agents and rules of restraining it which can be easily copied from other countries. But more importantly it requires institutional conditions of enforcing them. To take the example of the private bus service of Delhi again, there are regulatory bodies that are supposed to regulate but captured by vested interest groups. In the absence of effective institutional conditions, the private agents themselves may take the course of the law of the jungle. The competition between the numerous private bus operators in Delhi is intense. Each private agent tries to cut into the market share of the other not just by efficient operation but also by cheating. The efficient operation could be in a crude sense of speeding and overtaking each other which is observed to have resulted in significant increase in fatal road accidents. Since the cheating is not restrained by the regulatory organizations each private bus operator monitors other's behaviour and attempts to restrain it through whatever the means are available. One example of this from the author's personal experience while travelling in one these bus services is witnessing of a bus conductor beating up the other conductor by accusing him of violating the time schedule and for under cutting the bus fare. The emergence of the Russian mafia and the mafia in Bombay in India is basically a larger dimension of this result. In the case of the U.S, Douglas North (1990) observes that government intervention into the economic activity through anti-trust laws emerged in the U.S. because of

intense rivalry among the private producers. The private producers required a neutral body that restrains cheating or anti-competitive behaviour. If government organizations are week, this role could be taken over by the organized mafia. One good example in the Indian context is if a landlord wants to evict a tenant in large cities in India, s/he may prefers to go to the organized mafia rather than the legal courts because of high transaction costs of dealing with the Indian legal system.

The costs associated with informational imperfectedness (Williamson,1985 & 1994, Stiglitz,1972) is pervasive in the Indian economy- right from the activity of a poor illiterate person trying to acquire and use a ration card to the functioning of the capital markets. The inability of an illiterate person to receive and process correct information heighten the costs of transactions gives an undue advantage to other party in transaction who may possess more information. For example, the issuer of a ration card charges a bribe and the store keepers of the public distribution may not supply the commodities, a card holder deserves as s/he may not be in a position to verify. Even if s/he can verify, may have to incur high costs of enforcing his/her rights. Extending this argument, informational imperfectedness also causes monopoly and monopsony power. For example, a middle man who possesses more information about the correct price of a good may hide it from a producer and makes her/him to sell it below its opportunity cost. A producer who has more information could use it as an entry barrier to prevent a more efficient (in production) new entrant and derive market power. This possibility of lack of transparency of information of government agencies, and informational asymmetry across different private agents is pervasive in India and is a major source of rents and monopoly power to certain powerful groups. Under these conditions, the whole idea of liberalization lacks meaning.

During the last few years we have heard and read quite a bit about how the market reforms like industrial delicencing would bring in efficiency to industry by making it highly competitive by eliminating entry barriers. This approach appears to fail to understand a simple conceptual definition of free entry: absence of entry barriers would mean that an absolute (unknown) new entrant with a viable or more efficient project could raise capital without a relative disadvantage and contest a relatively inefficient incumbent firm. Why is that since the market reforms have been initiated the new entrants have been mostly multinationals and established domestic large houses (with large purses) diversifying into new areas ?. One can be sure that it is not because of dearth

of potential entrepreneurs in India. This is because of other sources of entry barriers owing to high market transaction costs combined with capital market imperfections exist (Patibandla. 1997b). Capital market imperfections in this context refers to differential costs of capital to new entrants and incumbents: a new entrant has to pay higher price to capital than a large established incumbent. An established incumbent has the cumulative experience (or accumulated contacts) of dealing with the Indian public and private organizations which, in turn, facilitates him/her to incur lower transaction costs than a new entrant. Higher transaction costs combined with capital market imperfections will be a major source of entry and mobility barrier to new entrants or more efficient smaller firms. This. in turn, facilitates a less efficient incumbent to derive long run market power and high profits irrespective of inefficiency in production.

Demsetz (1976) and others argued that certain firms in an industry are larger than others because they more efficient. Therefore competition (anti-trust) policy should not punish the more efficient large firms by restricting high industrial concentration. Can we apply this argument to Indian industries?. A few empirical studies have shown that in quite a few Indian industries small and medium scale firms are more efficient in production than large firms (Patibandla, 1997b, World Bank, 1989). The explanation for the large firms being larger irrespective of their relative inefficiency has to be traced from the entry and mobility barriers arising out of the prevailing capital market imperfections and high market transaction costs owing to sub-optimal institutions (Patibandla, 1997b). As long as these structural imperfections exist, the growth of industry will be lower than the potential: the production levels will be at sub-optimal capacities at higher average costs owing to presence of long run market power.

The institutional inadequacies of capital markets could be detrimental to industrial growth. The agency theory shows that when the ownership (the principal) and manager (the agent) of capital are separated, it can lead to moral hazard problem: a manager could use other's capital (savings) for his/her self interest and also less efficiently than its potential application. We all have heard how the public sector firms in India have been highly inefficient due to soft budget constraint and non-accountability of managers. Similar outcome (of high costs of moral hazard) takes place in joint stock companies when the actions of managers can not be seen or verifiable and monitored with minimum costs by the stock holders and also regulatory bodies. The amount of capital

misused or wasted by the Indian corporate sector could be quite significant when it is assessed in the context of presence of long run market power along with the highly imperfect institutional conditions of capital markets. Presence of long run market power helps the corporate sector to make high profits [2] (irrespective of their inefficiency) and provide certain minimum dividends to stock holders. Presence of market power does not force the management to utilize the capital most efficiently. In addition, the moral hazard outcome owing to institutional failures of capital markets facilitates managers to squander capital for personal goals and also to utilize it below its potential efficiency. One could speculate the amount of capital squandered by this mechanism in India could be phenomenal.

The other dimension of costs of institutional failure, as mentioned earlier, on the capital markets front can be seen from the havoc played by the speculators and adverse selection outcomes (for small investors) through engineered incomplete information and signalling by several companies operating in the capital markets. So much of capital has been siphoned off by these means in the recent years which not only eroded savings of small investors and also their confidence, now there is scarcity of capital for investment in productive assets.
The 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 modey for companies which exist only on paper. This is observed to take places under the collusion of merchant bankers, underwriters, advertisers, financial weeklies and other sundry marketeers under the very nose of regulatory bodies. It is estimated that about Rs.10000 million have been defrauded in this way during January and June of 1994, alone. The legally allowed preferential allotments of stocks and insider trading (informational asymmetry) by promoters and companies is observed to have caused misappropriation of capital anywhere between Rs.10000 million to Rs.50000 million (see Bhole, 1995). Furthermore, the high transaction costs in clearances, settlement, and share allotments and transfers works against small investors.

VIKRAM SARABHAI LIBRARY
INDIAN INSTITUTE OF MANAGEMENT
VASTRAPUR, AHMEDABAD-380015

[2] The average rate of profit of the Indian corporate sector have been observed to be 30 per cent while it is only 4 per cent for South Korean firms. See World Bank, 1989.

III. Property Rights

One of the important institutional requirements for efficient functioning of a free market economy is enforcement of well defined property rights. The above issues of contractual enforcement and the agency problem of capital markets implies the issue of establishing and enforcing of property rights. One of the propositions we discuss in the Indian context is: inefficient definition and enforcement of property rights causes under utilization of capacity, under investment and scarcity of goods and services and rent seeking which, in turn, stuns the growth of the economy: domestic and multinational firms may not invest in several developing economies where there is the fear of excess control rights by politicians and bureaucrats; under utilization of capacity of constructed houses arising out of the rent control act in India.

Following the work of Grossman and Hart (1986) and Hart and Moore (1990), Shleifer (1994) observes that establishing property rights means enforcing the contracts through which economic agents try to arrive at more efficient control structures themselves or finding ways to improve the efficiency of control rights directly. The capitalist mode of production, obviously, involves establishment of private property rights: the rationale behind this is that private agents with clearly defined legal possession of resources have incentives to utilize the resource efficiently. This does not imply that under free market economy there is no community owned properties: several public good provisions and also natural resources are common properties. The institutional requirements of free market economy involves not only conditions for enforcement of established private property rights but also for the management of common property resources. In several instances, management of common property resources is done without any explicit legal provisions. The trade offs involved in this context can be illustrated by a simple example that households with privately owned (or rented) houses would keep their houses clean and throw garbage onto the streets. As against this is the example of Calcuttans managing their underground commuting system quite efficiently and farmers managing common pool resource of irrigation system quite efficiently in Indian villages. This means that the efficient management of resources in free market economy involves legally established property rights and their enforcement mechanisms and also certain social norms, attitudes and foresight of private agents. The social agreements and norms may evolve through time of repeated transactions which facilitates economic agents to cooperate in order to avoid prisoner's

dilemma outcomes (cooperation taking place through repeated games). This implies that if an outsider is introduced into the system who has no long term stakes, it can result in competition (breaking up of the cooperative agreements) and mismanagemt of the resources. One good example of this result is the introduction of large fishing trawlers owned by large multinational companies in the Tamil Nadu and Kerala coast led to overfishing and erosion of livelihood of thousands of fishermen on the coast who has managed the common pool for centuries on the basis of socially agreed rules. In other words, the reckless approach to privatization could erode good prevalent institutions. Similarly, presence of negative externalities in production makes the control rights loose which means production activity by agent *A* may destroy the assets of agent *B* making him her loose complete control of efficient use of his/her asset: for example, the large scale fish farming and leather goods production destroying farm lands.

An illustration of poorly defined control rights (which are not fully legal) causing inefficiencies can be observed by comparing the functioning of the Indian and South Korean public sector firms. Public sector firms in South Korea and Taiwan are observed to be a lot more efficient than the ones in India (Datta Chaudhuri, 1990). As a matter of fact, the public sector firms in South Korea and Taiwan are observed to be more efficient than the private sector firms. The explanation for this is that control rights of the public sector firms in India has excessively vested with politicians and bureaucrats who have used them for personal goals like giving employment to their political groups. On the other hand, the management of the public sector firms in South Korea is a lot more autonomous and accountable.

The excessive control rights in the hands of politicians and bureaucrats causing rent seeking can be seen by the scams of land distribution by politicians in India and bureaucrats colluding and buying away high premium government owned urban land at throw away prices. In other words, politicians and bureaucrats may have disincentive in bringing about clearly defined rules[3] and laws about the public ownership of certain resources which may reduce their control rights and patronizing powers. Similarly, they may have lower incentive in

[3] When the rules are vaguely defined, they could be manipulated both by the public and private agents. It has been observed that most Indian corporate sector firms are zero tax paying. As the corporate tax laws have loopholes, the organized corpoarate sector manipulates them to avoid taxes.

privatizing or increasing the autonomy of the public sector firms which may reduce their patronizing powers, unless, of course, there are heavy pay offs involved in the privatization itself (a one shot gain). This vaguely defined control rights could result in under-investment by the private agents with a fear of politicians and government agents twisting these rules towards extracting rents.

High transaction costs of enforcing property rights can lead to under-utilization of capacity and scarcity of goods and services. This can be illustrated in the Indian context by the consequences of the rent control act in several urban areas. Under the existing rent control act, it is literally impossible for a landlord who gets into a contract with a tenant for its leasing for a particular period of time, to enforce the contract and make the tenant vacate the house after the completion of the specified time period. This gives a disincentive for a landlord to give his/her house for rent. It appears there are about more than two hundred thousand constructed flats remaining vacant and locked up in Bombay alone. In other words, the poor control rights have caused under utilization of capacity and scarcity of rentable flats to potential tenants. This, in turn, reduces the bargaining strength of people looking for rented accommodation in contract formulation with landlords who puts their apartments up for rent. Bombay's real estate prices are one of the highest in the world and at the same time one sees most underdeveloped real estate in the middle of the city which implies under-investment. While cities like Kaulalumpur and Singapore keep modernizing and developing into more efficient urban structures, Bombay appears to be trapped into the low development owing to the poor control rights.

IV. Unequitable outcomes of market reforms and institutions

It is generally well accepted that the structural adjustment policies which require significant reduction in government expenditure, exchange rate adjustments (which change relative prices of food and manufactured goods) and labour market reforms cause highly unequitable outcomes in the short run. There have been a few studies in India which have shown that since the reforms have been implemented, unemployment and poverty levels have gone up (Tendulkar and Jain, 1995). A referential observation for this issue of unequitable outcomes of market reforms is that market reforms benefit those who can participate in the market. There could be a section of people who can not participate in the market under the existing institutional conditions. Given the

expost institutions and unequitable distribution of assets, the present approach to reforms may not only exclude but also restrain a section of the people from participating in the market effectively. For example, since the reforms have been undertaken the stock market activity is becoming increasingly concentrated and non-competitive, serving the bigger and established interests (Bhole, 1995). This means small investors will find it increasingly difficult to participate in the market. Similarly, an illiterate person who can not receive and process information efficiently find it difficult to participate in the modern markets. It may also erode bargaining strength of a section of people in formulation of contracts. For example, the labour market reforms may increase the number of unorganized labour (looking for jobs) which, in turn, can erode the bargaining strength of trade unions. These outcomes have a cumulative effect because market reforms under the presence of sub-optimal institutions causes concentration of market power and this, in turn, may thwart emergence of right institutions.

A major part of the structural adjustment deal is the labour market reforms. Although one talks of labour market controls are very stringent in India, quite a large number of firms (in the textile industry) are able to close and retrench labour without much difficulty as the approach of the reforms to labour markets has been highly vague and adhoc (Anant and Goswami, 1995). The laws that were made to protect labour rights worked against them leading to lockouts by firms in textile industry and unemployment of labour. This type of perverse result of institutional failures on the labor market front is illustrated in the study by Anant and Goswami (1995). They observe that except in a few states in India, there is no widespread evidence of labour presenting insuperable hurdles to private sector restructuring. They observe that (p.281) " Usually, workers in the private sector agree to real sacrifices: (i) voluntary agreements to rationalization and retrenchment of surplus staff;(ii) phasing out of what is often a meagre retrenchment compensation; (iii) wage freeze; (iv) bans on fresh demands during a given period; and (v) agreeing to relocation, redefinition of work, and increasing productivity and working hours." Refusal on the part of state governments to terminate permanent workers (with due compensatory packages) led to several (sick) textile mills to declare lock outs in Bombay and Ahmedabad which means thousands of workers have been deprived of their terminal benefits and arrears. This, in turn, reduced these workers to almost to destitution. These illegally laid-off workers can not even avail of the government's Textile Workers' Rehabilitation Fund. Between 1983 and 1994, 50.000 odd-workers lost their jobs because of the

privately owned textile mills in Ahmedabad alone. Most of these workers failed to receive due benefits. The instrumentalities adopted by the Textile Labour Association to get compensation or alternative employment for these workers have been largely ineffective (Roy Chowdhury, 1995). The worst side of the story is increase in the unorganization of labour while the public distribution system (PDS) of food has been weakened by the approach of the policy reforms. The reduction in the budgetary allocation to the PDS under the structural adjustment caused not only weakening of the system organizationally but also narrowing of the gap between the open market price and the price charged for supplies through PDS.

On the institutional front of one of the major issues is targeting the poor by the PDS. A few studies have shown that a larger share of the benefits from the PDS accrues to the upper income groups. The poor both in the rural and urban areas depended on the open market for a large share of their food grains purchases than the PDS (George, 1996). On the organizational front, it should reduce leakage and effectively target the supply of basic goods to the poor identifying the target group and issuing the entitlements. For example, in Andra Pradesh the two rupee rice scheme by the state government has been effectively implemented by increasing the operational efficiency in identifying the target group and issuing the entitlements cards. The ability of the target group to be able to utilize the entitlements requires institutional conditions of transparency in the rights and accountability of the public agents. As mentioned before, the ability of the poor to utilize the public goods can increase through increased awareness which can be achieved through universal primary education and also decentralization of the government machinery.

V. Development State and Institutions

A referential question under this issue is whether the required institutional conditions for an efficient functioning of a free market economy (under a neutral state) are any different for a development state that takes up the role of correcting market failures for achieving economic growth. One can argue that if all the necessary institutional conditions which minimize transaction costs and informational asymmetry exist, Arrow-Debru general equilibrium conditions may be consistent with the notion of growth as they may facilitate efficient inter-temporal allocation of resources which is the crux issue of economic growth. But the germane point is as Frank Hahn

(1984:136) observes "....that a myriad of self-seeking agents left to themselves will lead to coherent disposition of economic resources, Arrow and Debrue show what the world would have to be like if the claim is to be true. In doing this they provide the most potent avenue to falsification of the claims." The absence of the necessary conditions for efficient functioning of free markets is generally accepted to be dominant in developing economies leading to market failures in (inter-temporal) resource allocation.

During the last few decades we have contrasting stories of development states of South Korea, Taiwan performing a good job and others such as India and Latin American countries performing relatively poor. One explanation put forward is that the costs of government failure in correcting market failures in the latter countries has been more dominant than costs of market failures (Datta Chauduri 1990). The government failure can be viewed as an institutional failure in terms of vested interest groups capturing the policy and using it for group interests trapping the countries into zero sum politics. This type of institutional failures leading to inefficient economic outcomes could very well take place under a free market economy. As mentioned before, for efficient functioning of free market economies, the government has to provide an effective rule governed environment. It has to play an effective economic regulatory role like implementation of competition policy and undertake provision of public goods etc. In the absence of effective institutional conditions, these organizations can be captured by powerful vested interest groups. In other words, one has to get the minimum institutional conditions right for the functioning of a free market economy. In the presence of effective institutional conditions in terms of high accountability of government agents and transparency of information, etc., government playing an additional role of correcting market failures may be a matter of increasing the organizational component and scope: collecting and processing information and making it available to private agents, facilitating investment into those sectors where private investment fails to take place owing to lack of intertemporal information etc. This role of correcting market failures by collecting and processing information from the world market conditions and using it for channelling both public sector and private investment can be easily seen from the Japanese and South Korean experience (Pack and Westphal, 1986, Amsden, 1989).

To elaborate on this issue of higher organizational scope for a development state, let us assume that both the public and private agents have the same ability to process information and make rational decisions and there

is no moral hazard problem (owing to high accountability). In other words one relevant question is whether increasing the organizational content and scope of the job of government agents (more than a regulatory role and provision of a few public goods) will increase chances of moral hazard problems. If it does not, the issue will be mainly the state's ability to invest capital into its additional job and capabilities in terms of identifying specific sectors for promotion and building net works between the private capital and the government as observed in the case of South Korea, etc. The ability of the government agents collecting information might be more than private agents operating individually because the public goods nature of information may make a private agent to refrain form investing large capital in the collection of information (market failure). An example is the Taiwanese government collecting, processing and passing on the information about the world market conditions for hundreds of small producers for facilitating exports.[4] Similarly, the Japanese and South Korean ministries in the 1950s and 1960s were able to process the world market signals and identify the electronics and automobiles industries to be the dominant future industries and guide private and public investment into those sectors through selective policy intervention. In other words, the development states of South Korea and Japan were able to play an entrepreneurial role.

Evans (1995) comparative study of South Korea, India and Brazil with regards to state involvement in the development of the information technology industry shows how Indian and Brazilian governments' organizational efforts or abilities fell short of making the industry internationally competitive in comparison to the counterpart in South Korea. In all the three countries the birth of this industry in the 1960's took place because of government's intervention. In the 1960s no private entrepreneur could even see the potential of this industry in a developing country. The indigenous entrepreneurs could not even think of competing with the internationally dominant firms such as IBM and ICL. The government initiatives in supporting private investment and also public sector investment (Bharat Electronics Ltd in India) led to the birth of the industry which grew into a significant one by the eighties and nineties. The Indian and Brazilian industry could not achieve the same success as the South Korean one which became a world leader in semi-conductors. Evans attributes this failure of Indian government to lack of capital and resources to nurture the industry continuously

[4] On the other hand there is the example of Italian industrial districts in which groups of small firms have been able to collect information and use it as a collective activity.

while South Korean government could do it by investing a lot of capital in a targeted and systematic way and building up a good net work between the government and private producers. In other words, South Korean government was able to use the capital and resources available to it in a very selective and targeted manner with lesser controls on the private producers while Indian government by taking up pervasive economic role used it in a highly diffused manner. The larger controls and pervasive intervention by the Indian government might have also caused high costs of leakage and rent seeking owing to existing institutional inadequacies. One does not know whether this larger job of the government caused increase in the probability of institutional failures.

The crux of the issue from the above discussion, to repeat, is that for free market economy to function efficiently one has to get institutional conditions right: the regulatory institutions and the public organizations that provide public goods have to function with minimum moral hazard (high accountability) and opportunistic behaviour on the part of public agents. Once we get these institutional conditions right, the government can play an effective role in correcting market failure for growth through *selective* policy intervention by increasing its organizational scope.

VI. Conclusion

Free market economies function on the basis of strong underlying institutions. Institutions, unlike organizations, have to evolve through time and can not be engineered at will. This paper has pointed some of the costs involved in the present approach of market reforms in India owing to absence of necessary institutions and inadequacy of existing institutions. In the context of market reforms, the policy role in minimizing the costs of inadequacies of prevalent institutional conditions and setting the right initial conditions for the efficient evolution of institutions is extremely important. The government has to minimize the highly unequitable outcomes of market reforms in the short run by creating and strengthening organizations that can provide minimum social security net. If the policy does not take up these tasks, the emergence of right institutions can be thwarted by the market reforms leading to increase in the concentration of market power and also emergence of wrong institutions (like the organized mafia enforcing property legal or illegal rights). One of the initial conditions is increasing the decentralization of government bureaucracy, increasing the transparency of

information, investing in universal primary education. Decentralization could increase the social interaction between the public agents and the public and increase accountability by reducing opportunistic behaviour of government servants and also by increasing the transparency of defined rights. Piecemeal approach to the policy setting the conditions may not be effective. For example, decentralization combined with increase in primary education could enhance the ability of the weaker sections to participate in the market more efficiently by reducing the transaction costs and informational asymmetry across economic agents. Furthermore, unregulated or reckless introduction of private capital into the use of certain common pool resources could destroy the good institutions of cooperation and misutilization of these resources. As discussed before, allowing fishing by multinational companies in Kerala coast has destroyed the livilihood of thousands of fishermen.

References

Akerlof, 1976, The economics of caste and of the rat race and other woeful tales', Quarterly Journal of Economics, vol.90, 4, 599-617.

Amsden, A., M.Intrilligator, R.McIntyre and Lance Taylor, 1996. Strategies for a viable transition: Lessons from the Political Economy of Renewal, Economic and Political Weekly, December 28, 52, 3383-3390.

Amsden, Alice, 1989, Asia's Next Giant: South Korea and Late Industrialization, (New York: Oxford University Press)

Anant, T.C.A and O.Goswami, 1995, Getting everything wrong: India's policies regarding `sick' firms, in Dilip Mookherjee (eds), Indian Industry: Policies and Performance (New Delhi: Oxford University Press).

Bardhan, P., 1984, The Political Economy of Development in India, Oxford:Basil Blackwell.

Bhagwati, J.N, 1982, Directly unproductive, profit-seeking (DUP) activities, Journal of Political Economy, 90, 988-1002.

Bhole, L.M., 1995, The Indian capital markets at cross roads, Vikalpa, 20, 29-41.

Datta Chaudhuri, M, 1990, Market failure and government failure, Journal of Economic Perspectives, Summer, 25-39.

Demsetz, H., 1973, Industry structure, market rivalry and public policy, Journal of Law and Economics, 16, 1-10.

Doner, F. Richard, 1992, Limits of state strength: Towards an institutionalist view of economic development, World Politics, 44, April, 398–431.

Evans, P, 1995, Embedded Autonomy: States and Industrial Transformation, (Princeton: Princeton University Press).

George, P.S, 1996, Public distribution system, food subsidy and production incentives, Economic and Political Weekly, September, 28, 39, A-140-144.

Grossman, S.J and O.D. Hart, 1986, The costs and benefits of ownership: A theory of vertical and lateral integration, Journal of Political Economy, 94, 691-719.

Hahn, F, 1984, Equilibrium and Macro Economics, (Oxford: Basil Blackwood).

Hart, O.D and J.Moore, 1990, Property rights and the nature of the firms, Journal of Political Economy, 98, 1119-58.

Kohli, A (1988), India's Democracy: An Analysis of Changing State: Society Relations, (ed) Princeton: Princeton University Press.

Krueger,A.O,1974, The political economy of the rent-seeking society, American Economic Review, 64, 291 303.

North, Douglas C., (1990), Institutions, Institutional Change and Economic Performance, (Cambridge: Cambridge University Press).

Pack, H and Westphal, L.E., 1986, "Industrial Strategy and Technological Change: Theory versus Reality," Journal of Development Economics, 22, 87-128.

Patibandla, M, 1997a, The Policy reforms, evolution of domestic market structure and exports, Indian Institute of Management, Ahmedabad.

-------1997b, Structure, organizational behavior and technical efficiency, forthcoming in Journal of Economic Behavior and Organization.

------ 1994, Defunct economists and economic Policy: Economic policy reforms in India', Economic and Political Weekly, November 5-12, 45, 2935-39.

Roy Chowdury, S, 1995. Industrial restructuring, unions and the state: The case of textile mill workers in Ahmedabad city, Working paper 1269, Indian Institute of Management, Ahmedabad.

Roy, Sumit, 1995, New institutional economics, state and development: Some conceptual and empirical issues', Economic and Political Weekly, July 29, PE-65-72.

Shleifer. A, 1994, Establishing property rights, in Proceedings of the World Bank, Annual Conference on Development Economics.

Stiglitz, J, 1972, On the optimality of stock market allocation of investment, Quarterly Journal of Economics, 86, 25-60.

Tendulkar, S.D and L.R.Jain, 1995, Economic reforms and poverty, Economic and Political Weekly, June 10, 23, 1373-77.

Williamson, O.E, 1994, The institutions and governance of economic development and reform, in Proceedings of the World Bank, Annual Conference on Development Economics.

_______ 1985, The Economic Institutions of Capitalism, (New York: Free Press).

World Bank Country Study, 1989, India: An industrializing economy in transition, World Bank, Washington D.C.

PURCHASED
APPROVAL
GRATIS/EXCHANGE
PRICE
ACC NO.
VIKRAM SARABHAI LIBR..
I. I. M. AHMEDABAD