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## Budgetary Processes: A Political Economy Perspective

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### Abstract

The response to macro shocks, given the electoral structure, built in perverse incentives that influenced India's development process. The chapter selectively surveys political economic theory, Indian and other country experience to bring out the systemic incentives that affect political behaviour, government budgets, and expenditure. Conceptual categories developed are found useful in interpreting Indian experience. Overtime, conflicts between groups were handled in a way that lowered incentives for expansion of the cake, and led to a short-term focus. Price controls bred inefficiencies, especially after the oil shocks. But there are leverage points for change. Well-coordinated macro policy, including infrastructure spending, with some restraints on political-bureaucratic choices, could create incentives for rapid growth. The latter eases political adjustments. It makes longer-term sustainable re-distribution feasible, and raises returns to choices that improve human capital.

*JEL codes:* D72, D73

*Key words:* perverse political incentives, macro shocks, price controls, political bureaucratic choices

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## 1. Introduction

The perspective taken in this chapter is that political structure influences incentives, choices, including those of politicians, and outcomes. Historical shocks and past administrative choices are responsible for the current structure. Budgetary processes and policy more generally are endogenous. There exist leverage points for change (Morris, 2001), and change can be rapid once it reaches a critical mass. Well-coordinated macro policy, including infrastructure spending, with some restraints on political-bureaucratic choices, could create incentives for rapid growth. Growth eases political adjustments. It makes longer-term sustainable re-distribution feasible, and raises returns to choices that improve human capital. The popular awareness of the long-term consequences of past choices that were focused on the short-term, and the bankruptcy of governments, may make some changes incentive compatible for politicians. Others would require public awareness and pressure.

The chapter surveys theory, Indian and other country experience to bring out the systemic incentives that affect political behaviour, government budgets, and expenditure. The surveys are all partial. For example only the incentive features of choices made by fast growing countries such as the US and China are explored. It is not possible to do justice to the enormous debate on India's development/political economy. Although the rapidly expanding debate on governance<sup>1</sup> addresses some of these issues, the latter's role in India's developmental history has been somewhat neglected. It is necessary to try to understand why policies that are known to be desirable are not implemented, and what changes would make them more feasible. The new feature is the emphasis on disincentives built in due to responses to macro shocks, given structure and history.

There is a large body of recent theoretical and empirical work in the new political economics literature on the incentive effects of budgetary procedures and political processes. We extract lessons both from theory and country experience relevant to Indian

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<sup>1</sup> In particular the India Infrastructure Reports, (3i network, 2001 and 2002) focus on regulation and governance in the context of infrastructure. See the overview chapters by Morris (2001, 2002), and others by Anant and Singh, Morris, Pandey, and Varma.

conditions. Readers who are interested only in the latter should, at this point, go straight to section 5 on history.

The structure of the paper is as follows. Section 2 identifies the surplus that can be released by institutional re-structuring. Section 3 briefly surveys relevant concepts in the theoretical literature on budgetary institutions, section 4 does the same for political processes, section 5 shows how these, together with its history, help to understand outcomes in India. Section 6 brings out relevant aspects of country experience, section 7 draws together implications for policy based on analysis and experience, and section 8 makes some concluding remarks.

## 2. Sources of Surplus

Laffont (1999) remarks that economists can serve as technicians, and give politicians information, which will help them favour their constituency at the expense of other groups. This leads to a worse average outcome. But they have an alternative. "By suggesting constitutional rules which decrease the discretion of politicians even at the cost of some efficiency losses, economists can enhance expected social welfare (pp.150)." This approach differs from the earlier Chicago school political analysis, since the latter took the political structure as given and uncontrollable. It focused on interests groups and the deadweight losses of rent seeking activities, but ignored asymmetric information, which gives the source or supply side of influence activities. Transaction costs and information imperfections are one source of the inefficient political equilibrium, and potential distributive benefits. Simple rules that take these factors into account reduce inefficiencies and yield extra output, which is then available to implement the rules. If political economy is a game of redistribution of rents, the economics of incentives provides the necessary tools for modeling interest-group rent capture as a function of deeper economic parameters. Hoff and Stiglitz (2001) argue that for deep changes to be possible, it is necessary to understand political interests. The role of the politician is then in between, neither like the predatory Government of the Public Choice School, nor like the optimal planner of neoclassical theory. The surplus out of change can

be used in ways that further enhance it, which in turn makes cumulative improvement possible.

One definition of politics is *a mechanism for making collective choices, for gaining power and using it in a conflict of interest among economic actors*. Political economics recognizes the existence of political constraints that cause actual policies to differ from optimal policies. It leads to a normative research program for discovering which policymaking institutions produce better policy outcomes. Since policies are endogenous, change can come only by changing underlying institutions. Ideology and even ideals have a role in political decisions, but once perverse incentives affect a critical mass, it becomes difficult for the few to resist the trend.

A planner's optimal solution frequently differs from one that is influenced by political forces. A planner's solution for aggregating individual preferences to maximize social welfare is Pareto efficient so that no one individual can be made better off without making another worse off. The outcome is always on the Pareto frontier or set of such Pareto efficient points. In political economics the focus is on the political process by which the policy choice emerges. Therefore the outcome may not maximize social welfare, and may not even be Pareto efficient. If a mechanism can be designed that moves society to the efficient point a surplus becomes available that may help to incentivise the mechanism. The electoral process throws up political power, and the political process in appeasing heterogeneous interests, determines expenditure allocations. Are there changes possible in these deep-seated institutions and processes that can lower waste and improve outcomes?

Public goods are non-excludable so there is a free rider problem in their provision, although some infrastructure can be priced. If consumers cannot be excluded from consumption of a good there is no direct incentive for them to pay for the good, leading to the collective action problem. In the latter, the net benefit to a participant in any group activity, after subtracting costs from gross benefits arising from contributions to the group's activity may be negative. It is analogous to the Prisoner's Dilemma Game (PDG),

in that, the rational outcome where everyone maximizes their own welfare makes everyone worse off since now public goods are under provided (Hardin, 1982). There is a natural role for the State in coordinating to the better equilibrium<sup>2</sup>. *Thus although politics is about power, conflicts and re-distribution, it is also about solving the collective action problem. It can do this by changing zero or negative sum conflicts into interactions that yield a potential surplus.*

To sum up, externalities can arise from higher growth, asymmetric information rents, and coordination problems. These are all potential sources of surplus, which if realized, can incentivize change. But the collective action failure that gives rise to coordination problems influences political and budget processes. Asymmetric information adds inefficiencies to the latter two. All these influence growth, which is itself a source of surplus. Therefore deep and sustainable change needs to act on these foundations.

Dominant international ideas have influenced Indian policy makers. Independent India inherited a strong state, and wartime controls, from the British. The dominant development idea was of state led industrialization. But as growth slowed down after about ten years, political pressures resulted in direct short-term transfers that had indirect and non-obvious long-term costs. The incentive properties of these interventions only harmed growth. Current dominant ideas that suggest a more balanced role of government give an opportunity to set right some of these distortions.

### 3. Budgetary Institutions

Theoretical models allow sharp derivations of the consequences of structure and behaviour. If the aspects focused on are dominant in real economies, such models aid in understanding actual tendencies at work. In the next two sections we present such model

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<sup>2</sup> Basu (2000) argues for this view of the State and of law, as an equilibrium selection device, that solves a coordination failure. Since both are endogenous, they can change only the selection of equilibrium, not the economy game. He points out that it was the 19th century British philosopher Hume, who first understood the role of the state in this way. While our collective action problem gives rise to a PDG, there can also be a simpler coordination failure with multiple Nash equilibria.

dependent results<sup>3</sup>, where the models capture some relevant aspects of Indian reality, related to budgetary institutions and political processes. We briefly indicate in what respect the model or result is relevant to India. In section 5, these results are used to explain aspects of a more detailed Indian developmental history.

The major rules and institutions that determine government spending are first, quantitative limits or budget laws, and second procedural rules. Finally, implementation methods and tax-transfer policies also affect incentives.

### *Laws and Rules*

Limits can be legislated on different government deficits and debt or targets set, and ceilings put on expenditure. But it is always possible to evade a budget law. Empirical work, with data for the US States, has shown that laws were complied with but only in letter. The laws had very little effect because creative accounting was often able to violate their spirit<sup>4</sup>. For example, fiscal restrictions affected the debt mix, but not the total. There was a shift to non-guaranteed debt. Indian national and sub-national governments are also able to hide deficits by juggling extraordinary expenditure categories and so on. The problem is compounded by difficulties in measuring government debt or deficits. Therefore internal as well as external incentives for budget control are required in addition to laws. Examples of the former include norms, ethics, and accepted practices. Better-designed budgets should make it easier to plan and run programs, and together with more transparency, work to increase voter pressure to limit budget sizes. It would remedy the frequent complaint of Indian local governments about the imposition of rigid budgetary practices from above, without a consideration of local needs and capabilities. Flexibility would moderate the effect of rigid budget laws in inducing a larger initial size to take care of unforeseen contingencies.

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<sup>3</sup> The survey in this and the next section is largely based on Blanchard (2000), Drazen (2000), Goyal (1999, 2001), Laffont (1999), and Persson and Tabellini (1999, 2000, 2002).

<sup>4</sup> See Drazen (200), pp. 701. The Enron, Anderson and WorldCom debacles have highlighted a similar problem in American corporate governance. The letter of the law is often followed, but many innovations including off balance sheet items violate its spirit. Proposed reforms include stricter CEO accountability, control of conflict of interest in the board of governors, transparency, and market discipline.

### *Budgetary Procedures*

One basic reason a democratic government may end up overspending is the common pool problem. This arises whenever spending decisions are made in a decentralised way, in favour of different groups, and the tax rate is then residually determined. The concentrated benefits are fully internalised, but each group internalises only a fraction of the social marginal cost of the tax increase required for funding, since the pool of tax revenue available for funding is common. There exist specific procedures to help overcome the problem, and limit the size of the deficit. We discuss some that have been examined analytically and tested empirically.

Consider the following stylized budgetary process. Any one representative, chosen to be the agenda setter, makes a policy proposal. The legislature votes on the proposal, if a simple majority approves, it is implemented, otherwise the status quo remains. This is known as a closed rule since proposals cannot be amended. It turns out that spending will be lower if ministers without constituencies, such as a prime minister or finance minister, are given special powers. These include agenda setting rights, right of veto, and setting binding limits on allocations. It should be clear who is responsible for an observed abuse of power. This hierarchical process strengthens collective interests, against the selfish interests of ministers who, under a more democratic decision process, would push the interests of their specific constituencies. The drawback is that minority interests can be neglected. In addition, if the status quo entails zero-base budgeting, this acts as a further disciplining factor to control excess spending, since in that case the default alternative involves minimal spending. The basic reason separation of powers reduces expenditure is because it removes conflict of interest; whoever cuts slices from a cake should not be responsible for distribution of the slices. The agent who has proposal rights over expenditure should not be the one who stands to directly gain from it. The countervailing pressures generated induce, although they may not ensure, a more fair and efficient division.

Under an open rule other legislators have amendment rights, and there can be separation of proposal powers. For example, there may be a vote on an amendment offered on an

initial proposal, with further rounds of amendments. Although the possibility of amendments in the budgetary process increases the size of the deficit, there is a theoretical result that wasteful expenditure can be higher under a closed rule compared to an open rule (Baron, 1991). The reason is, if legislators are forward looking and sophisticated, they internalise the stages of the budget process. Therefore in order for them to support a budget proposal, when no amendments are allowed, net benefits they gain must exceed those that could be expected if the proposal is defeated and the budgetary process continues. To gain majority support such a proposal needs to be large enough to please everyone. There may be non-budgetary or office related payoffs.

A similar problem as occurs in the closed rule can defeat two-stage budgeting (2SB). Under 2SB, aggregate spending is decided before allocations of expenditure in order to insulate the total from interest group pressures. But if sophisticated legislators realize the implications of their decisions for subsequent appropriations, 2SB need not lower budget size in equilibrium. A larger size would be set at the first stage. The value of 2SB in lowering budgetary waste has empirical support, however. Particularly when there are agency problems the separation of powers in 2SB helps voters to discipline their agents, the legislators. For example, if the agenda setter is not the "residual claimant" at the second stage, he will have no interest in expanding the budget.

In Indian central government budget practices, primary responsibility for the budget-size does lie with the finance minister and the Prime Minister, although budgets tend to be incremental so this is not really exercised. And forward-looking beneficiaries are able to get what they want by, for example, padding salary bills (Das-Gupta, 1999). But still deficits were in control until the period of unstable coalition governments and competitive populism that set in from the eighties. Although there are pre-budget meetings with the different interest groups, these tend to be routine. Widespread media debate after the budget speech can lead to substantive changes<sup>5</sup>. There is vote in the legislature before the budget bill is passed.

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<sup>5</sup> An example of this is the rollbacks announced in 2002. The budget initially targeted the middle classes heavily. It was perceived to be unfair and there was widespread protest in the media. Finance minister Sinha's response was that he was not out to win a popularity contest, but the Prime Minister intervened after

### *Implementation*

Budgetary implementation through control and monitoring make incentives low powered. The use of self-motivation is minimal; agents are supposed to obey instructions. This works better for simple processes or in early stages of development or planning when effective and low-cost monitoring is feasible. In more complex processes monitoring needs to be complemented by delegation to residual claimants. The latter have high-powered incentives, since the returns from greater efficiency stay with them. Such changes characterize the movement from planning to more market led development. If politicians plan to stay in power for long, campaign contributions are important, and there is little competition, so that reputation does not matter, they will still prefer simple command-and-controls mechanisms (Laffont, 1999). In India political fragmentation occurred rather than competition. Reputations were uniformly bad and a system was not devised for campaign funding. Therefore politicians clung to discretionary power to be able to implement short-term transfers and secure votes.

Following the control philosophy budgetary implementation in India, although quite detailed, tends to focus on monitoring inputs. This makes participants strategic and forward looking in trying to maximize their allocations, but with no incentives for delivery. The horizon is very short-term regarding outcomes. Modern management information systems, in contrast, clearly allocate responsibility for outcomes, measured as variance from budgeted amounts, right down the hierarchy, together with continuous feedback. Mid-term correction is possible and delivery is ensured. The system is transparent and incentives are very different<sup>6</sup>.

Daily expenditure control and tax-transfer mechanisms also affect budgetary implementation. One such mechanism is user charges for public services. In India, as a populist measure in the context of low growth and major cost shocks of the early

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the BJP lost some by-elections, a new more politically savvy finance minister was brought in who announced concessions for the middle-class.

<sup>6</sup> I thank Niraj Goyal for helping me understand the cost and responsibility accounting very successfully introduced in a multi-national company.

seventies, many such user charges were frozen. Apart from expanding budget deficits, this had major incentive effects on the provision of public services. Exploring these will help to understand the disincentives built into the Indian system.

Two extremes in pricing rules have opposite effects on the incentives of a provider of a public good or service, to lower cost or to improve quality. With a price cap, incentives are high-powered since the residual profit share lies with the producer. The latter is motivated to decrease costs. Since rate of return regulation reimburses the cost of the service, incentives are low-powered. Profits from improvements do not stay with the producer. Thus there is a trade-off between rent extraction and providing incentives for additional effort. With a low enough price cap the regulator extracts all rent, but incentives to invest and improve quality may fall. Since costs rise with quality low-powered incentives are required for the provision of quality. There is a disincentive to invest in the presence of low price caps also because sunk costs made for investment may be expropriated. If even costs are not covered rent is over-extracted<sup>7</sup>.

Optimal cross-subsidization is derived if social welfare is maximized subject to a budget constraint. This gives the Ramsey-Boiteux rule that the price marginal cost gap should be inversely proportional to elasticities of demand. Thus the poor should be charged higher prices if they have a lower elasticity of demand, but they can be cross-subsidized as long as the budget is balanced. The rule has been generalized into the theory of optimal non-linear tariffs. These pricing principles are violated if, in the aggregate, charges do not even cover costs. Cross-subsidization is then excessive and generates inefficiencies that raise cost further. Moreover, competitive entry occurs if, with cross subsidization, the price in any sub-market exceeds cost, or if new technology lowers cost or breaks a natural monopoly. Then government revenues from these sub-sectors fall further. This happened in Indian telecommunication where expensive international calls used to subsidize local calls.

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<sup>7</sup> Many chapters in IIR 2001, which was on regulation, cover these issues in detail. See the overview in Morris (2001).

The underlying political structure influences budget processes adopted. We turn to the former in the next section.

#### 4. Political Processes

Since the focus is on systemic incentives, the role of individual politicians, their leadership or lack of it, is abstracted from. It is possible for individuals to rise above a perverse system, but the majority gets affected adversely. Consider voters (the principals) who delegate control rights and collective decision making to elected officers (their agents) because of costly and asymmetric information. Since the preferences of voters and their elected representatives are not perfectly aligned there is an agency problem. Elected politicians know more than the voters do, so that there will be information rents associated with the provision of any public service. A stronger media and other measures to improve transparency can lower such rents, but not eliminate them altogether. Revelation mechanisms, such as supervision or separation of powers, cannot fully extract politicians' information or prevent the politician from favouring interest groups, without perfect enforcement by courts, perfect foresight, and rationality.

There are three degrees of freedom, the electoral structure, which selects the politician with residual control rights, the discretionary decisions left with him, and the non-contracted states of nature. There is a tradeoff between rents and efficiency. If the decisions of the politician are restricted, his discretion and rent or political capital taking falls, but ex-post efficiency may also be destroyed. When politicians are chosen as residual decision makers for ex-ante non-contractible social decisions, if they have more instruments available, the more efficient is the outcome, the less is the underutilised surplus from asymmetric information, but they have more discretion to favour their own constituencies.

##### *Separation of Powers*

The constitution uses separation of powers, checks and balances, and elections to align incentives, but it is an incomplete contract. Under non-contractability about ex-post states

of nature there are cases where the constitution provides no guidance and the politician has residual control rights. Features such as a specific allocation of proposal and veto rights, that create a conflict of interest among politicians, can reduce the rent they capture.

One conflict of interest the constitution builds in is that between the legislature, which makes laws and the judiciary, which interprets them. The judge-based system imposed by the British government, was based on legislative statutes meant to keep a subject nation in control, unlike their own common law traditional based on past judgements. There was a strong contempt of court clause to give more power to the judges. Post independence a heavy use of law to enforce development, confiscation of property etc. continued. So the legal system functioned as an instrument of the State. Judges were also expected to interpret the constitution to maintain individual liberty and social justice, and defend the weak against the strong. Conflicts often arose with the State. In the eighties public interest litigation (PIL) became a useful way to put pressure on the executive to deliver, and to cover lapses in legislating, as governance failed. Conflicts sharpened; some landmark judgements were made. Since legislators will not pass laws against themselves they resist attempts to enforce greater probity and transparency on them, leading some commentators to suggest an independent law board to pass laws that affect legislators (Haldea, 2002).

But there are limits to judge-based activism. Too much power to any one arm tends to corrupt it. It also goes against the Indian native jury system of wise men that did not directly confront the ruler, but reminded them indirectly of the Dharmashastras, and local norms. Judicial instincts retain enough of the old value based system to moderate conflict (Dhawan in Frankel et. al., 2000). Moreover, the rule of law is expected to aid development of markets by upholding certain basic principles, and ensuring predictability in transactions across agents, over space and time (Trubeck, 1972). Excessive legislation, regulation, or judgements, can impede these developments, restrict individual liberties, leading to corruption and delays, which make a mockery of the law. India has an archaic, cumbersome system of laws whose basic underlying principle of control is no longer

relevant. There are huge backlogs and delays in justice. If law is ineffective more of it, or imposing stricter punishment, may not work, but simplifying it, and bringing it closer to the way people actually live, may work. Judges also do not have the technical knowledge to pass judgements on areas where expertise lies with the executive and should therefore restrain themselves to enforcing contracts (Anant and Singh, 2002); other means of ensuring better governance are still required.

Hardin (1999) argues that a constitution is not only a contract but also a coordination device that can serve to moderate group conflicts and push society to a better outcome. Constitutions differ across countries. He suggests that the US constitution, while protecting individual liberty, property rights, and social justice, was able to coordinate the society around commerce and prosperity. Universal suffrage did not lead to expropriation as was initially feared; opportunities expanded for the less well off also. Elster (1995) has argued that since it requires a super majority to change the constitution, it is a means of credibly binding the government against future reneging, much as Ulysses bound himself against the sirens. This reassures against future imposts and expands social surplus available. The Indian constitution has many of these desirable features, and can serve such a purpose, but the electoral structure built in has had adverse effects.

### *Electoral Structure*

Given the constitution, elections impose ex-post discipline, and together with lobbying and legislative bargaining influence outcomes. One general principle is that forward looking private maximisation can lead to extreme outcomes, reversing institutional safeguards. Elections limit rent extraction only if electoral promises are binding and if alternative candidates are good substitutes for voters. But often neither condition holds. In conditions where pleasing the voters is very costly, or the politician has more discretion, he may choose to grab as much rent as possible. Voters can punish a candidate if he has not performed, but the punishment is ex-post, not ex-ante. Reputation may not be sufficient to enforce ex-ante discipline if alternatives available are poor, as in India, where all politicians are tarred by the same brush.

The structure of elections, written in a country's constitution, also affects politicians' incentives. A representative democracy may have proportional or majoritarian ("first-past-the-post") voting. India has the latter system. In the pure form of the first, parties are given seats proportional to their overall vote total. A minimum percentage vote is required for a party to enter a legislature. In the second, each district elects a single member by plurality vote. Varying mixtures of the two systems are possible. The way voter preferences reflect in electoral outcomes will differ in the two systems, especially when there are more than two parties. In general, under proportional elections in a single national district, the incumbent needs the support of a broader coalition of voters, so he provides more public goods, which serve a larger population. Under single member districts and plurality rule, it is necessary to win only in a few pivotal districts. Therefore incumbents make transfers to smaller geographic voter-groups. This tendency has exacerbated India's regional and caste based electoral polarization. A downside of proportional elections is since voters vote on party lists rather than for single individuals, corruption and equilibrium rent rise for politicians. Their incentives to work for voters fall.

Both voters and parties can behave strategically so conclusions have to be drawn with care. Even so, when there is sharp polarization among voters and multiple parties, the representatives of smaller parties in the legislature will normally be below their strength in the electorate. But their power in the government may be disproportionate, because if no party has a majority they may be critical in a coalition. Therefore legislative influence may not be monotonic in vote share. For example, in a model with three parties it can be shown that first and third ranked parties form the governing coalition (Austen-Smith and Banks, 1988). Voters will vote strategically, rather than sincerely. Sincere voting is according to actual preferences, and strategic takes account of other's choices.

Opportunistic candidates will allow for this in taking up pre-election positions. Under proportional voting the share of minorities in the legislature can increase, but their importance in winning and losing falls. It is not true that a coalition government will

necessarily be unstable<sup>8</sup>, but if there is a pivotal party this will dictate policy preferences. Thus those with a small block of votes may have large power if they are required to help form the Government. In India since the nineties unstable minority dependent coalition governments have become the rule. Shifting to some form of proportional voting may increase the share of minorities but decrease their power, and make for more stable governments.

An interesting question is, will parties pamper swing voters, whose loyalties are fluid, or will they target core supporters? The latter could either be groups they can reach effectively, or those who are ideologically fully committed to the party. Opportunistic politicians will favour core supporters if they believe that is the cheapest way to buy votes, otherwise they will take them for granted and court swing voters who may switch votes in exchange for favours. Core supporters may even be taxed since the party knows how to effectively extract resources from them, without any change in their loyalty. Indian voters have understood this and are beginning to insist on performance, rather than being satisfied with ideology. There are dramatic reversals in election results and incumbents often lose elections.

If an electoral system favours many small parties, governments tend to have short-horizons and avoid tackling hard choices. Grilli, Masciandaro and Tabellini (1991) find that in OECD countries with such systems debts and deficits rise. The greater the government fractionalisation, that is the greater the number of policy making veto actors, the more difficult it is to devise plans that distribute costs neutrally among their various constituencies (Franzese, 2002). Therefore reducing fractionalization in Indian politics is a priority.

A presidential-congressional regime is an alternative to a parliamentary regime. Equilibrium rents are lower in the first as separation of powers and conflict among politicians helps voters control the agency problem. But the presidential system supplies

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<sup>8</sup> While in Italy coalition governments have been highly unstable, stable coalitions have governed Germany, Luxemburg, and Austria, over much of the post-war period.

less public goods and more targeted redistribution compared to the parliamentary system since under the latter incentives to form broad stable coalitions are higher. Thus if public goods are under provided, the parliamentary system is better, but if rent extraction is high or punishment from losing the next election is small because entry barriers are high, the presidential system would work better for voters. In India public goods are under-provided and pressures to increase their supply must be maintained, so that a parliamentary system should be better suited.

Democratic voice is valuable and must be preserved. It allows robust institutions to develop that reconcile different interests and should make it possible to implement the common interest. In a careful empirical study of the outcomes associated with democracy, Tavares and Wacziarg (2001) find that democracy reduces growth by reducing physical capital and raising government consumption, but stimulates growth by improving human capital and reducing inequality. Redistribution is responsible for the second set of factors, but excessive redistribution for the first set. Our argument is that the second set can dominate if interest groups are reconciled in a way that helps long-term growth, for example, by developing human capital rather than making short-term consumption transfers (Goyal, 2001).

In the next section we find the conceptual categories to be useful in interpreting Indian experience.

## 5. History

If aspects of the structure of an economy are captured by a theory, it can be useful as an aid in bringing out underlying causal factors, and explaining stylized historical facts. Although one must always be aware that in a complex system, there are multiple interacting tendencies, we focus here on the consequences of political structure and macroeconomic shocks. These partly explain the perverse administrative choices and incentives that were built in.

India has a parliamentary democracy, which is expected to lead to broader redistribution, larger government, and more public goods, according to the analytical framework of the earlier sections. It has majoritarian as opposed to proportional elections, which lead to less public goods, more targeted transfers and larger government. They also lead to less representation, but more power for minorities under multiple parties and coalition governments. India's poverty, caste, religious and regional heterogeneity added to the effects of the electoral structure, as multiple parties appeared. Provision of public goods has been falling and transfers targeted to well-defined electoral groups, rising after the 70s. We argue that these ill effects and pressures became apparent after growth faltered in the mid-sixties.

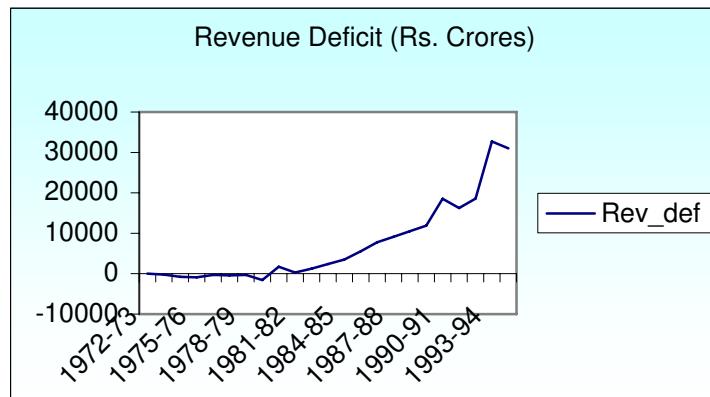
### *Macroeconomic Events*

The post war control regime was continued to target accelerated planned development with equity, according to the development ideas of the time (Patel, 2002). This worked reasonably until the late sixties when there was a growth slowdown, partly due to a series of shocks. There were, of course, inefficiencies due to the import substitution regime, and the failure to carry out land reforms and develop a broad demand base. The country had not been able to make much of a dent on poverty. This was also the period of the oil shocks, and sharp peaks in inflation, which hurt the poor. Realizing that the latter were a large vote block<sup>9</sup>, Mrs Gandhi coined the slogan of "garibi hatao"<sup>10</sup>, and used it aggressively in the early 70s, in her political battle with the old congress guard. Disregarding the rise in costs, several user charges were kept fixed, which led to more and more distortions. In the years that followed subsidies and transfers increased while current and future provision of public goods suffered. As these effects cumulated, the revenue deficit became positive, or government consumption exceeded its income. Figure 1, shows that the first year the revenue deficit became positive was 1980-81 and it grew every year after that. The government was now borrowing for consumption, and accumulating debt. These policies once implemented set in vicious or virtuous self-

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<sup>9</sup> For example, 60 percent of Mumbai's population lives in slums, providing a concentrated target for politicians. This is not to rule out that some politicians may be sincerely concerned to better the lot of the people. But they still did not use the most effective means of doing so.

sustaining dynamics partly by creating interest groups or constituencies they favoured<sup>11</sup>. The majoritarian democratic regime was emphasizing targeted transfers at the expense of public goods.



### *Political Changes*

Political fragmentation made matters worse. In the first twenty years after independence the Congress party provided a stable government. There was no serious opposition. A period of bipolar consolidation followed, with the gradual development of an opposition system to the congress (Frankel, 2000). The Congress first lost the elections after the emergency of the mid-seventies. In 1979, 1989 and the mid-90s different governments were formed, but all were derived from the Congress in various ways. The third phase, starting with the state assembly elections of 1993-1995, was of a competitive multiparty system. In the 1998 elections, the Election Commission registered 176 parties; 41 won representation to the Lok Sabha, but of these 7 had two or three members and 14 had one member each (Frankel, 2000). The current NDA coalition of 1998, led by the BJP, is the first genuinely non-congress government.

As the Congress lost dominance and intense multi party competition set in, populist schemes multiplied. Populist Central Sponsored Schemes (CSS) became a way for the central government to directly reach the masses, by the 1980s. New schemes were

<sup>10</sup> She first used the term while intervening in a debate in the Lok Sabha on the Constitution (24th Amendments Bill, August 4, 1971, see GOI, 1975).

<sup>11</sup> Stiglitz and Hoff (2001) develop the idea of past choices creating interest groups under the concept of dynamic political economy.

announced every year, although targeting was poor and waste and corruption proliferated. With multiple competing parties, swing votes became very important for winning in our first-past-the-post system. Identity politics, based on caste and religion, was a way of cultivating these swing voters. The Congress cultivated the Muslim vote, encouraging a conservative backlash<sup>12</sup>. Yadav provides evidence that electoral participation by minorities and backward castes has risen since the 70s, compared to other groups. He calls this the "second democratic upsurge" (Frankel, 2000). Sometimes minority groups had enough electoral power to swing outcomes in their favour, for example, when parties representing them were pivotal in a coalition. Defections and frequent elections, as with unstable coalition governments, meant that politicians were concerned only with the votes that would get them to power. Once in power they were concerned with "loot" in order to buy votes and legislators in the future. Since state elections were separated from those at the Centre in 1971 (Jha, 2002), frequent elections kept this pressure up continually and harmed longer-term development.

The democratic empowerment of the poor, with the lower castes and regional parties acquiring voice and vote, was a positive and necessary development in the path to a stable, mature and inclusive democracy. But it further encouraged identity politics. The first reaction of new parties to the acquisition of power was consumption transfers to their support groups, especially as belief in a vibrant future was missing since the development policies of the past had not delivered growth. Institutions of governance were undermined. Pai (2002) documents how in UP identity and caste politics was responsible for poor governance and low development expenditure. Each short-term coalition government reversed jobs given to other caste groups and put its own group in positions of power. Frequent transfers of officials politicised and demotivated the bureaucracy. It is true, as Pandian (2002) points out that arguments about the common good and efficiency can be used to keep the oppressed down. A creative ferment is necessary for them to

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<sup>12</sup> Vote bank politics created bitterness and set the communities against each other. Narendra Modi's inaction and the NDA's support to his Government despite accumulating evidence of the State Government's failure and even complicity in the anti-muslim riots, are said to be motivated by the BJP's recent election losses, and the assembly elections due in Gujarat. Playing the Hindu card became an electoral strategy for the BJP.

come up, but the policies followed do not have to be regressive if a longer-term perspective is taken. In the South where the movement is older, it has achieved progressive reform, emphasizing education, and going beyond symbolic gestures such as building memorials to Ambedkar.

### *Administrative Choices*

Administrative choices led by the populist stance, made matters worse. After the oil shocks and in the presence of an inflation sensitive electorate, many prices of public services were kept fixed; incentives and efficiencies were sacrificed for consumption redistribution. The choices made amounted to protecting the poor through current transfers, rather than building their assets and human capital, when it was the latter that was the sustainable option. This was a rational social outcome because the rich could often escape imposts in the long-term, and the poor had high discount rates and pessimistic growth projections.

The objective of providing government services at affordable prices led to cross-subsidization both in the provision of specific products and across government functions. Low price caps for many public goods led to systematic incentives to lower quality and investment. Thus falling efficiency and rising costs compounded the problem of low user charges, and prevented a natural fall in prices from improvements in technology and organization. But where the government had monopoly power and was servicing the rich, prices were raised much above costs of production, or indirect charges, not obvious to voters, such as the prices of intermediate goods, were raised (Morris, 2001). As the rich turned to private providers, revenue losses contributed to the inability to service the poor adequately. The cross-subsidization was not sufficient to cover costs. General revenues did not even cover government consumption expenditures, as the widening revenue deficit shows. Long-term human and physical capital formation (including infrastructure) were harmed. Again we see public good provision suffering in order to raise targeted transfers.

Power, telecommunications, railways, roads, education, all illustrate the effects of these incentives. Quality and availability of services fell. Poor quality served as a cost that lowered consumption demand. For example, freight rates were raised to subsidize passenger travel. The railways steadily lost customers to diesel trucks. Since diesel was also subsidized this further reduced government revenues, apart from raising pollution levels. The average rate per passenger kilometer was raised from 4 paise in 1980-1 to 15 paise in 1991-2, but the rise in the average rate per tonne kilometer was more over the same period (from 10.5 to 35.1 paise), although the demand for freight is more elastic. International call charges were kept high, to subsidize domestic calls; again the aim was to tax the rich and subsidize the poor. In 1998 the cost of calling America using Internet telephony was Rs 4 per minute but the public sector monopoly charged Rs 75 per minute. But companies formed in America made it possible to call from India and pay abroad. Thus price distortions invited entry the government could not retain its domestic monopoly and lost revenue. As new technology and companies entered and cut international call rates, the public sector giants are being forced to follow suit<sup>13</sup>. This is the history against which reform is taking place in the provision of public sector services.

The special powers of the Finance and Prime Minister were not able to protect the Central Budget once the era of competitive populism set in. In addition, perverse incentives in the accounting procedures adopted, led to problems on both the revenue and expenditure side. Budgeting is only incremental, with a mechanical increase in Plan expenditure<sup>14</sup>. The division between Plan non-Plan expenditures, together with the focus on starting new schemes, has harmed maintenance. After the shocks of the seventies, as fund constraints appeared, it was easiest to postpone investment plans. Moreover decision-making and monitoring procedures became inadequate as complexity increased and contributed to delays.

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<sup>13</sup> See Goyal (1999) for more details and examples. IIR (2001) documents many such examples. The point made (see Morris, 2001) that cross-subsidization often raised the prices of intermediate goods, again provides evidence of politician's tendency to give short-term or direct benefits at the expense of rising long-term or indirect costs.

<sup>14</sup> These points are well accepted in the Indian debate. Amaresh Bagchi and Govinda Rao reiterated them at a meeting in IGIDR and at a Mumbai University seminar respectively in 2001. See also Rao (2002).

The Centre has constitutional powers to restrict borrowing by States, and States do not have the ability to monetize their debt<sup>15</sup>. This works to limit their deficits but a number of avenues are available to soften their budget constraint. Disbursements from the Finance Commission, Central Schemes and the Planning Commission are multi-purpose, poorly designed and therefore fungible. The presence of multilateral lending institutions may worsen the problem. States can float special purpose vehicles to borrow funds, and do other smart accounting to soften budget constraints (see Rao, 2002). Good performance has not been rewarded, so even though more equality in revenue sharing was built in across the States, equality in per capita incomes was not achieved. The 11th Finance Commission put in some performance incentives, and improvements in States' revenue collection have been reported. On the other side, delays in specific funding further delay projects and expand their costs. Poor management practices and bankruptcy is making these problems more acute. Low recovery of user charges and the absence of a service tax are constraining States' revenue. The direction of reform towards simplification, rationalisation and harmonisation is well known, but is not being speedily implemented, even after being initiated in 1993. There are similar problems at the third tier, the ULBs and the Panchayats. The Centre has not performed its coordinating function well. States were able to hold it to ransom especially as regional parties became critical. Adversarial positions taken in negotiations on issues that affected a number of parties contributed to delays (Basu, 1995). The common pool problem was aggravated and free riding became pervasive. The Centre used its power over States only to impose distorting policies that fragmented markets.

The choices made led to the conflict between rich v. poor, labour v. capital, the present v. future, being handled in a way that lowered incentives for expansion of the cake. The plan emphasis was on long-term capital goods but implementation led to a short-term focus. Redistribution concentrated on short-term consumption subsidies rather than on assets, education, health and infrastructure. The poor were needed for votes, the rich for

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<sup>15</sup> Armijo (2002) argues that since inflation hurt the poor, and there was universal franchise, macro policies were conservative in India. One aspect of this was limits on States ability to undertake deficit financing. In Brazil, where universal franchise was granted only in 1986, credit limits on states were lower and inflation much higher.

buying votes. Apart from short-term consumption redistribution to woo voters, the rich were given opportunities for rent seeking in a system of controls and distortions<sup>16</sup>.

Labour laws secured jobs for a small labour elite, but restricted the expansion of such jobs. Indians became used to direct subsidies and indirect costs, or short-term benefits and disguised long-term costs. Although these measures did not deliver long-term benefits voters valued them because in a low growth environment indirect benefits are often discounted because of their uncertainty and greater chance of going to others.

Moreover, in the absence of a viable two party system voters had little choice. If status quo is lower the agenda setter can extract more of the surplus from voters. In the more recent period, however, a strong anti-incumbency vote has developed, suggesting that delivery has begun to matter. Citizens are seeing the long-term consequences of short-term populism. Since political parties are careful to listen to the people--there are signs that they have also realized this. Governance is the new slogan; for example, the Congress has moved from "garibi hatao" to governance at its 2002 meeting.

Even after reforms and the move towards more market oriented high-powered incentives, government procedures often continue to be based on the philosophy of monitoring and control. Sometimes rules and procedures appropriate in one stage persist in another when they become harmful. Many improvements are possible, but deep and sustainable changes require addressing the underlying causes. Politicians have to be motivated to push the changes. Before turning to such measures in the final section, it may be useful to see how better performing countries have ensured a stimulating macro environment and used high-powered incentives.

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<sup>16</sup> Bardhan has developed the idea of warring interest groups in a number of articles. Bardhan (2002) sums up his position as that there were multiple interest groups with the power of veto, but no one was strong enough to take over the government. Therefore the collective action problem could not be solved, and the country settled for short-run transfers at the cost of long-term growth. The position in this paper differs in that democracy should be able to achieve common interests, but macro shocks, the electoral structure and administrative choices created perverse incentives in the Indian case.

## 6. Other Countries

Two countries that have grown rapidly in the past decade and used macro policy and incentives to do so are China and the US<sup>17</sup>. Non-transparency moderated international pressures and allowed China to use massive fiscal-monetary stimuli according to domestic requirements. One-party dictatorship made it possible to reverse direction quickly when inflation rose too high. Thus stop-go cycles led to some waste but facilitated required structural changes, and induced high savings. Moreover, China successfully used economic incentives, even without full property rights. The US succeeded when it shifted from an overly strict budget law to a more realistic one that allowed countercyclical fiscal stimulus and monetary accommodation, in an interest rate-targeting regime.

### *America*

In the 1990s, the American budget deficit, which had mushroomed in the eighties, was converted into a surplus while the economy prospered. Among the factors that made this achievement possible, were rules that limited wasteful government expenditure, and allowed monetary stimulus to which the economy responded. Supply-side tax cuts in the Reagan era were expected to stimulate output. But the expected increase did not occur, and since there was no compensating cut in government expenditure, the deficit grew rapidly. It fluctuated around a peak ratio to GDP of 6.1 per cent in 1983. The Gramm-Rudman-Hollings Act passed in 1985, set yearly ceilings for the deficit with a target for a zero deficit by 1991. It had some effect, but creative accounting --because of design flaws (including overstrictness) -- prevented the realization of the target. The Bill also lost credibility because a very large deficit was required to fund the 1990 crisis in savings and loan institutions. Therefore, it was replaced by the Budget Enforcement Act of 1990, which corrected the design flaws shown up by experience. First, rather than restrict the deficit itself, constraints were placed only on spending. Caps that enforced small reductions in discretionary spending were set, but escape clauses were provided for emergencies. A 'pay-as-you-go' rule meant that new transfer payments to individuals

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<sup>17</sup> The discussion of the US experience follows that in Goyal (2002), and that of China follows Goyal and Jha (2002). See also Morris (2002).

could be made only if these transfers were demonstrated to have assured funding, so that they would not increase deficits in the future. As revenues fell in a recession, the deficit could increase, since restraints only covered spending. This macro-stabilization provided another escape clause. Such flexibility lowered pressure to break rules, gave the Act more credibility, and contributed to its success. There was a systematic attention to incentives. For example, there was a shift from matching to block Federal grants for state welfare payments; the former had motivated the states to overspend. After twenty-nine years America had a balanced budget.

### *China*

China is a one-party dictatorship, but before its high growth phase, it shared with India the pressures of a large number of poor. Both had a rigid bureaucracy and controls meant to ensure redistribution and to reduce inequalities. Even without private property rights and functioning markets, China was quicker than India to decentralize, create intense local competition, and incentivise economic decision making. In India checks on economic decisions created delays and discouraged productive activity. China focused more clearly on high growth, and this was able to overcome other obstacles and allow the regime to adapt.

Partly because of socialist ideas of equality, without populist pressures of ensuring votes, protecting the poor largely took the form of human capital development-- improvements in health, education, and endowments. Over the period that food remained a major part of the average household budget, adequate supplies and low prices of essential foods were maintained. As long as these minimum requirements were met, the Government was able to extract obedience.

After 1978, economic decision making was decentralized to farmers, firms, and lower level governments and incentives were given. The people by now had the skills to respond rapidly. The government policy of "crossing the river while feeling the stones", prevented too large and disruptive changes. Mistakes were made, but as quickly reversed. Decentralization and a conscious policy of taking intellectuals abroad, preparing

thoroughly and examining alternate future scenarios overcame some of the information inadequacies of a dictatorship. More drastic reforms such as privatisation, closing down bankrupt banks, restructuring the bureaucracy and introducing VRS were only undertaken in the late nineties after twenty years of rapid growth. China had always controlled its labour markets tightly. As the boom in exports absorbed labour and migration restrictions were relaxed, urban decay was minimized through policies such as that new firms had to provide housing for workers. The idea was to make those who stood to benefit most from it, contribute to infrastructure development.

The official debt GDP ratio remained at around 10 percent, but official data on government debt are suspect. Lower level borrowing is not well captured. There are many contingent and hidden liabilities in the banking and pension systems. Recent reports suggest that, properly measured, deficit ratios are as high as Indian ones. But the lack of transparency, and capital controls, deflected international pressure for macro stabilization, and allowed them to implement large macro stimuli and create a good infrastructure for growth. In the 1998 slowdown, for example, the fiscal stimulus, from large-scale public sector infrastructure projects was about 2.5 percent of GDP. Rules to restrain credit expansion were enacted later. After a new Budget Law in 1995, the central government could not borrow from the CB on current account, although deficit financing was permitted on capital account. The deficit had to be financed with government bonds. More stringent budget balance restrictions were imposed on local governments. The law strictly controlled their bond issuance and restricted their borrowing in the financial market. An independent auditing system was also introduced for enforcing the budget law.

Till 1993, 70% of the central bank's loan to state banks were made by the central bank's local branches, which were heavily influenced by the local governments. In 1993, the central bank centralized its operation. In 1995, China passed the Central Bank Law to give the central bank the mandate for the monetary policy independent of the local governments. These reforms reduced the local government's influence on the monetary policy and credit allocation decisions. In 1998, the central bank replaced its 30 provincial

branches with 9 cross province regional branches. This reform further minimized the local governments' influence on monetary policy, and closed inflationary loopholes.

These changes were part of new feature of the 1990s worldwide--the adoption of fiscal and monetary rules to improve incentives. The rules have worked best when they have been used to facilitate macro policy coordination and stimulus. The appropriate structure varies with levels of development. A democracy cannot afford Chinese-style stop-go cycles, or make the quick reversals. Therefore, in the former, self-enforcing general rules, which allow sufficient discretion for flexibility, should work better.

## 7. Policy and Structural Change

We have demonstrated the importance of macroeconomic shocks and the disincentives that can be built in by inadequate responses to them. Therefore discretion needs to be constrained by rules that would ensure adequate responses to future shocks, without long-term damages. Even in a complex system it is possible to identify marginal feasible changes that can trigger others.

- A Fiscal Responsibility Act would restrain fiscal populism, it should have escape clauses to allow counter-cyclical stimulation of the economy, and protect investment in human and physical infrastructure. Monetary policy then can be supportive and stimulate growth. Such a set of policies is self-enforcing given democracy and existing economic structure. Monetary policy can be bound less strictly than fiscal policy because democratic pressures work to force it to keep inflation low<sup>18</sup>. Higher growth will facilitate the removal of political hurdles, and changing incentives in administration.

### *Electoral Reform*

Deep structural changes would also minimize perverse responses to shocks, and have better incentive features. Electoral reform may be possible in the longer-term. Even a few of the structural reforms below have the potential to reduce populist pressures on Indian politicians. The long history of backwardness, for some sections of society, makes

measures to empower them necessary. Bhargava points out that many such measures are provided in the constitution itself (Frankel, 2000). The reforms suggested below would actually increase the representation of minorities, but reduce their power over political outcomes, so that more long-term measures to benefit them could be taken.

- A presidential system would probably be too authoritarian to balance India's diversity. Moreover, since the supply of public goods needs to expand, a parliamentary system is better. But shifting to a system with some features of the proportional voting, with some lower limits on the minimum size of parties, would raise the supply of public goods, reduce transfers, decrease swing votes, vote blocks, fractionalization and instability in politics.
- Hung assemblies that give importance to identity based splinter groups can also be reduced if a variant of the French system is followed whereby in the absence of a clear majority there is a re-poll among the two parties with the highest totals. This would lower instability in governments, frequent elections, and their ill effects. Some change is required because of extreme fragmentation in Indian politics. If State and Central elections are coupled once more, governments will not have to continually implement populist schemes to appease voters (Jha, 2002). Unfortunately, the recently concluded Venkataswami Commission on constitutional review has not suggested any serious reform.
- The anti-defection law has effectively stopped single defections, but since it does not rule out splits or group defections, we have the spectacle of groups of MLAs being hidden away to keep them from temptation in toppling episodes such as in Maharashtra in 2002. Splits were allowed because it was thought that they might be based on principle rather than the lure of office or lucre. But that does not seem to be the case, leading to suggestions that the anti-defection law be extended to splinter groups (Parikh 2002). This would make coalition governments less hostage to special interests, while democratic freedoms of choice could still be exercised before elections.

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<sup>18</sup> This policy coordination is discussed in detail in Goyal (2002). Morris (2001, 2002) also argues for interest rate targeting and a high growth target.

### *Political Changes*

Some political changes are feasible even without changes in electoral structure.

- There are signs that the political system is moving towards single party led broad coalitions, one towards the right and the other towards the left of the political spectrum. This could lower electoral competition, but this would require the large parties to become more inclusive and sensitive to regional aspirations. If two big parties one on the moderate right and the other on the moderate left accommodate local satraps, and each sits regularly in opposition, there could be more genuine consultation across parties and more stability (Chidambaram, 2002).
- Even without such an outcome, it may be possible to achieve consensus across parties on major economic policies. All parties more or less agree to the necessity of reform today; bankrupt governments have no other choice. The broad coalition governments of the nineties have hammered out large areas of consensus (see box). If an all-party consensus can be reached banning populist policies, such as free electricity, no government would fear an electoral reversal from implementing the policy, and it would become politically feasible. It is a fear of the other party using populism to gain electoral mileage that is preventing deeper reform today. Such a self-binding would improve governance and fundamentals. Voters have begun not to reward governments that give populist sops but do not deliver on fundamentals. They have voted out incumbents on non-performance. Both rich and poor are converging on governance. As controls dissolve politicians' ability to extract rent from the rich is falling, and the poor are now in the long-term where they see the decay in vital economic services that affect them. Political parties have realised this, and therefore may be willing to agree to a consensus that would allow them to deliver on governance. Then short-term transfers would fall and allow a rise in public goods provision.

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#### Box Is Consensus Possible on Policy?

The United Front and the National Democratic Alliance were both broad coalition governments, one to the left and the other to the right of the Indian political spectrum.

The first came up with the Common Minimum Program (United Front, 1996), and the second also with a joint Manifesto. Studying the two statements gives an indication of the extent to which a consensus is possible in economic policies across parties. Each involves a consensus among the parties comprising the coalition; the two together give an idea of feasible consensus across the Indian right and the left.

Being political statements both emphasize food security, health, water, housing, education, and governance. The first puts more emphasis on price stabilization, provision of basic needs, and technology, the NDA on agriculture and infrastructure for employment, swadeshi with openness, privatization, commercial principles in general but protecting farmer subsidies.

Thus both are concerned with higher growth, and there is a general agreement on the reforms and other measures required to achieve it. The left is more concerned with affecting transfers to the poor and preserving public property. But it is willing to accept that more of these transfers should come in the form of building human capabilities, and to make allowances for the bankruptcy of government.

There are sensitive electoral issues like subsidies and user charges that neither document touches upon. These are precisely areas in which, if there were an all-party agreement, so that none could gain political mileage by renegeing, all parties would gain. They would be able to deliver better governance, and compete on that basis.

The NDA document for the first time talks of the necessity of consensus across the political spectrum. "Governance must become unifying, not divisive, in its practice. It is this mindless manner of the domination of the majority that has led to bitterness, hostility and confrontation - and has even made the opposition and ruling parties like permanent adversaries. This destructive trend of politics of negativism and political untouchability which has distorted our body politic in the last few decades calls for an immediate corrective. We will, therefore, strive to develop national consensus on all major issues confronting the nation by involving the opposition parties and all section of society in dialogue. We will also try for a consensual mode of governance as far as practicable." Words need not imply actions but they are a first step.

There are other initiatives to achieve this. The CII has set up a public policy council to facilitate policy dialogue and consensus across political parties. Sanjiv Goenka is the current head (Soota, 2002). Chidambaram (2002) is also of the view that such consensus is feasible. Vajpayee went to brief Sonia Gandhi after the Jammu terrorist attack in May 2002, in order to involve all political parties in India's response, and in his Independence day speech again emphasized the necessity to build consensus on economic policies.

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### *Using Democracy*

Democracy is not just about voting. There are other ways in which democratic pressures can enforce governance.

- The media and the people, bolstered by special institutions, can function as watchdogs in areas where politicians use power for personal gains or do not deliver (Paul, S. and Gopakumar, 2002). New communication technologies and norms favouring transparency make this easier. India has a long tradition of open discussion and respect for different views. But peoples' right to knowledge needs to be better implemented. It is time the Official Secrets Act, inherited from British times, was modified. Citizen groups and NGOs have become active in enforcing civic rights and improving urban infrastructure (Raval, 2002). If they publicize the failures of politicians and indirect costs of populist policies, it will increase the accountability of politicians and incentivize them in the right directions. For example, in cross-subsidization, the government keeps 'poor' class consumer prices low, raises 'luxury' goods prices, but increases intermediate prices (Morris, 2002a). This eventually raises a wider range of prices, besides bringing about severe distortions. Such effects should be made transparent.
- More feedback is a strength of democracy, and today's technologies allow faster feedback, so that the speed of decision-making can be raised. Inequality and low growth heighten conflicts that make a democracy slow moving. Therefore conflict resolution strategies that focus on the common good, and not on specific groups will help. Mechanisms that resolve conflicts in ways that increase the surplus or growth are required. For example, giving free school meals or dry rations to girl students, illustrate how policy can improve returns to choices that raise human capital. The latter carries externalities for society that benefit all. Another example is if mandated contributions to a worker's welfare fund across industries<sup>19</sup> accompany laws that make it easier to fire workers. This illustrates another general way of solving the collective action problem: gainers should partially compensate short-term losers. If

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<sup>19</sup> Kavita Khanna, as a representative of CII, made the suggestion at an episode of the Big Fight, Star News, on labour laws.

such laws increase employment both industry and workers would gain in the longer-term. Democracy is one of the best ways to integrate heterogeneous groups.

Moreover, its balance and variety allow it to survive shocks better. As India's polity and economy matures, it is showing resilience in the face of shocks that would have precipitated a crisis earlier<sup>20</sup>. Some parts benefit from adverse shocks and can have positive feedback for others.

- It is said that Indian democracy has too many checks that paralyze decision-making. But because of the past emphasis on monitoring and the use of law to enforce development, these checks and balances apply more on citizens. Some of these designed for politicians and bureaucrats, to create conflict of interest among them, would restrain the legislature and the executive from using power to benefit themselves, and aligning officials interests with the common good. Separation of powers concentrates information rents in a single office. If the other office is not a residual claimant on rent, its interests would be aligned with voters, and it would share information, resulting in more transparent policy. If one office has the power of initiative, and a veto but not an amendment right (therefore is not a residual claimant), and the other allocation rights, the two have a strong conflict of interest and no incentive to collude, which helps the voter control their rents. If combined with other design features to speed decision making, this need not increase delays.

### *Administrative Changes*

Administrative changes, both at the design and procedural level, can improve efficiency. Changed circumstances sometimes make it possible to change set ways of doing things.

- Independent professionals should be appointed as regulators, not retired bureaucrats. The present generalist bureaucracy could be modified, giving it a core with more independence from politicians (limiting their rights to transfer officers) plus a contract system where an incoming government appoints its own officers, but based on strict professional criteria and skills.

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<sup>20</sup> Bimal Jalan, Governor of the RBI, made the point that although shocks had regularly led to crises in the past, India faced a number of adverse shocks in the late nineties without a crisis. Speech at the release function for the India Development Report, May 2002.

- Like China India should give civil servants some benefits from growth, so that they are motivated to encourage it instead of using their discretion to create delays to make money. The rewards need not be only monetary but could be in terms of professional development or reputation, thus creating a strong work ethic. Since bureaucrats have multiple tasks monetary incentives alone are insufficient and can take attention away from essential tasks whose output cannot be measured. Still, better management systems can ensure accountability and transparency, with emphasis on delivery (Morris, 2002b). Better pay and equipment must accompany incentive payments linked to performance. Monitoring on outcomes should be designed to encourage risk taking in bureaucracy. For example, bankers should be judged on their entire loan portfolio not on individual loans, the emphasis should be on quality of loans, not quantity. They should be given an official incentive payment on loans repaid, instead of the illegal cut in loans sanctioned that is common at present.
- Well-sequenced, contextual policies can be designed. Like the Chinese asked construction firms to provide housing for workers, or closed down regional bank branches to contain the inflation of credit, thus making direct beneficiaries contribute to infrastructure development. New transfer schemes must be asked to demonstrate the source of future funding. The systematic removal of discretionary controls will reduce sources of corruption and delay. As complexity and asymmetry of information increases, outcome oriented, market based delegation works better.
- India has a three tier budgeting process, at the central, state and local level. Urban local bodies (ULBs)<sup>21</sup> give an example of problems at lower levels. Services are generally poor. They start with a balanced budget, since law requires it, but end the year with deficits. These are adjusted in creative ways, contributing to the general opacity of the budget. Data is either not current or is difficult to interpret. Schemes are delayed for lack of funds, but sometimes money is available but authorities do not know it. The required reforms are known but do not occur. Opacity continues in spite of many training sessions, capacity building and attempts at standardization. Perhaps it facilitates the siphoning off of money so political bosses do not want transparency.

Politicians must be motivated to actively push for these changes or at least stop resisting them. This can happen if deeper changes in political structure make the provision of public goods to a broad set of population rather than narrowly targeted transfers in politicians' interest.

- Alternatively, conflicts of interest could be used/created to decrease political power in administration, or voter pressure used to monitor and ensure performance. It may be possible to introduce management accounting if the utility of the capacity created is demonstrated at the local level. Transparency and standardization improve implementation. Information technology gives fast useful feedback, makes decentralization, and faster decision-making possible. Co-ordination of central transfers and their quick disbursement according to simple non-discretionary rules will also be motivating. On the expenditure side, performance clauses must emphasize maintenance. Program budgeting, with a clear idea of cost effective expenditures targeted to programs demarcated on functional grounds, such as administrative, or social headings, rather than the present classification into development, non-development expenditure, would be much more effective. Simple forward-looking rules can prevent bottlenecks, even in complex situations (Basu, 1995).
- Increasing the rewards to self- policing works better than a strict law, which is kept in letter but violated in spirit. This often happens with the PILs (public interest litigation) where citizen groups bring court injunctions against the executive to enforce service delivery. Direct voter pressure on politicians and changes in the incentives of politicians and bureaucrats will deliver more genuine changes. Tough penalties often require tougher evidence, so that conviction becomes more difficult. Rewards motivate relatively more, compared to punishment. Under asymmetric information a carrot relaxes both the participation and incentive compatibility constraint, since it improves returns to the better alternative. A stick just relaxes the incentive compatibility constraint since it reduces returns to the worse alternative. And growth makes more carrots available.

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<sup>21</sup> The workshop for the report gave me an understanding of ULB financing. In particular I thank K.P. Krishnan and Dr. Ravikant Joshi for detailed discussions on this topic and refer the reader to their chapters in this book for more details.

- Awards to states have been based on filling trend non-plan revenue gaps. This rewards fiscally profligate states, but has not succeeded in closing gaps in per capita incomes (Rao, 2002). Transfers from the rich to the poor states can continue by having higher block grants for the latter; but an incentive component linked to fiscal prudence and efficiency may motivate them to take more responsibility. This, together with reforms such as allowing them to levy service tax, making user charges more feasible, tighter budget constraints and better accounting, competition among states, openness to the world, may help spread best practices among the states. States tax mobilization has been better than the Centre's in 2002, because of competition and incentive features the 11th Finance Commission built in.
- Public investment in human and physical infrastructure continues to be essential given the severe shortages in this area and the large externalities it carries. The public sector also has the advantage of being able to borrow more cheaply to finance such activities. But some commercial principles are required in allocation and pricing. Otherwise the asymmetric information and rent seeking activities we have been examining imply that politicians may follow self-serving policies such as build huge highways to their small villages. Innovative public-private joint initiatives and independent agencies for finance, allocation, and regulation, need to be established in this area. But attention should be paid to the dynamic sequencing of reform. For example, more competition should accompany privatization, to prevent the creation of private monopolies (Hoff and Stiglitz, 2001), and interest groups that impede further reform. Political forces are actually working to make such changes more likely. More and more bankrupt public bodies are welcoming private participation as a means of protecting them from voter and worker pressure. It is a way of tying their hands; they can say it is the private partner who is insisting on payment, performance, and raising prices. Market procedures can short-cut delays due to adversarial negotiations. For example, auctions can be used as a way to determine values available to settle claims<sup>22</sup>. Although these changes would reduce their discretion, it is possible politicians will be forced to adopt them.

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<sup>22</sup> Raghuram Rajan pointed out, in a lecture at IGIDR, that this is used in Sweden to determine the value of bankrupt firms.

## 7. Conclusion

In India politicians get too much rent and too many resources are dissipated in short-term transfers to build vote banks. We have tried to discuss some systematic changes that can release resources for activities that generate externalities and stimulate growth. Politics has two basic functions. It can solve the collective action problem and coordinate to a better outcome, but it can also use conflict among groups to maintain power. India has seen too much of the latter function. Conflicts make a democracy slow moving under inequality and low growth, therefore changes that improve outcomes for all, and not only for specific groups are required. Higher growth reduces group conflict. The general principle is that policies should improve returns to choices that raise human capital. The latter benefits more than just the recipient and improves future prospects.

When the underlying political structure has major effects, the question arises, will politicians allow the changes required? If they are aware of the consequences they will only allow changes that are in their own interest. If policy is endogenous so are institutions. Ideas do have an effect but take time to acquire a critical mass. Deep political changes may be some time in coming, but the bankruptcy of governments is forcing reform, reforms are changing incentive structures, higher growth rates are reducing the conflicts and short-term perspective. Indians had become used to direct subsidies and indirect costs, or short-term benefits and disguised long-term costs. But they are beginning to see the long-term consequences of short-term populism. Political parties have understood this perception; for example, the Congress' slogan, is changing from "garibi hatao" to governance.

Changes will occur, but with conscious design they can be surer and faster. It is often said that a few good principled people can make a difference; but good systems can induce better behaviour from most people.

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