Information asymmetry and institutions: re-looking at autonomous councils in the hills district of Assam

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Abstract

The transaction cost approach can be used as a tool for studying the political institutions which engage in sharing of power and responsibilities. This paper makes an attempt to present an analytical framework of governance structure in the Autonomous Councils in the two hills districts of Karbi Anglong and N.C. Hills in the State of Assam. The first section of the paper gives a brief introduction to the theoretical framework of the transaction cost and information asymmetry and moral hazard problem. In the next section, these concepts are examined in the context of the autonomous councils in the hills district.

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I. Introduction

The transaction cost approach can be used as a tool for studying the political institutions which engage in sharing of power and responsibilities. The concept of transaction cost has been applied to study institutions governing the relations among political actors in the state polity, international relation (polity and economy), legislative organisations etc. Most of the scholars developed their theoretical perspectives on the two types of transaction costs mentioned above. Working from the '*Opportunism'* angle, the scholars have looked into economic development in the west (North 1990), Federalism (Montinola et al 1995). *Asymmetric information*, on the other hand, formed the core of most of the studies on delegation (Aranson et al.1982; Kiewiet and McCubbins 1991) and bureaucratic control (Weingast and Moran 1983; McCubbins and Schwartz 1984; McCubbins, Noll, and Weingast 1987, 1989) in American politics. These works brought in a new term "transaction cost politics" in political science (Dixit, 1996).

Central to the theory of transaction cost and economic institutions is the question of property rights and the surfeit of literature on transaction costs have dwelt on the two concepts of opportunism and asymmetric information (Akerlof 1970, Spence 1973, Stiglitz, 1974, 1981) in analyzing the transaction costs, economic institutions and the intrinsic issue of property rights.

Information Asymmetry

Asymmetric information assumes that at least one party to a transaction has relevant information whereas the other(s) do not. The information asymmetry leads to two different problems-*one* is the *adverse selection* problem and the *second* is the problem of *moral hazard*. *Adverse sel*ection occurs as some persons in the transaction, such as managers and other insiders know more about the current condition and future prospects of the firm than outside investors. *Moral hazard* arises when of the two contracting parties one does not have perfect information on the contract agreed upon; it becomes difficult to monitor the other side's behaviour. This uncertainty about the behaviour of the other side and the difficulty of monitoring means that there is a possibility of breach of contract or the other party may behave contrary to what was agreed upon. The mainstream literature on moral hazard is contingent upon a simple two player model - *one principal and one agent*. According to this model, the principal needs an agent to accomplish some tasks on its behalf. This is a common reality in our daily life e.g., a housewife hires a domestic help for to the daily household chores, parents hire a teacher to tutor the child etc.

In the case of an agency contract theory, moral hazard can arise when an economic good is not effectively controlled by its owner -the *principal* but by a different person called the *agent*, an employee. Information asymmetry produces moral hazard in conjunction with the separation of ownership and control. The agent, who is fully informed about his own activities, has an incentive to act in his own material interest against the material interests of his less informed principal. Whenever the principal cannot effectively monitor the activities of his agent, the latter has an incentive to increase his own (monetary and psychic) income at the expense of the former. The basic problem of moral hazard in response to this delegation of power is: *How does the principal ensure that the agent will not abuse its discretion and will conform to the orders given by the former?* This problem arises under two conditions: first, there should be information asymmetry – the agent has informational advantage about the local environment and the actions to be taken. The second condition under which the problem surface is when there is a conflict of interest between the principal and the agent. The conflict of interest ensures that the agent acts contrary to the task delegated by the principal and this deviation is proportional to the gains derived from the deviation. This assumption in the moral hazard problem leads to the problem of shirking. In politics, there are more frequent causes for principal-agent interests to diverge. Apart from the absence of initiative the political agent may be motivated by the personal desire to maximize individual profit and career prospects of re-election.

Controlling conflict of interests

The transaction cost assumes two costs- *first*, is the agency cost which, refers to the cost of delegation of responsibility to the agent by the principal and *second,* is the monitoring cost essentially meant for monitoring the activities of the agent and ensure compliance on the task entrusted by the principal. The monitoring cost is presumed to narrow the information asymmetry between the principal and the agent and allow for principal's observable monitoring system on the agent. Though theoretically sound, the real world stands contrary to this and the agent by virtue of his spatial and contextual advantage enjoys information supremacy and this inevitably leads to the difference between the principal's expectation and the agents' service outcome. The principal therefore has to face consequences of the imperfect monitoring as incompetent masters. This drop down in the principal's management is the agency cost. The precise puzzle for the principal is to frame and design institutional set up that will minimize the agency costs.

One of the possible arrangements is to retain the existing interest conflict in the principal-agent relationship and focus on regulating the agent's incentives through more cost-effective control mechanisms. The other approach focuses on the attempts to align the interests of the two through institutional innovations. As conflict of interest widens, so does the agency cost. Hence, reducing the interest gap between the two can in effect lower the agency costs. Economists in their attempt to address the problem have analysed the institutional restructuring which involves some devolution of power to the agent who is more informed. In other words, the agent must have a stake in the reward linked directly to performance like the principal. The arrangement further requires conferment of decision-making power on the final output and the principal agrees to share this power with agent with positive incentives for the agent. When interests align, monitoring costs are reduced and that lowers agency costs. However, Akerlof and Kranton (2005) argue that monetary rewards and punishments are often ineffective at motivating subordinates; more important is the extent to which subordinates identify with the organization. Miller (1992) argues, purely economic contractual arrangements can hardly suffice, and cognitive differences in organizational cultures or norms are needed in hierarchies. This is so as because, in addition to economic gains, people also have other motivations to pursue different goals depending on their cultural and cognitive differences. Granovetter's famous embedded argument (1985) insists that any transaction is embedded in social networks, and the trust generated by personal interactions is helpful in discouraging malfeasance. He argues that within both markets and hierarchies, actor's interactions in a relationship network exist and serve as an important form of malfeasance control.

Multitask Multi Principals

In most principal-agent relationships, the agent is engaged in several tasks simultaneously by the principal. The agent's performance cannot often be measured accurately; the classic example is that of a school teacher who teaches the students basic skills like the three R's (reading, writing, arithmetic), which can be measured in standardized tests, but the teachers efforts to bring out their creativity, sense of responsibility are much harder to evaluate. Holmstrom and Milgrom (1991) analyzed optimal incentive provision in a multi-task principal-agent model. They showed that there are important interaction effects between the incentives given for one task and the agent's incentives for engaging in other tasks. This naturally exacerbates the control problem for the principal in charge of tasks with low measurability. In addition, the agents can also play principals against one another as has often been the case with India's rural credit programmes (Choudhury: 2004). The problem becomes even worse if principals have diametrically opposing goals. In such situations, it is desirable and effective to assign different agents for different principals. The multiple agents may be under the control of separate principals in consonance with the line of task. Baker, Gibbons and Murphy (1994) suggest that if some aspects of the agent's performance cannot be contracted upon, relying on subjective performance evaluation and voluntary bonus payments might be optimal.

II. The Autonomous Councils

Genesis

The genesis of the Autonomous Councils in the region lies in the British administrative policy towards the region. The British Imperial Power made its advent in Northeast India in 1820's. The region was a part of the Lt. Governor- ship of Bengal till the early phase of 1874. Prior to culling out Assam as Governor's Province, in 1873, the British promulgated the Bengal Eastern Frontier Regulation of 1873 (popularly known as the Inner Line Regulation) which restricted contacts between the plainsmen and the people settled on the hill tracts (tribesmen). The British preferred to leave the tribes in their indigenous surroundings and excluded the remote tracts of British India from the operation of General Acts and Regulations under Scheduled District Act, 1874. As per the Assam Frontier Tracts Regulation, 1880, the Chief Commissioner of Assam was empowered to exclude any part of Assam from the enforcement and operation of general enactments in force there. Under Section 52A of Government of India Act, 1915, further amended by Government of India Act, 1919, power was vested in the Governor-General's Council to declare any territory 'backward tract' and exclude such tract from the application of any legislative Act.[1] Following the Government of India (Excluded and Partially Excluded Areas) Order, 1936 these areas were declared as excluded areas.[2] The Excluded Areas were administered by the Governor of Assam and Partially Excluded Areas were made his special responsibility and these areas were excluded from the powers of the provincial legislature.

In the post independence period, North East Frontier (Assam) Tribal and Excluded Area Committee set up by the Constituent Assembly with Gopinath Bordoloi as its Chairman. recommended creation of District and regional Council to leave the tribal free from the fear of exploitation and domination by the people from the plains. The Drafting

[1] Under this provision, the Garo Hills District, the Khasi and Jaintia Hills District (except Shillong Municipality and Cantonment Area), the Mikir Hills (in Nowgong and Sibsagar districts), the North Cachar Hills (in Cachar district), the Naga Hills district, the Lushai Hills district, and the Sadiya, Balipara and Lakhirnpur Frontier Tracts were declared as backward tracts.

[2] The Excluded Areas included (a) North East Frontier (Sadiya, Balipara and Lakhimpur) Tract, (b) the Naga Hills District, (c) the Lushai Hills District and (d) the North Cachar Hills sub-division of the Cachar District. The partially excluded areas included (a) the Garo Hills District, (b) the Mikir Hills in the Nowgong and Sibsagar districts, and (c) the British portion of the Khasi and Jaintia Hills District

Committee accepted the recommendation of the Bordoloi Committee. Before independence the tribal areas in North-East India were divided into Excluded and Partially Excluded Areas. From 15th Auguest 1947, the administration of the Excluded and Partially Excluded Areas was entrusted to the Government of Assam. With the adoption and enforcement of the Indian Constitution, five District Councils were constituted in 1952 under Sixth Schedule (Article 244 (2)) of the Indian Constitution in all the hill districts excepting the Naga Hills in Assam. The District Council is a unique institution in Northeast India which is not existent in any part of the Country.

The essence of the provisions under the Sixth Schedule are to provide the tribal people with simple and inexpensive administration of their own which would safeguard their tribal customs and ways of life and assure them maximum autonomy in the management of their geographical territory. The provisions in the Sixth Schedule provide for legislative, judicial, executive and financial powers to the Autonomous District Councils.

Devolution of powers to the Autonomous District Councils

In the sphere of legislative powers, the Autonomous District Councils (ADCs) are empowered to make laws related to land, forest (other than reserved forests), and water bodies, regulate shifting cultivation, inheritance of property, and regulate usury by persons other than schedule tribes. In respect of resource mobilisation, the Autonomous Councils are empowered to assess and collect land revenues, levy taxes on professions, trades, callings and employment, animals, vehicles, boats, roads, passenger tolls, goods toll and such other activities. The revenue mobilised is credited to a District/ Regional Fund and managed and guided by in accordance with the rules framed by the Governor. Like any other government accounts, it is subject to auditing by the Comptroller and Auditor General (CAG) of India.

The judicial powers under the Sixth Schedule provides for a two-tier system of justice: District council or any court constituted on its behalf at the district level and the Village councils and courts for the trial suits and cases of the Scheduled Tribes. No other courts of the state except the High Court or the Supreme Court of India have jurisdiction over such suits and cases. The Sixth Schedule has retained within it the original proviso of the

Inner Line Regulation whereby any act of the State legislature or Parliament in respect of subjects and powers vested with the Council will remain inapplicable until the ADC decides to accept such acts. However the Governor is authorized to withdraw or modify any act of the judicial powers conferred on the autonomous councils. The Governor is also empowered to appoint a commission of enquiry into the administration of the autonomous councils and suspend an act or a resolution of the council if he is satisfied that such acts or resolution is against national interest subject to the approval of the State Legislature.

The administrative powers of the Autonomous Councils include establishment, construction and management of primary schools in the district, dispensaries, markets, roads and road transport and waterways besides such activities as cooperative societies, social welfare, village planning, agriculture, animal husbandry and all such activities pertaining to management of the resources of the District under the jurisdiction of the Council.

State and the Autonomous District Councils in Assam

The State government has an overbearing presence on the ADCs. The senior officials of the Councils are deputed from the State government administrative services whose ultimate accountability lies with the State government and not to the Council. The financial devolution of resources to the Autonomous Councils is through the State government whether for the plan grants or the centrally sponsored schemes. Significant to note here, that the sectoral allocations for the two districts are done by the Development Commissioner Hill Areas of Assam which is then communicated to the council. Although the ADCs have a plethora of legislative powers but these are subject to the Governors assent after approval of the State legislature. The Council receives the sectoral plan allocation from the Commissioner Hills, Assam which is then passed on to the sectoral departments to prepare the annual action plan. The Council approves the annual action plan of the various sectoral departments based on the fund allocation made by the Commissioner. Once approved, the fund is transferred to the sectoral department. The plan and non-plan fund is released to the council on a half yearly basis in two instalments, the first instalment of 50 percent in the month of April and second instalment of other 50 percent in the month of October. Apart from plan and non-plan fund assistance under central sector schemes, central subsidy and share of centrally sponsored scheme directly go to the council. The Council submits quarterly utilisation report covering physical and financial achievement for each sectoral department to the Commissioner Hill areas of Assam**.**

Principal-agent model of ADC

The principal agent model in ADC can be identified as two *principals and two agents' model.* The first *principal* is the people of the two Districts which elect the ADC members (CM) acting as their *agents*. The second *principal* is the State government leadership (SL) essentially the political party in State power which has its *agents* the bureaucrats (BC) to deliver the task. The BC is sent on deputation posting to ADC for delivering tasks. The *two principals* theoretically have same assignment for their agents viz. work for the growth and development of the territory under the two ADCs. However, from administrative and functional point the SL acts as the main principal in the model for both the BC and the CM.

The two agents too have same objective-maximizing personal gains. The BC aims for promotion in the bureaucratic hierarchy as higher ranks are associated with higher incomes and more power, better amenities and parks, and higher social prestige. CM wants to get re-elected to the ADC and enjoy the special privilege and power of the ADC with more discretion (bigger budgets and more manpower). The CM therefore will look for public support from below as well as approval of the SL while the career-oriented bureaucrats need to look for approval from above (SL).

As discussed earlier, moral hazard problem that plagues the *principal agent* relationship arises under two conditions. The first is *asymmetric information* and the second condition is *conflict of interest*. If BC and the CM share the same interests with that of the SL and the people respectively, the control problem simply disappears and asymmetric information, while still existing, no longer will be an issue in their relations. It is assumed that *agents* want to shirk responsibilities as assigned by the *principal* while the *principal* values more of it and this assumption underlies *agents'* incentive for shirking and the ensuing control problem for the *principa*l.

Incentive Rules and Conflict of Interest

The players' incentives or interests derive not only from their preferences but also from institutional arrangements to which they are subject. In the democratic polity of the ADCs, CM prefers to stay in power and get re-elected. However, depending on what kind of electoral rules (majority, proportional, or mixed) they face, politicians have different incentives for adopting the median voter's position as their policy platforms. For BC, the promotion rule in the bureaucratic institutional arrangement plays an important role in shaping interest. Any organization needs some criteria to select and promote the right people. For BC to get promoted, the criteria hinges on two aspects: loyalty and capability to the SL. In short, the promotion criteria can be summarized as:
*P (*promotion) = *f (loyalty, capability).*

For the CM the institutional arrangement for incentive is to get re-elected to the Council. This they try to achieve by winning the trust and confidence of the SL and the electorate. This can be summarized as
E (elected) =f (trust, capability)

The dilemma for the BC is whether loyalty or capability- loyalty demands compliance and therefore implementing the policy faithfully while the capability encourages them to manipulate SL policy. The conflict of interest will also inflict the relationship between SL and BC. In respect of the CM, trust implies working to the best satisfaction of the electorate while capability gives them the opportunity to manipulate the demands and the policy of the SL. The question therefore is how the signals are generated when both the *principals* and both the *agents* are theoretically working towards the same goal. The answer to this can be found in the phrase 'encompassing versus narrow interests' coined by Mancur Olson, While SL is overseeing a State economy, BC and the CM are concerned with the growth and development of local economies under their jurisdictions. The growth and development of a State economy and a local economy are not conflicting in nature, but, in certain policy dimensions, what is good for the local economies may not be universally true at the macro level in the State economy. For example, the ADCs may prefer to develop their own plan models of growth, have an independent industrial policy and negotiate trade and investment plans for their territorial jurisdiction. If each of the ADCs adopts this approach, the State economy will have to go in for too many micro management with additional transaction cost. The information asymmetry between the *principals* and their respective *agents* that leads to the conflict of interest between both the sets of actors is thus an endogenous factor in the framework of Sixth Schedule and the ADCs.

The two agents BC and the CM have same self interest and both perform the same sets of tasks at two different levels. Hence neither can reach their goal without the other's help and therefore will share information mutually which will not be available to the SL or the electorate of the council. A natural alliance develops between both sets of *agents* and a rational outcome will be one where both function according to capability by manipulating SL policies.

Asymmetric Information, Incentives and the Decision Problem

As explained earlier, because of information asymmetry and conflict of interest, monitoring costs is incurred by the *principal* to keep a track on the activities of the *agent* for detecting deviant behaviour. No monitoring can be perfect, and the *principal* therefore has to bear residual effects which are essentially the agency losses. For SL facing asymmetric information, the decision problem is to design appropriate rules and institutions to minimize agency costs by minimizing both monitoring costs and agency losses. However, reducing both monitoring cost and agency loses are inversely related. If monitoring can be increased agency losses can be minimised but monitoring costs will escalate. The challenge therefore is to adopt institutions to minimise the overall agency costs.

How the State Leadership can achieve this

The task before the SL is essentially to lower the agency losses by narrowing the interest gap with BC deputed to ADCs. The *'administrative rule'* of better transfer posting and promotion are two such mechanisms used by the SL to minimise both monitoring cost as well as agency losses. However, such mechanisms do not deliver the desired results if an alliance grows between the BC and the CM given the functional coordination between the two. The argument is drawn from the clauses of MOU signed between the ASDC, Karbi Student's Association, N.C. Hills Students' Federation and the Dimasa Students' Union on 1st April 1995. The MOU states that the administrative control of the Council over BC is complete in all matters relating to inter council transfer and postings. Further, in respect of disciplinary actions against the BC, the ADC shall exercise the powers as the borrowing department and the relevant service rules of the State government will be binding in this respect. The chances of individual agent manipulating the outcome (alliance) are minimal. Each of the members in the *agent groups* are interested in maximizing their interests and the majority rule is one of capability in a situation of conflict of interests with the principal. It is this dynamics of relation between the CM and the BC which is central to the *agents' alliances* in the ADCs. Hence, in order to lower its agency losses SL would try to narrow the interest gap with the CM through 'interest convergence'.

Since this alliance between the SL and the CM narrows down their interest differentials, the monitoring cost can be minimized assuming that each party, the SL and the CM will respect each other's trust. The expected behaviour in such an outcome is one of compliance to the SL by the CM and not capability since capability motivates for deviant behaviour. However in reality, due to information asymmetry, this trust is dependent on ideological closeness and political power relations of each with the other and is a 'bargained issue'. The question therefore is how this balance of trust can be achieved between the SL and the CM and how can it be sustained?

A careful analysis of the autonomy structure of the ADC reveals that autonomy of the ADCs has been more favourable for the SL and the individual CM rather than ADC as an institution of the people of the two hill districts. The autonomy of the ADC is built upon the trust made sustainable through interest convergence and compliance of the CM to the SL through the incentive mechanism. There are reasons for this argument-

First, the autonomy of the ADCs is essentially autonomy without any manoeuvrability on financial autonomy. The whole financial planning is done at the SL level and the ADCs are involved only in allocating the expenditure under different sector heads. Thus it leaves the SL with virtual control over the ADCs since autonomy without any financial power has no practical meaning. The ADCs as an institution has been assigned all powers except the funds flow which rests with the SL. *Second,* since finance is routed through the SL, it leaves enormous power with the SL in ensuring compliance of the ADCs by either squeezing or delaying the release of funds to the Council. Since CM want to be re-elected, they do not like the 'recurring development work' be stalled and hence compliance is one way of ensuring funds flow to the ADCs. The Sixth Schedule therefore leaves the ADCs with the scope for financial leakages through 'recurring developmental work'. *Third,* since the BC is deputed to the ADCs in consultation with the CM, it leaves the CM and the SL with the option to choose and pick a person who they deem fit can negotiate terms for their mutual benefit. Notwithstanding the fact that the BC is under full administrative control of the ADCs, the MOU of 1995, stipulates that State Government can initiate actions against an officer found involved in any prima facie case of misconduct/dereliction of duty etc. during the deputation period to council even after the officer has been repatriated to the state government. Hence the BC will always prefer a closer alliance to the dictates of the SL for safeguarding future career. Since, promotion and upward movement in bureaucracy is the ultimate interest of the BC, they can act as the conduit between the SL and the CM.

The political leadership of the Council comprises the newly educated middle –class who has found a distinguished identity through the ADCs. This leadership however has been more interested in consolidating its own power rather than grassroots empowerment of the people as because no sincere efforts have been made by the CM to constitute the Village Councils and Courts. Contrary to the ethos of the democratic decentralization by involving people in decision making, the district councils expanded the administrative staff to the extent that the government subsidy meant for development activities had been diverted to meet administrative expenses (Sarmah:2002). This diversion cannot be achieved until all the three players SL *(principal)* and the BC and the CM *(agents* have different interests and collusions of different order. The CM with their lack of administrative experience depends on the BC for execution of administrative and developmental activities. The BC by virtue of their administrative experience and departmental postings are more information rich have developed a cohesive relation each with the CM and the SL. This cohesion is built up on the incentives available to each of the agents and the principal (SL). The problem of underdevelopment that plagues the two hill districts essentially stems from the share of incentives (funds) available in the whole model of autonomy when put in the framework of *principal-agent* relation. Higher the rate of incentive (development funds of the ADCs available), higher will be the compliance of the agents. And it is in the battle of incentive shares that the whole development process of the district has suffered. If the two hills district of Karbi Anglong and N.C. Hills have been falling behind rest of the State in terms of their growth and development and are threatened with mushrooming of underground subversive activities and ethnic clashes, it is precisely because of the very structure of the autonomy given under the Sixth Schedule which conceals within it the problem of moral hazard beset with opportunism and information asymmetry between the different players. The two essential components of governance are administrative power and the financial power and it is the Sixth Schedule has left the SL with more efficient system of agency management (CM + BC =ADCs) by conferring on them the power to regulate career graph of the BC and funds flow to the Council. Thus, the SL as a *principal* with its command over resources has more power in manipulating the behaviour of the CM than the electorate of the two districts- *the other principal* as because alignment of interests between the SL and the CM and the accompanying incentives are far larger which can be used for manipulating the electoral outcome of the Council members.

Keeping at abeyance the functionality of the Village Councils and the Village Courts at the grassroots has been the control mechanism adopted by the CM to sustain the information gap between the CM *(agents)* and the people of the two districts who form the electorate *(principal).* The cash poor electorates in the hill economies who are insular and exclusive in their socio-cultural milieu are far less acclimatized to the democratic polity and market rules of transaction economies. Hence pre-election funds disbursement under various development schemes is used as a potent tool to capture the electorate by the CM. Since opportunism is an important element in the problem of moral hazard, the recent trends in the hills district reveal a clear play of such opportunism. 'Incentive shares (funds)' have been the noble control mechanism used by the SL to negotiate the alignment of interest incentives with the various *agents* (CM, BC). Autonomy to the peoples of the two hills districts sans their political consciousness on the autonomy has reinforced 'opportunism' in the structure of the ADCs.

Theoretical validity

In the foregoing sections, a micro-political foundation of governance in the two hills district under the aegis of ADCs has been discussed. It has been argued that information asymmetry is an important variable in the governance structure in the hills districts under the ADC and has influenced institutional choice mechanisms. It would be pertinent to see how the problem of principal –agent relation affects the institutional functioning and generates conflict of interest between the CM and the SL and how different strategies are at work to mitigate the same.

1. Controlling the agents of governance

The control is not uniform across all areas of the ADC and SL and this variation emerges due to two reasons. The *first* is the *level* of information asymmetry and second is the conflict of interest between the *principal and the agent.* The SL, CM and the BC are rationally assumed to have same identifiable goal as development practitioners. For the SL, their central concern is the overall development of the State while the CM and the

BC are assigned to work for the development of the two hills districts within the broad framework of the State policy. However, the interests of the SL and the CM and BC may have conflicts under two conditions.

First is when policy issues are designed with a macro perspective. Theoretically, sum total of the growth of each individual constituent unit will contribute to the growth at macro level. When externality exists (e.g. when SL controls the funds allocation of the ADC as well as career promotion of the BC), career-oriented BC will be pitted against the CM to pursue policies that suits the SL. The second is with respect to distribution of funds between SL and the CM and the BC i.e. budgetary transfers from the State government to the Council and then to the line departments executing the programmes. The two hills economies will obviously benefit from a larger budgetary support and a lower tax rate. The Sstate however with its serious financial constraints takes recourse to delayed funds transfer to the ADCs since in terms of their contribution to the State GDP, both the districts do not contribute enough to the State kitty. The delayed fund flow from the State headquarter has led to diversion of funds from one head to the other head of expenditure at the convenience of the CM. Sectors like infrastructure, urban development receive greater thrust of spending and funds for expenditure under these heads are for contractual work which creates routes for leakages. The SL has failed to control or develop measures on such diversion. In fact, the statement of expenditure for plan funds and non-plan funds maintained at the Council office and the Commissioner of Hills Office are also at variance as reported in the Kumaran Committee. This clearly reflects the control problem of the SL over the ADC. Besides the ADCs are empowered to levy and collect all taxes within their territorial jurisdiction to which the state tax laws are not applicable. Such distributive roles generate conflict of interests. A wider interest gap leads to higher agency costs for the SL and the hence h*igher the conflict of interests, less likely is the control of SL on the functioning of CM and hence the ADC.*

2. How to ensure monitoring

One effective way of lowering agency cost is to outsource the monitoring to third party. However, such third party monitoring in ADC is outside he ambit of its institutional design. The ADC encompasses within it an inbuilt monitoring mechanism through the Village Councils but which has been kept suspended by the ADC and no attempt has also been made by the SL to ensure its implementation.

The Development Commissioner Hill Areas (DCH) is entrusted with the task of review, monitoring and evaluation of the hills areas plans and development programmes implemented by the ADC which essentially is a quantitative evaluation of the statistical information. The DCH is also a part of the bureaucracy and under the direct control of the SL. Hence likelihood of grouping with the BC is higher as both have same career goals and interest. Notwithstanding such institutional deficiencies, the arrangements are politically more acceptable to the SL which can maintain an indirect control on the BC and also the Hill Areas Commissioner assigned with the task.

The other alternative is indirect monitoring through 'convergence of interests' between the CM and SL. To understand the importance of convergence of interest persuasion, it would be necessary to make a reference to the political context in the State and the hills district. Since the tribal and the hills people had been left outside the influence of national politics since the days of the British, the mainstream ideological forces of the state polity comprising of national parties and the regional parties have been distinctly different. However, as many theorists of political science term politics 'is a marriage of convenient alliance' the sharing of interests by the SL and the CM is therefore a potent tool in their hand. The transfer of more subjects to the control of ADCs has helped in furthering the process since the incentive available under such convergence is far greater. Ideally, this is the cheapest form of control where agency losses are least and the payoffs are highest for all the players. However, nature and effectiveness of the mechanism will depend on convergence of interests between the SL and the CM. Therefore, as the strength of interest indoctrination weakens, the control will also decrease. Hence we can ague that *existing monitoring mechanism for the ADCs is only cosmetic and of limited usage. When there is convergence of interests the SL can effectively use the control mechanism on the CM. The BC accountable to both the CM and the SL follow suit since it is in their best interest to toe the interest of forces in power. However, in the absence of interest convergence between the SL and the CM, the BC is exposed to uncertainty of risks and this weakens the monitoring.*

The recent dissolution of the NC Hills District Council on May, 2009 which assumed office on December, 2007 proves the point of divergence of 'interest convergence'. The Congress party, which had ruled the district council for more than four decades since its inception in 1954, managed to win only three seats out of 27 seats in the last council election. The main opposition party in the hills areas, the Autonomous State Demand Committee (ASDC) won 12 seats and their ally, the Bharatiya Janata Party gained nine seats while three seats went to Independent candidates. The arrest of Chief Executive Member (CEM) of the NC Hills Autonomous Council for his alleged links with a militant group which is a break up faction of the militant group with whom the SL had signed ceasefire agreements reveals how ideological and interest divergence can call for *ex-post* actions from the principal. The arrest of a liaison official of the district council and a former Joint Director of the Social Welfare Department under the Autonomous Council exposes the uncertainty behaviour of the BC and the weak monitoring designs of the ADC.

3. Problem of monitoring costs

The SL in the State faces a tougher problem of controlling CM than the BC. The reason being, that between the BC and the SL the information asymmetry is likely to be lesser than between the CM and the SL. The BC which is ultimately accountable to the SL for upward mobility prefers to align its interest with that of the SL. Apart from the monitoring and evaluation by the DCH, the SL uses the BC as the control point on the CM. A simple example may illustrate this point: the funds transfer to the ADCs is deferred towards the end of financial year with an oral instruction to the Principal

Secretary to deposit the money back to the treasury as unspent balance (Sarma: 2002). This deferred transfer stalls the development works in the districts and add up to non performance of the CM. Therefore, one way of lowering monitoring costs is simply to use 'verbal quantification' of tasks to the BC *(agent)* and such 'verbal quantification' lowers measurement costs. The central dilemma in the moral hazard problem is that *agent's* behaviour is difficult to observe. Verbal quantification of tasks helps in mitigating the information asymmetry partly by making final outcomes more qualified. Administrative procedures on the other hand attempt to streamline different aspects of policy implementation so that the *principal* can detect deviations easily e.g. the ADC is responsible for implementing roads construction and maintenance works in the hills district. The CM prefers to implement as many roads construction projects as possible and issue tender notices as this leaves an opportunity for CM to seek private gains. But since the departmental officers report directly to their heads of department at State headquarters in respect of technical control and sanction, the SL can effectively check on the merit of such proposals. Such administrative rules may not lead to the most efficient outcome if the CM can offer higher incentives to the BC to manipulate the same for favour of technical merit. But given the final accountability to the SL, the BC is likely to be less deviant to SL. Therefore, it surmises to say that *in addressing their agency costs, SL will prefer actions that lower monitoring costs, such as un-quantified task delegation and quantified administrative procedures. However, the outcome depends on the BC who then becomes the central figure in the monitoring task and the strategy will be one of weighing the incentive shares by the BC with SL and the ADC respectively. The monitoring therefore becomes uncertain under the given circumstances.*

4. Credibility of punishment

All the possible arrangements as discussed above are based on simple cost-benefit principle on the part of the agents. The BC will comply with the orders from SL if the chances of deviant behaviour being detected are high along with penalty. These mechanisms become less effective if such chances are less. The control of final accountability of the BC to the SL reinforces the credibility of penalty. To clarify this point it is pertinent to refer the clauses in the MOU of 1995, where the BC has been subject to control of both ADC (CM) and the SL in respect of his discharge of duties. The assumption made in the moral hazard problem in the ADC model is that BC and CM will align their interests for mutual benefit. While these two groups share many similarities vis-à-vis the SL, a subtle difference remains. As part of the strategy to rein in regionalism, the Constitution has designed the ADC by functional separation. At every level of local governance the BC has to follow commands from two sources: CM and the SL. Thus, BC now faces *dual principals*-the SL and the CM. The chances of BC following the commands will be determined by payoffs from non-compliance, probability of the deviant behaviour being detected and the penalty clauses involved. This overlapping in control of BC by the SL under the State Administrative Service Rules and deputation posting control under the ADCs is quite unique and important for understanding the incentives of BC. The line departments in ADCs hand down policy instructions to the BC but the power of deputing and removing the BC in the ADC rests finally in the hands of SL but the BC are functionally subordinates of CM. This creates a serious dichotomy in the form of hard functional authority and soft local authority in the administration of ADCs. Infact, all the senior level posts including the Principal Secretary and Secretaries which are supposed to be held by officers from the Indian Administrative service are in reality filled up from officers belonging to State Civil Service in view of the local politics prevailing between the CM and the SL (Kumaran: 2003). In case of conflict between administrative governance and regional autonomy interests of the ADC, career-motivated BC will have strong incentives to follow the SL as because even though the dossier on Annual Confidential Report (ACR) is certified by the CM, the SL reserves the right to take action under relevant Service Rules if any dereliction of duty during deputation to ADC even after being expatriated to the state government is detected. This significantly mitigates the problem of non compliance and the severity of the punishment. Hence, we argue that *the effectiveness of ex post penalty is credibly built within the Service Rules for the BC.*

Now with CM as the agent facing two principals- the electorate of the districts and the more powerful SL, the institutional design of the ADC establishes the credibility of punishment for the CM. In the absence of interest convergence, it remains a fact that the SL can exercise the restraint on the behaviour of the CM under the proviso of dissolution of Council by the Governor with consent of the SL. As the CM is directly elected by the electorate of the districts, suspension of the ADC (CM) is likely to lead to chances of rejection if a deviant behaviour is exposed. Hence *the effectiveness of ex post penalty on the CM is pre determined by the SL based on the institutional design of ADC which may influence the electoral results if deviant behaviours of CM are exposed.*

A classic example of the weak monitoring but strong penalty clauses can be found in the statement issued by the State (Assam) Chief Minister Shri Tarun Gogoi on May 30, 2009 in the press;

"We have to find ways to check the pilferage of development funds to militants, if need be by making the officials running the administration accountable. We have to bring modification in the entire administrative set-up in the hill district. We won't spare anyone if found guilty. Yesterday, I asked the police to arrest NC Hills Autonomous Council (NCHAC) Chief Executive Member (CEM) Mohet Hojai within 24 hours."

5. Interest alignment and institutional designs

Mitigating the problem of penalty does not suffice to say that monitoring efforts are in vain. To ensure compliance (as a condition for mitigating penalty clauses) from the BC, the SL has often used verbal orders. Between CM and the SL, the interest alignment and institutional design has been reworked in such a way as to use the ADCs funds for those activities as desired by the CM. The institutional restructuring for alignment of mutual interest has been well drafted under the transfer of sixteen departments to the ADCs in June 1970. However, the transfer left the SL with the power to exercise control over the ADCs e.g. community development and Panchayat were transferred to the ADCs but the centrally sponsored schemes were not given to the councils for implementation. Hence the SL continued to interfere with the functioning of the department and this created resentment among the CM. Hence the MOU of 1995 transferred 14 more departments to the Councils along with the Centrally Sponsored Schemes (CSS) and the District Rural Development Agency (DRDA) fund. Further, under the new MOU, the Executive Council of the ADCs have been assigned the responsibility to prepare the budget estimates which is passed by the Council and sent to the finance department of the state government for inclusion in the state budget without any change normally.

The power sharing provides strong incentives for CM to share SL interest. The alignment of interest between SL and the CM ensures compliance by the BC. While direct monitoring of CM and the BC is difficult for the SL, designating more focused tasks may offer some relief. The MOU of 1995, which incorporates specialized *multiple agencies* (*line BC*) on *multiple tasks* (transfer of total 33 departments and administrative restructuring of the officers) has helped SL to design appropriate incentive packages (e.g. budget preparation by the Executive Members of the Council, transferring the control over BC below the rank of zonal heads with the ADCs) to induce compliance. Further delegation of power and transfer of departments under the MOU of 1995 is an attempt to narrow the interest gap. As discussed earlier, there are three approaches to lowering agency costs and in some situations; giving away more power may align better, these agents' interest, with that of the principal. SL may have given up some power or resources (budget) through the MOU of 1995, which they probably could never have exercised effectively.

Therefore, *the SL endeavours to restructure institutions to realign interests and lower agency costs. Institutional changes incorporating share of power and resources are derived with specialization in distribution of tasks and assignments.*

Within the framework of ADC and its institutional design, the *moral hazard* problem and the accommodation of the various agencies can be understood from the perspective of transaction cost and property rights. Central to this relationship between transaction cost and the property rights is the common pool problem. While Coase's theoretical examinations looked at bilateral externalities, Hardin (1968), Libecap and Wiggins (1985) analysed the common pool problem where there are many actors and the need for co-coordinating all the actors. Additional problems arise because different actors are differently situated, relevant information is scattered and cost intensive for verification, politicization and strategizing emerges. This requires consent among actors to evolve an organization/institution that can give effect to the plans agreed upon by the actors. Posited against the backdrop of the theory of the firm, it suffices to say that although the ADC (as an institution of the hills people) is the *de jure* owner of all resources in the hills districts but effective or *de facto* ownership had purportedly passed into the hands of the CM. The incentive structure generated by this ownership has made ADC into an instrument of profit maximization by the CM. A separation of the ownership and control helps in reformulating the objective function to reflect the *de facto* control rights. The MOU of 1995 is therefore an attempt at maximizing the management control by the CM, while the transfer of departments and administrative restructuring viewed from the perspective of the SL is an attempt at convergence of interests. The segregation of ownership and control rights and *de facto* control rights when cast against the CM one can see the applicability of the principle of sale maximization in the theory of firm. The growth of local ethnic political forces has to be understood from the incentive shares available in the *principal agent* model with SL as the *principal* and the CM as the *agent*. These forces comprise a section of politically conscious people who are indigenous and are information superior. The power to gain control over resources by differing warring forces has gained legitimacy from the 'incentive sharing' at two levels the SL and the CM due to weak monitoring and accountability of the ADC. The institutional weakness, has in fact led to strengthening of the opportunism in the system. It therefore can be argued that *institutional structure of the ADC has the embedded problem of moral hazard. The presence of multiple agencies in delivery of tasks has led to battle of information access and the opportunistic behaviour. The weak monitoring and accountability of the ADC as an institution in fact reinforces this opportunism and presence of multi agency interest and incentive convergence perpetuates the process.*

That compliance rather than capability, and interest convergence rather than divergence has influenced the institutional designs and arrangement is reflected in the decision of the elected members of the dissolved NC Hills District Council. The nineteen executive members of the dissolved North Cachar Hills Autonomous Hills Council belonging to Autonomous State Demand Committee (ASDC), BJP and Independents members in a press statement issued on 17th June, 2009 expressed their desire to join the Congress. These members led by Debojit Thousen told reporters that in order to ensure stability and all round development of the hill district the members were willing to join the Congress party which held the reins of power both at the State and the Cente. A senior minister of Assam and spokesman of Congress party, Himanta Biswa Sarma told reporters that the decision to accept the members into the Congress will be taken by the state Pradesh Congress committee.

Ever since its inception in 1954, the Congress had ruled the NC Hills district council, the rejection of the party in the 2007 election, led to divergence of interest between the CM and the SL. The absence of credible monitoring opens scope for opportunism and alliances under the existing institutional design of the ADCs in the hills districts and presence of multi agencies and interest convergences reinforces the moral hazard problem.

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