The *Chakravyuha* Challenge of the Indian Economy

02

CHAPTER

From socialism with restricted entry to "marketism" without exit

India has made great strides in removing the barriers to the entry of firms, talent, and technology into the Indian economy. Less progress has been made in relation to exit. Thus, over the course of six decades, the Indian economy moved from 'socialism with limited entry to "marketism" without exit'. Impeded exit has substantial fiscal, economic, and political costs. We document its pervasive nature which encompasses not just the public sector and manufacturing but the private sector and agriculture. A number of solutions to facilitate exit are possible. The government's initiatives including the new bankruptcy law, rehabilitation of stalled projects, proposed changes to the Prevention of Corruption Act as well as the broader JAM agenda hold the promise of facilitating exit, and providing a significant boost to long-run efficiency and growth.

Introduction

2.1 The *Charkravyuha* legend from the Mahabharata describes the ability to enter but not exit, with seriously adverse consequences. It is a metaphor for the workings of the Indian economy in the 21st century, the legacy of several decades of economic policy making.

2.2 A market economy requires unrestricted entry of new firms, new ideas, and new technologies so that the forces of competition can guide capital and labour resources *to* their most productive and dynamic uses. But it also requires exit so that resources are forced or enticed *away* from inefficient and unsustainable uses.

2.3 Joseph Schumpeter recognized the vital role of exit, via "the gale of creative destruction," in the efficient workings of a market economy, the "process of industrial mutation that incessantly revolutionizes the economic structure from within, *incessantly destroying the old one*, incessantly creating a new one."

2.4 Structural impediments to India's economic progress have often been framed in relation to the problem of entry as evoked in the famous phrase--"licence-quota-permit Raj"--of C. Rajagopalachari, India's original economic liberal. Since the early 1980s, the Indian economy has made remarkable progress in increasing entry: industrial licensing has been dismantled, public sector monopolies have been diluted, some public sector assets have been privatised, foreign direct investment has been considerably liberalised, a process that has been accelerated under this government, and trade barriers have been reduced. Indeed, the narrative of reforms has been one of promoting entry by eliminating the barriers to it.

2.5 Yet, as this chapter will document, there has been less progress in relation to exit. Indeed, the twin balance sheet challenge confronting the Indian economy today highlights vividly the exit problem. One might, therefore, hazard that the Indian economy had moved from

socialism with restricted entry to "marketism" without exit.

2.6 To be sure, in a country as large and diverse as India, exit may not always be desirable. But policy action is needed when the costs clearly outweigh the benefits, when the lack of exit generates externalities that hurt others—such as firms that have to compete with subsidised "sick" firms or taxpayers who have to pay for the corporate subsidies. Those paying the costs could well be the poor. They pay taxes, even if only indirect ones. And they may also have to bear the burden of paying higher prices while getting substandard goods and services from inefficient firms which should have exited, but haven't. In fact, the true beneficiaries of the interventions that prevent exit may often be the rich, who own the firms.

2.7 Two caveats are in order. First, focusing on the exit problem does not mean that the challenges of entry have been fully addressed. The Government's reform agenda, including liberalising FDI and launching the Start-up India and Entrepreneurship initiatives are noteworthy endeavours to further facilitate entry.

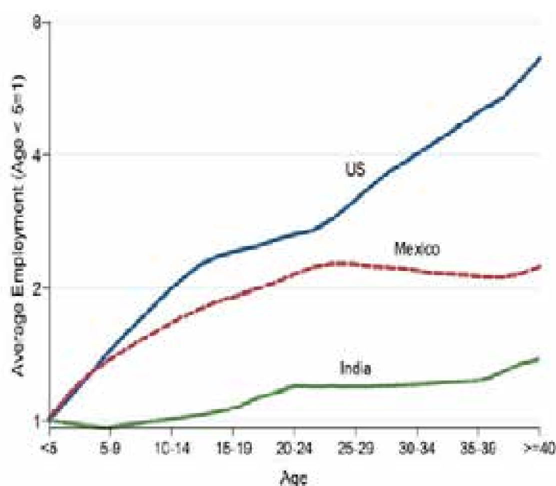
2.8 Second, there are sectors in which exit is not a first-order problem, for example IT services and e-commerce, evidenced most recently in the dynamism displayed in relation to start-ups in India. The case studies suggest that the Chakravyuha challenge is more a feature of the relatively traditional sectors of the economy but is not restricted to the public sector—indeed, impeded exit in the private sector is becoming a major challenge.

2.9 The chapter is divided into four sections. In the next section we briefly describe the costs of impeded exit. In subsequent sections we illustrate costs of impeded exit and the severity and breadth of the problem with sectoral examples. We then place them into analytical categories that explain why exit is difficult. And, finally, in the last section, we provide tentative solutions for facilitating greater exit.

Magnitude of the Problem

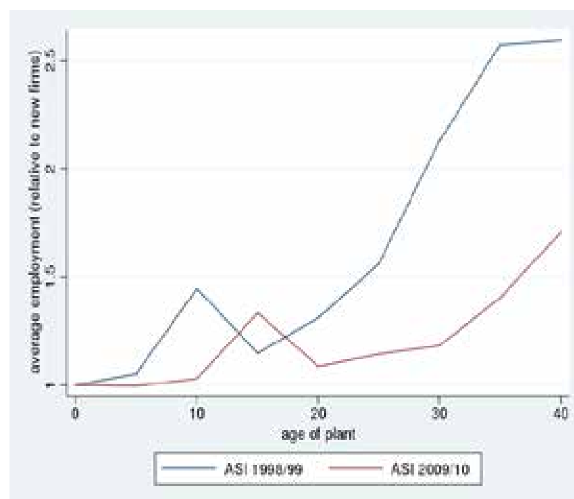
2.10 That there is an exit problem in India is beyond dispute. But how severe is the problem? There are several ways of answering the question. Figure 1 below provides one measure, based on the size of firms. In principle, productive and innovative firms should expand and grow, forcing out the

Figure 1: Average employment of old and new plants in India, Mexico and US



Source: **Hsieh and Klenow (2014).**

Figure 2: Average employment of old and new plants in India, FY1999 and FY2010



unproductive ones. So surviving firms should be much larger than new ones. Figure 1 shows that in the US the average 40-year old plant is 8 times larger (in terms of employment) than a new one. Established Mexican firms are twice as large as new firms. But in 2010 India the average 40 year old plant was only 1.5 times larger than a new one.

2.11 Figure 2 illustrates the situation has worsened over the years. It plots the size of Indian plants relative to new ones across their ages from the Annual Survey of Industries in 1998-99 and 2009-10; in 1998-99 the ratio was 2.5. But now the gap between old and new firms is much smaller. Taken together, these charts show that there are not enough big firms and too many firms that are unable to grow, the latter suggesting that there are problems of exit.

2.12 Bloom and Van Reenen (2010)[1] take another approach. They show that India unlike many countries seems to have a disproportionately large share of inefficient firms with very low productivity and with little exit. They assign a management practice scores of 1 to 5 (worst to best) for a sample of 695 randomly chosen U.S. manufacturing firms with 100 to 5,000 employees and the second panel for 620 similarly sized Indian ones. The results reveal that compared to the US, there is a “thick tail” of badly run firms in India. This is directly related to an exit problem in Indian industry because a majority of these large numbers of small and inefficient firms should not survive.

Costs of Impeded Exit

2.13 *Why does the situation matter?* The lack of exit creates at least three types of costs: fiscal, economic (or opportunity), and political.

2.14 ***Fiscal costs***: Exit is impeded often through government support of incumbent, mostly inefficient, firms. This support—in the form of explicit subsidies (for example. bailouts) or implicit ones (tariffs, loans from state banks)—represents a cost to the economy. The cost is an increasing function of the taxes that will have to make up for the lost revenue, and/or the general equilibrium effects of greater deficits, via the greater interest costs and reduced private sector investment activity that result if the government borrows to finance the foregone revenue.

2.15 ***Economic costs:*** Economic losses result from resources and factors of production not being employed in their most productive uses. In a capital scarce country such as India, misallocation of resources can have significant costs. In their study, Hsieh and Klenow ("*Misallocation and Manufacturing TFP in China and India*", The Quarterly Journal of Economics, 2009) argue that when capital and labour are hypothetically reallocated within firms to equalize marginal products to the extent observed in the United States, it leads to manufacturing TFP gains of 40 – 60 per cent in India. Now, not all of this misallocation is due to impeded exit but that does play an important role in impeding the needed reallocation of resources.

2.16 Another cost, in the current context, stems from the overhang of stressed assets on corporate and bank balance sheets. It reflects the difficulty of apportioning costs of past mistakes between equity holders, creditors, taxpayers and consumers. The consequence is a reduced flow of new investment, dampening medium term growth.

2.17 ***Political costs:*** The lack of exit can also have considerable political costs for governments attempting to reform the economy. The benefits of impeded exit often flow to the rich and influential in the form of support for "sick" firms. This can give the impression that governments favour

[1] Bloom, N. & John van Reenen, 2010, “Why do Management Practices Differ across Firms and Countries?” *Journal of Economic Perspectives.*

large corporates, which politically limits the ability to undertake measures that will benefit the economy but might be seen as further benefitting business. Similarly, if wilful defaulters cannot be dealt with appropriately, the legitimacy of a market economy and the regulating institutions can themselves be called into question.

2.18 No sector illustrates the combination of fiscal, economic, and political costs more starkly than fertilizer. As shown in Chapter 9, fiscal subsidies amount to 0.8percent of GDP, much of which leaks abroad or to non-agricultural uses, or goes to inefficient producers, or to firms given the exclusive privilege to import. But precisely for these reasons it has proved politically impossible to close the inefficient firms or eliminate the canalisation of imports.

2.19 While recognising the centrality of low cost fertilisers for all farmers, big and small it should be noted that the subsidy to farmers—which predominantly benefits large farmers-cannot be reduced/eliminated because of an exit problem- the entitlement that farmers, especially rich farmers, have internalised, and the power of their voice in preventing reform. In order to maintain low domestic prices to farmers (the consumer subsidy), both producers and importers have to be subsidised. But eliminating the producer subsidy runs up against the exit problem in relation to inefficient producers. Eliminating canalization could face resistance from existing importers and so on.

2.20 Nor is agriculture immune from the exit problem evidenced in the persistence of policies that promote some crops that create

Table 1: Characterising the Exit Problem

Sector	Employment	Inefficiency Measure/Cost[2]	Solution
PUBLIC SECTOR			
Fertilizers (inefficient firms)	15,619	Estimated subsidy based on economic cost of production Rs. 23,013 crore in 2013-14 .	Progress being made with neem-coating which reduces diversion, decanalisation, JAM for farmers (Chapter 3).
Civil Aviation	25,047[3]	In 2013-14, the total loss was about Rs. 2400 crore; 7th straight year of loss	Strategic approach.
Public Sector Banks (a few banks)	86,744	Capital infusion between 2009-10 and 2015-16 (H1): Rs. 1.02 lakh crore.	Consolidate; Strategically disinvest; 4 R's for the NPA problem: *Recognition, Recapitalization, Resolution* and *Reform* (Chapter 1).Changing PCA (Box 2.2)
Discoms (major loss-making states)	2.6 lakh	Accumulated losses over 2008-09 and 2013-14 about Rs. 2.3 lakh crores.	Tying structural improvements with debt relief (as in UDAY). Create 'one market' in power (Chapter 11).
Central Public Sector Enterprises	2.5 lakh (sick CPSEs, 2013-14)	Accumulated losses of sick units as of 2013-14: Rs 1.04 lakh crore.	Allow sick CPSEs to exit. Leverage the land and capital unlocked to promote new investment.
Administrative Schemes	N/A	Number of central sector and centrally sponsored schemes increased from 908 in 2006-07 to 1086 in 2014-15.	Rationalisation of schemes as done in 2014-15. Regular evaluations.
Regulatory bodies	N/A	The average age of their heads is about 60.	Administrative reform to bring in young, professional talent.
PRIVATE SECTOR			
Agriculture (cereals and sugar)	N/A	Over-intensive cultivation of water-intensive crops has led to water tables declining at a rate of 0.3 meters per year.	Incentivize pulses over water-guzzling crops. Facilitate use of *drip irrigation* (chapters 3 and 4). Highlight social costs and benefits of crop production.

[2] Unless otherwise specified, numbers are inflation-adjusted.

[3] Air India Annual Report 2012-13.

Table 1: Characterising the Exit Problem

Sector	Employment	Inefficiency Measure/Cost[2]	Solution
Steel	N/A	Cost of production 50-75% higher for few inefficient firms in comparison to global norms.	Bankruptcy Code.
Infrastructure (few large groups)	N/A	As of FY15 the average interest cover is about 0.3.	Kelkar (PPP) Committee recommendations, bankruptcy code. Changing PCA (Box 2.2 below)
Small Savings	N/A	Implicit subsidy to well-off: Rs 11,900 crore.	Rationalize schemes to benefit the small savers. Make transparent true beneficiaries (chapter 6).
		ECONOMY WIDE	
Trade Liberalisation	N/A	Nearly highest restrictions on imports; gains from liberalisation of goods and services estimated at 1% of GDP[4].	Safety nets to tackle transitory costs of greater trade liberalization and competition (chapter 1).
Labour	N/A	Not enough big firms and too many small and inefficient firms (Hsieh & Klenow, [2014][5]; Bloom and van Reenen [2010]).	Employee-centric regulations; provision of greater choice to employees (chapter 10).

adverse externalities at the expense of others; nor is it the case that impeded exit benefits the poor because the relatively well-off are also beneficiaries of the interventions that prevent exit.

Describing the Problem of Exit

2.21 An exhaustive documentation and quantification of the exit problem is difficult. We will instead illustrate the problem by a partial listing. In what follows, we cite and briefly discuss (Box 2.1) instances where exit has emerged as a serious constraint.

2.22 There are many ways to measure the exit problem. For the sake of simplicity and consistency, we use some simple metrics. These are presented in Table 1. For each case, it presents a measure of employment, inefficiency and potential solutions.

2.23 Box 2.1 also documents in greater detail the exit problem for certain specific sectors listed in Table 1: public sector banks, infrastructure, steel and trade.

Why is There an Exit Problem?

2.24 It is useful to understand the exit problem in terms of analytical categories because it aids in the search for solutions. In India, the exit problem arises because of three types of reasons, what might be called the three I's: *interests, institutions*, and *ideas/ ideology*.

Box 2.1: Characteristics of Selected Sectors

I. Public Sector Banks

The first figure reports the bank-wise time series of return on assets (RoA) which are declining rapidly across the banking landscape. There is a corresponding deterioration in the asset portfolio the full extent of which will be known after the RBI completes its asset quality review. The second figure plots the return on assets against employment for all public sector banks.[6] The lines represent median values. The RoA for most banks is currently less than one third of the norm of 1 per cent that is considered reasonable.[7] Many, though not all, of the less profitable banks are those with smaller levels of employment.

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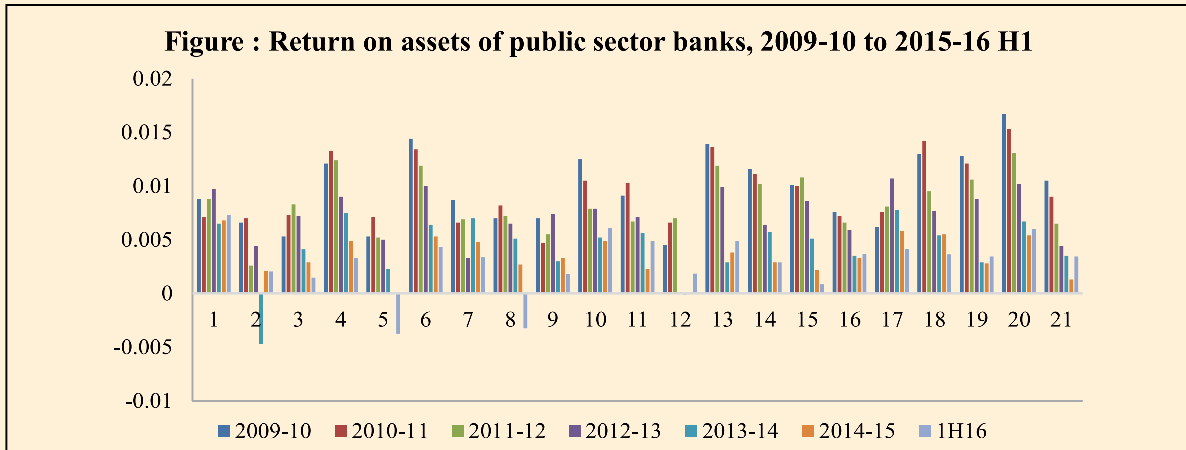
[4] The World Bank. http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/03/10/090224b082bf51e6/1_0/Rendered/PDF/Economic0impli0nd0the0United0States.pdf

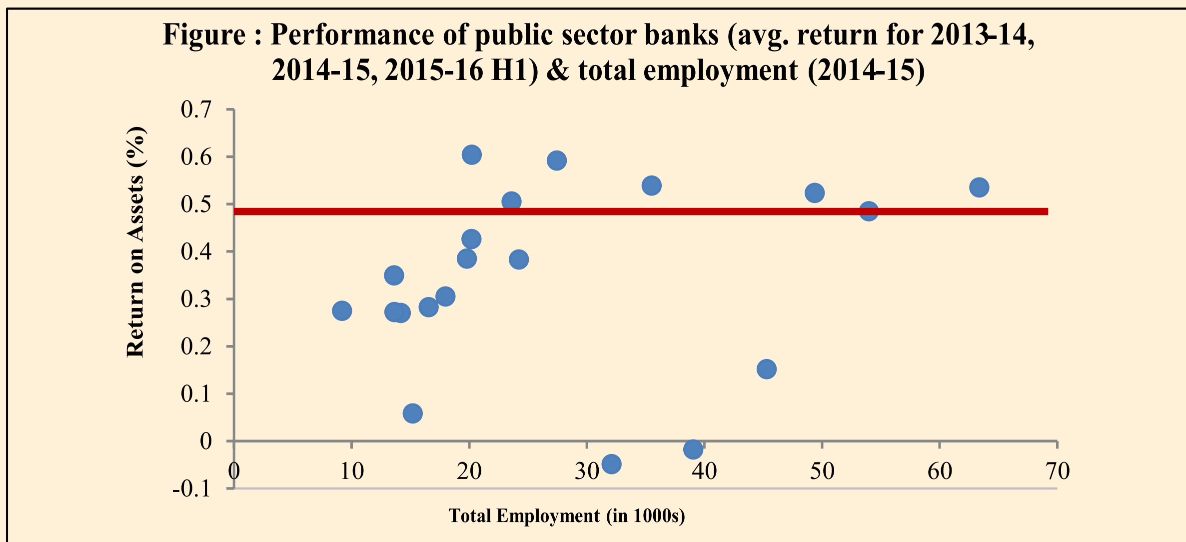
[5] Klenow, P & Chang-Tai Hsieh, 2014. "The Life Cycle of Plants in India and Mexico", *The Quarterly Journal of Economics.*

[6] Note that State Bank of India and Punjab National Bank are not included- they are two largest employers.

[7] Most private sector banks currently in India have a RoA of more than 1 per cent.



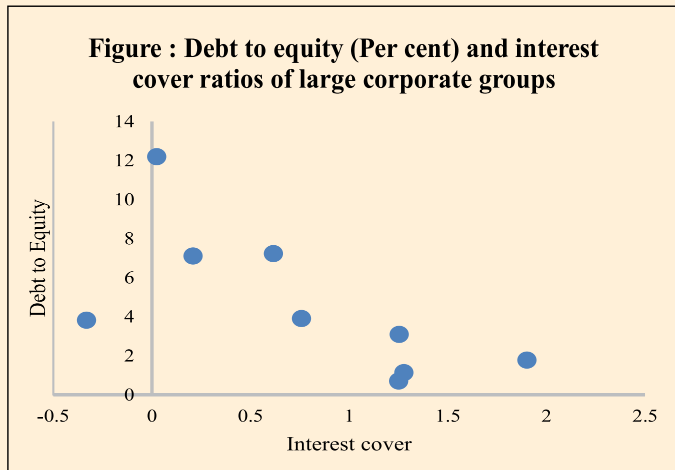
Source: **Reserve Bank of India (RBI).**



Source: **Credit Suisse.**

II. Infrastructure and Corporate Performance

Corporate balance sheets are stretched, depressing private investment. In the Economic Survey 2014-15, we called it the "balance sheet syndrome with Indian characteristics." The figure below provides a scatter plot of debt to equity ratios against interest coverage ratios (ICR) of the 10 most overstretched corporate groups according to the latest data from Credit Suisse. An ICR of less than 2.5 is considered quite low- it implies that the revenues are not sufficient to cover the interest costs on debt.



III. Steel

The steel sector is under severe stress for domestic and international reasons. The figure below shows that the cost of production of a few private players (5 and 6) for FY15 is significantly greater than that of other firms when benchmarked against international prices.

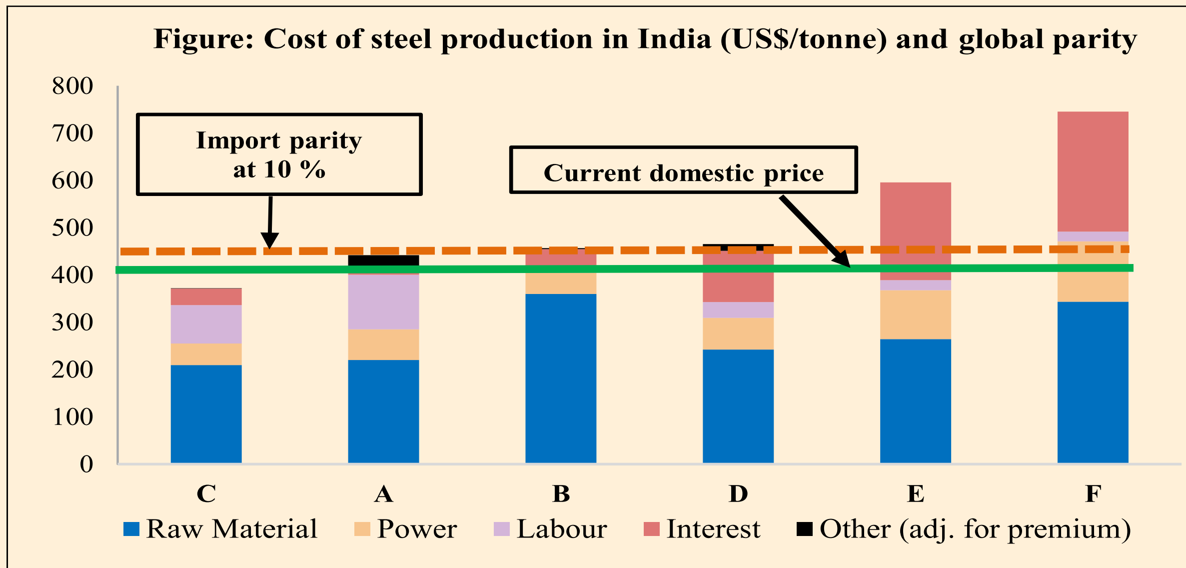


Figure: Cost of steel production in India (US$/tonne) and global parity

Source: **Credit Suisse.**

IV. Trade

The last figure of the box shows that India has amongst the severest trade restrictions in goods (y-axis) and services (x-axis). Only Brazil has higher manufacturing tariffs, China and Indonesia more severe restrictions on services trade. This ambivalence about greater foreign competition owes in part to the domestic politics of disruption and exit, and might be at the heart of India's difficulties with the WTO, trade agreements, and trade policy more broadly.

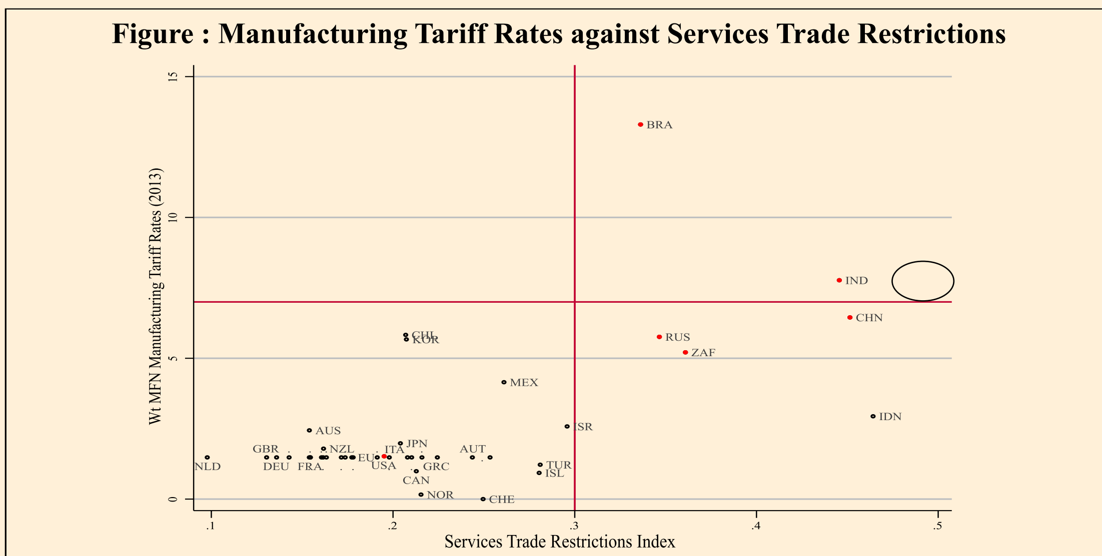


Figure : Manufacturing Tariff Rates against Services Trade Restrictions

Source: **World Bank.**

2.25 ***Interests:*** The first, most obvious, and perhaps most powerful reason for lack of exit is the power of vested interests. Often, this vested interest problem is aggravated by a certain imbalance or asymmetry (first identified by the Italian economist Pareto) that confers greater power on concentrated producer interests in relation to diffused consumer interests. It has long been known that trade liberalization is difficult because the beneficiaries are consumers (whose aggregate benefit is large but who benefit individually

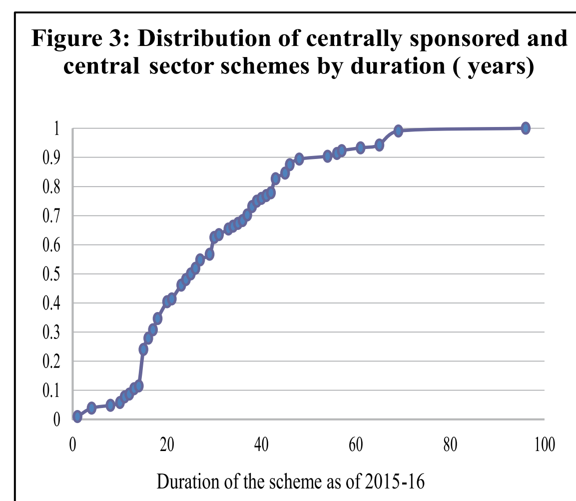
by a small amount) and the losers are a few producers each of whom stands to lose by a lot. The latter will be more influential because they have more voice, backed by financial power. And often democratic political systems will give disproportional influence to the latter.

2.26 One good example of interest groups blocking reform comes from introducing JAM for MGNREGA expenditure. It is acknowledged that MGNREGA, despite its benefits as a well-targeted social insurance mechanism and for rural development, suffers from significant leakage. To reduce leakages and payment delays, Andhra Pradesh introduced direct benefit transfers, so that salaries would be paid directly to workers, with biometric Smartcards to reduce the scope of siphoning of funds via registering ghost workers.

2.27 The Smartcards program was a tremendous success, reducing payment delays by 19 per cent, increasing MGNREGA wages by 24 per cent and reducing leakages by 35 per cent. The return on investing in Smartcards infrastructure was thus seven times the cost of implementation. 90 per cent of beneficiaries also preferred the Smartcards system (Muralidharan et. al. 2015)[8]. And yet, the perception was created that the program was mostly negative. This was a classic case of the imbalance of power between concentrated losses and diffuse benefits.

2.28 In the case of administrative schemes, vested interests often create a market of their own, planning their actions to benefit from it: put differently, this is a case of supply creating its own demand. Thus schemes may become an instrument of granting favours. Finally, bureaucratic inertia perpetuates persistence. Figure 3 plots the cumulative distribution function of Central Sector Schemes that were allocated money as per the Union Budget 2015-16[9]. It shows the percentage of schemes by their longevity. For example, 50 percent of schemes were 25 years old. And out of the 104 total schemes, 92 have been ongoing for 15 years or more.[10] Longevity, per se, may not be a problem but extra vigilance is necessary to ensure that schemes remain relevent and useful over time. And vigilance should probably increase in proportion to the longevity of schemes.

Figure 3: Distribution of centrally sponsored and central sector schemes by duration (years)



Source: **Ministry of Finance.**

2.29 ***Institutions:*** Another reason for impeded exit is institutions. The interesting, even paradoxical, fact about India today is that the problem arises from a combination of both weak and strong institutions.

2.30 Examples of weak institutions are legal procedures that increase the costs—time and financial costs—of exit. One example is the

8 Muralidharan, K., Paul Niehaus & S. Sukhtankar, 2015, "Building State Capacity: Evidence from Biometric Smartcards in india", J-PAL.

9 Note that Central Sector Schemes are different (and less in number) than Centrally Sponsored Schemes. The major difference is that the former is funded entirely by the Central government and implemented by its machinery, whereas the latter is based on subjects in the State List, and is majorly funded by the Central government but implemented by the states.

10 There is scheme that is 96 years old called 'Livestock Health & Disease Control' under the Department of Animal Husbandry, Dairying and Fisheries. In the Union Budget 2015-16, it was allocated ₹ 251 crores.

debt recovery tribunals (DRTs). As the name suggests, they perform the role of helping financial institutions recover bad debt quickly and efficiently. In principle, both banks and borrowers can approach the DRTs to settle outstanding debt repayment problems.

2.31 With rising non-performing assets, recourse to DRTs has increased dramatically. Figure 4 shows that the share of settled cases is small and declining; and the accumulated backlog of unsettled cases increased to nearly Rs. 4 lakh crore at the end of FY15.

2.32 The delay in debt recovery creates dynamic efficiency cost on the economy since it prevents the cleaning up of balance sheets of banks and the corporate sector.

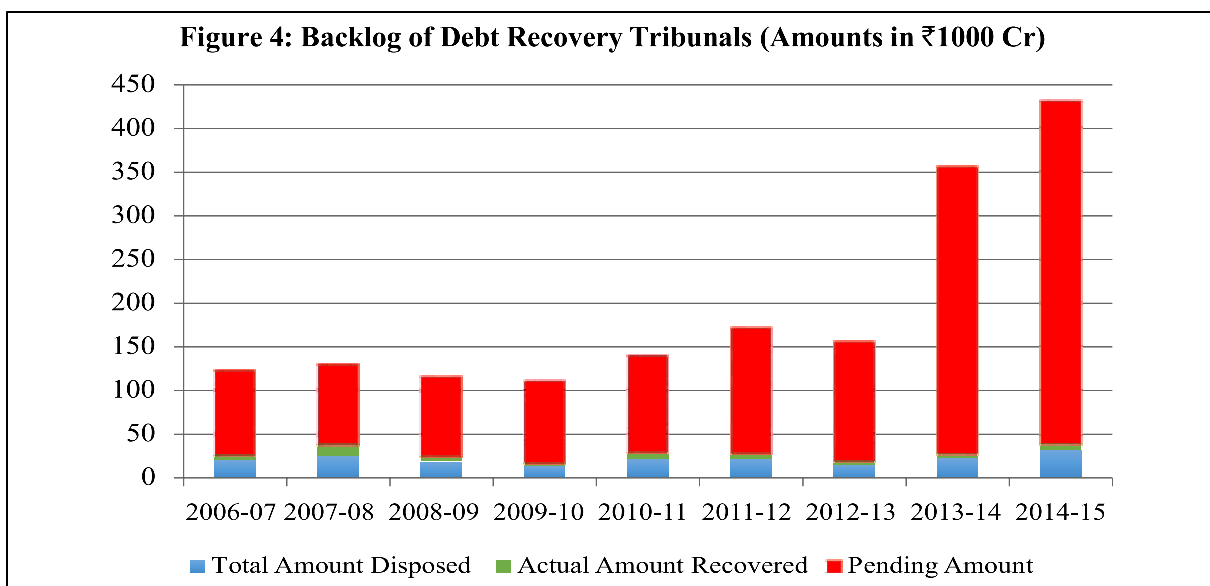
2.33 Another stark example of weak institutions is simply the inability to punish wilful defaulters: if demonstrable wrongdoing goes unpunished, the legitimacy of all institutions is called into question.

2.34 Paradoxically in India, exit is also impeded by "strong" institutions. For a number of reasons, certain institutions—characterized by Devesh Kapur of University of Pennsylvania as "referee institutions"--for example, some of our investigative institutions have become enormously powerful over the last few decades. The strength of these institutions now exists in conjunction with another feature of Indian decision-making, namely the asymmetric incentives for bureaucrats that favours abundant caution and hence the status quo.

2.35 One consequence of this is that incentives are stacked against decisions to precipitate exit. In the case of public sector banks, it is well-known that senior managers are often reluctant to take decisions to write down loans for fear of being seen as favouring corporate interests and hence susceptible to scrutiny. This encourages ever-greening of loans, postponing exit. (see Box 2.2 for an analysis and possible solution).

2.36 Consider the difficulty. On the one hand, a market economy requires the operation of the perpetrator pays principle (PPP). If equity providers/promoters take risks that do not pay off, they must pay the financial consequences: that is at the heart of limited liability in a market economy, and bankruptcy procedures enshrine this principle. Otherwise, perverse incentives—the problem of moral hazard—are created.

Figure 4: Backlog of Debt Recovery Tribunals (Amounts in ₹1000 Cr)



Source: **Ministry of Finance.**

2.37 On the other hand, though, circumstances may demand that the PPP be applied with less than full vigour. In the case of India, ten large corporate houses account for a sizable share of private capital expenditure. Penalising them might lead to the destruction of assets which might otherwise be amenable to rehabilitation. Tricky trade-offs must be made between the perpetrator pays principle and the need to revive investment in a weak economy. But the Damocles sword of "strong referee institutions" -- undoubtedly critical for any democracy -- militates against nuanced, even risky, decision-making when departures from strict principles may be necessary.

2.38 ***Ideas/Ideology:*** A third reason for impeded exit relates to ideas/ideology. All around the world, and at most points in time, it is very difficult to phase out entitlements. But this may be especially true in a country with sizable poverty and inequality and one that is a democracy. Democracy will favour—legitimately—redistribution for the numerous poor. The founding ideology of state-led development and socialism both mirrored this imperative and furthered the objective.

2.39 A good illustration arises in relation to all the interventions in agriculture and all the anti-poverty programs. The objective in all these cases is laudable. But once the policies and programs have been set in place, they are very difficult to reverse. Minimum support prices (MSPs) were envisioned as an insurance mechanism for farmers, but have become price floors instead, favouring some crops in some regions at the expense of others. A variety of subsidies and tax concessions are intended for the poor end up accruing to the relatively better-off (see Chapter 6). The political communication of targeting and policies that promote it are evidently not easy.

2.40 Another factor that impedes exit is what might be called the "sanctification of the small." To be sure, small firms and enterprises merit help through easy availability of credit. It is equally true that economic dynamism and long-run growth requires small firms becoming big and efficient. The experience of the infrastructure boom in which big corporate groups were serial perpetrators should not result in the "sanctification of the small."

Conclusion: Addressing the Problem

2.41 How might the exit problem be addressed? At least, five possible ways suggest themselves.

2.42 ***Avoid exit through liberal entry:*** Since 1991, an overarching principle for eliminating inefficiency and/or addressing the exit problem in vast parts of the economy has been this: to promote competition via private sector entry rather than change ownership through privatisation. This approach had some intrinsic merit - after all, Russia suffered from trying to privatize assets which ended up in the hands of a few so-called "oligarchs."

2.43 More importantly, the entry-favouring approach had the virtue of political expediency. Achieving exit via privatising public sector companies would have encountered significant opposition from their managers as well as labour interests. Allowing private sector companies to enter the market without touching the public sector incumbents bypassed some of these costs. The logic, of course, was that a vibrant private sector would grow rapidly.

2.44 And the strategy broadly worked. The Indian aviation and telecommunication sectors of today are unrecognizably different from what they were 20 years ago, with enormous benefits for the citizens. Public sector companies now account for a small share of the overall size of these sectors. In some ways, the exit problem has been skirted if not avoided.

2.45 In the financial sector, liberal entry of more banks and different types of banks and entry into capital markets still remains an option to shrink the role of inefficient public sector banks.

2.46 ***Direct policy action:*** Some of the problems of weak institutions can be addressed through better laws. This is why the government has introduced a new bankruptcy law that will significantly expedite exit (see Appendix for salient features of the draft Bankruptcy Code submitted to Parliament).

2.47 Similarly, part of the problem arising from overly strong institutions can be addressed by empowering bureaucrats and reducing their vulnerability. One way, which the government is actively considering, is to reform the Prevention of Corruption Act, differentiating cases of graft from those of genuine errors of decision-making (see Box 2.2).

2.48 The exit problem in relation to public-private partnership projects requires the creation of alternative, albeit temporary, structures to be able to credibly allocate the burden of past failure. The Kelkar Committee on "Revisiting and Revitalising the Public Private Partnership model of Infrastructure" has made recommendations on resolving legacy issues and key contractual features going forward. The Committee has recommended quick finalisation of principles of renegotiation to build in the flexibility while protecting authorities against the risk of moral hazard. Recognizing the importance of predictability and fairness in dealing with both sides of the partnership, the Committee has recommended the setting up of independent sector regulators with a unified mandate.

2.49 ***Technology and the JAM solution:*** Many of the exit problems—in relation to fertilizer, agriculture, sugar etc—can be addressed through technology and leveraging the potential of JAM. DBT in fertilizer and other input use can achieve targeting which allows the poor to be protected while allowing the underlying and persistent distortions to be removed.

2.50 Technology can help in two ways. First, it brings down human discretion and the layers of intermediaries. And, second, it breaks the old shackles and old ways of doing business. Both can contribute directly to finding solutions to the exit problems plaguing Indian agriculture and informal sectors (Chapter 3 discusses these solutions in greater detail).

2.51 ***Transparency**:* In relation to agriculture, the government sets minimum support prices to create incentives for producing wheat, cereals, and pulses. It is increasingly clear that there is over-production of cereals, especially in some states. Reducing this over-production—a manifestation of this exit problem—is difficult. But one possible way of effecting change it to throw light on the costs of the status quo.

2.52 One possibility might be for the government to highlight the social costs of producing cereals in the north-western states: over-use of fertilizer and the health and soil quality costs; over-use of water and power and the environmental costs; and the post-harvest burning of stalks that leads to pollution and health hazards. For pulses, the social and economic accounting should include the benefits that their cultivating creates in the form of better fixing nitrogen and efficient use of fertiliser and water. The Commission for Agricultural Costs and Prices (CACP), for example, could publish these social costs and benefits of production along with its routine calculation of the private costs of production.

2.53 Another example relates to the "small" savings schemes. Here, transparency about the real beneficiaries—identified in Chapter 6 as the very rich and not the "small" at all—can help further reform and facilitate exit.

2.54 ***Exit as an opportunity:*** In many cases where public sector firms need to be privatized, the problems of exit arise because of opposition from existing managers or employees' interests. But in some instances, such action can be converted into opportunities. For example, resources earned from privatization could be earmarked for employee compensation and retraining.

2.55 Most public sector firms occupy relatively large tracts of land in desirable locations. Parts of this land can be converted into land banks and made into vehicles for promoting the 'Make in India' and Smart City campaigns. If the land is in dense urban areas, it could be used to develop eco-systems to nurture start-ups and if located in smaller towns and cities, it could be used to develop sites for industrial clusters.

2.56 One concern with privatization is the fear that social policies—of reservation for example—will become casualties when the underlying assets move from public sector to private sector control. Credibly ensuring that such policies will be maintained will be necessary to secure wider social acceptability for exit.

Box 2.2: Improving economic policy-making and implementation by getting public servants to decide without fear or favour

Rapid and equitable economic growth requires the formulation and implementation of good policy, which in turn involves both ministers and civil servants. There is a widely held perception, both within the civil service and among outsiders who interact with government, that civil servants have in recent times become increasingly reluctant to decide issues quickly and firmly. This has consequences for the economy.

The problems with civil service decision-making stem from multiple sources. Firstly, there are gaps in capacity, training and specialised knowledge in dealing with certain kinds of economic issues. Secondly, the increasing number and rigour of external oversight mechanisms may have unintended effects. As Prendergast[11] and Kapur[12] have argued, external monitoring in the public sector tends to be skewed towards bad decisions that were taken rather than good decisions that were not taken (i.e. opportunities that were missed). This promotes a culture where avoidance of mistakes is more important than the pursuit of opportunities. However this box will focus on the third and possibly most important reason which may also be the easiest to remedy: certain provisions of the anti-corruption law and the way they have been used in recent years.

Good public administration and sound policy making requires that public servants take decisions in public interest and, in particular, without 'fear or favour' (a phrase which finds place in the oath of office for ministers). There is a credible perception that well-intentioned but draconian legal provisions seeking to prevent decision making with favour, seem to be resulting in decision taking with fear. Some provisions of anti-corruption law seem to scare the honest without deterring the corrupt.

The Prevention of Corruption Act

In a bid to tighten anti-corruption law, the new Prevention of Corruption Act of 1988[13] (PCA) added a provision in Section 13(1)(d)(iii) according to which:

> A public servant is said to commit the offence of criminal misconduct if he, while holding office as a public servant, *obtains for any person any valuable thing or pecuniary advantage without any public interest.*

Because the definition does not include words like 'corruptly' or 'wrongfully', this offence has no requirement of mens rea or guilty intent – it is an 'absolute offence'. Since the law does not require the public servant to have had any improper motive, even a benefit conferred inadvertently is sufficient to be prosecuted. For example, suppose an honest public servant makes, in good faith, an error of judgment and undervalues an asset which is being disinvested. Obviously that undervaluation causes a pecuniary gain to the buyer of the asset and is not in public interest, but it was not a corrupt or deliberate undervaluation. Indeed it may not even have been appeared at the

[11] Prendergast, C., 2001, "Selection and Oversight in the Public Sector", *NBER Working Paper No. 8664*,

[12] Kapur, Devesh, 2003, "Do As I Say Not As I Do: A Critique of G-7 Proposals on Reforming the Multilateral Development Banks", United Nations Conference on Trade and Development, *G-24 Discussion Paper Series*.

[13] http://www.persmin.gov.in/DOPT/EmployeesCorner/Acts_Rules/PCAct/pcact.pdf

time of the decision to be an error of judgment. An error (with no benefit to the public servant), or something regarded with hindsight as an error, can constitute a crime punishable by imprisonment and, during the trial stage, the stigma of corruption. No such section appears to exist in other democracies, where it is the duty of the investigating agencies to establish corruption including evidence of motive and thus mens rea.

Is public interest served by this approach?

Wrongdoing by public servants can fall in a continuum ranging from receiving minor non-monetary benefits to outright bribery. The purpose behind Section 13(1)(d)(iii) was to provide a catch-all offence to deal with difficult cases where a public servant could confer favours without leaving any trail. Since other provisions of law specifically deal with a wide range of corruption offences covering every form of 'illicit gratification', Section 13 (1)(d)(iii) essentially targets minor forms of corruption (by diluting the standard of proof). It is meant to make it easier for Indian investigative agencies to prosecute for corruption without having to establish any direct benefit to the decision-taker or participant in a decision.

In tackling corruption, two kinds of error may arise- Type I error where the corrupt may escape, and Type II error where an innocent person may be falsely accused of corruption. An extremist approach to reducing Type I errors by preventing the escape of those who may have received minor or non-monetary favours, or against whom proof of illicit gratification cannot be found, increases the chance of a Type II error where an innocent person (who took decisions with no ulterior motives) is prosecuted.

From an economic point of view, the loss to the public from the Type II error and the policy and implementation paralysis it promotes, is far larger. This draconian section therefore appears to be hurting the public more than it has helped it. There is considerable and very credible evidence that many serious governance problems--the reluctance of government to accept responsibility for its own delays in projects, the penchant for departments to appeal even fair and reasonable arbitration awards or lower court judgements, the tendency to raise tax disputes based on audit objections even if the tax authority disagrees with the auditor, the reluctance of civil servants to sell land or divest public enterprises--are traceable in large part to the fear of 'causing pecuniary gain' to the other side.

Remedies

Amendments to the PCA

The Prevention of Corruption (Amendment) Bill 2013[14] , which is pending in the Rajya Sabha, seeks to carry out major improvements to the PCA and in general strengthen the anti-corruption law by bringing it into conformity the United Nations Convention against Corruption. It proposes to replace the provisions of Section 13(1) with new wording in conformity with international norms that is fairer and would prevent prosecution for mere administrative errors. The Kelkar Committee on Public Private Partnerships too has strongly recommended amendment of the law to protect bona fide decision-making.

Commission to recommend a new prosecutorial approach

The combination of Section 13(1)(d)(iii) PCA and Section 120A of the Indian Penal Code may have rendered prosecuting agencies 'lazy' in the figurative sense of not needing to do the painstaking forensic and investigative work needed to trace the money flow of bribes and establish pecuniary gain. Experience with successful prosecution of white collar crime in developed countries suggests that Indian investigative agencies may need to change their approach and modernize their investigative techniques. Many staff of the investigative agencies do not have the tools, skills or training to do a proper investigation of modern day financial crime and corruption. It would be desirable for the Government to set up a Commission to recommend a *new prosecutorial policy for the offence of corruption which balances the need for probity with the need for bona fide decisions to be taken without fear of false allegations of corruption.* The Commission should also recommend measures to improving the capacity of both the investigative agencies and the public prosecutors. It is crucial that the Commission have the resources needed to *access international expertise.*

Re-assess the relevance of the Vigilance machinery

The Government and public sector are dotted with a large number of 'Vigilance Officers'. Quantitative evidence and public perception both suggest that this has not been accompanied by any reduction in levels of corruption, and if anything the problem is perceived to have worsened. The Vigilance Officer system is widely felt to be ineffective and in some cases even counter-productive. It may be time to consider whether the costs of this elaborate, but apparently ineffective, system are worthwhile.

[14] http://www.prsindia.org/administrator/uploads/general/1376983957~~PCA%20Bill%202013.pdf