Governance Issues in India's Economic Reforms

Montek S Ahluwalia

(at Workshop on Governance Issues in South Asia; Yale University
November 19, 1997)
Discussant: Mr. Rui Coutinho, World Bank

The past few years have seen a growing consensus that good governance must be an integral part of any development strategy. The phrase good governance is used in widely different ways in this context. It is often used in a narrow sense to refer to problems of corruption, which is not only morally corrosive but is also viewed as a source of serious economic inefficiency. It is also used in a wider sense to refer to the effectiveness of government policies and systems in achieving declared objectives. Policies and programmes can be ineffective even in the absence of corruption because they are poorly designed to achieve their objectives, or there is a mismatch between the administrative requirements of a particular policy and the actual capability of the State machinery. These are clearly failures of governance as defined by the Commission on Global Governance i.e. "the sum of the many ways in which individuals and institutions, both public and private, manage their common affairs." Finally, good governance is also used in a political sense to refer to the need for greater people's participation in the design and implementation of government programmes, an approach which implies a commitment to democratisation, which is quite distinct from corruption on even effectiveness, though not unrelated to them.

2. Governance issues in all these different senses have surfaced in India in recent years as part of the policy debate on economic reforms. India's reforms, initiated in 1991, are similar to the reforms being undertaken by many developing countries. They involve a restructuring of economic policies based on a redefinition of the role of the State, leaving larger areas of economic activity to the private sector and to market forces, while at the same time increasing the role of the State in other areas such as the provision of social services and basic infrastructure. Greater freedom for market forces is vigorously defended by reformers on the grounds that it increases efficiency and reduces the scope for corruption and black markets but it is also criticised by sceptics as giving "license" to those who can exploit markets through manipulation and other unscrupulous activity in situations where markets are vulnerable to such activity. This raises issues about positive state action to ensure that markets function effectively i.e. the role of the State as a regulator and institution builder. The process of redefining the role of the State also raises some concern about premature withdrawal of the State, before it can be effectively replaced by other alternatives. There is also concern that some of the new roles envisaged for the State, e.g. in providing social safety nets to offset possible negative effects of economic reforms on some sections of the population, may not be put in place effectively on a sufficient scale to achieve their objective. A comprehensive treatment of these issues is beyond the scope of this paper. Instead we focus selectively on some important issues that have surfaced in recent years.

1. The Problem of Corruption

3. The narrow definition of governance relates to the avoidance of corruption which is a difficult but undoubtedly very important issue. The concern with corruption is neither new in India nor unique to her. India's vigorous democratic polity and free Press have ensured a high level of public consciousness about corruption as a social evil. Public opinion polls have repeatedly shown that corruption is regarded as a major problem leading to erosion of credibility in public institutions. It is obviously impossible to quantify the extent of corruption in India on any reliable basis and even more difficult to compare the situation across countries. Transparency International (TI) publishes an annual Perception of Corruption
Index, but (as TI is careful to point out) this index measures not the extent of corruption but rather the perception of corruption among people working in multinational corporations who constitute the sample of TI's surveys. In 1996 India was ranked ninth on a list of 54 countries in descending order of perceived corruption. Nigeria topped the list followed by Pakistan, Kenya, Bangladesh, China, Cameroon, Venezuela and Russia. India's score was marginally higher (in terms of perceived corruption) than Indonesia which is a reversal of ranking compared to earlier years. Thailand, Malaysia, Mexico, Brazil, Egypt and Sri Lanka, among many others developing countries fared distinctly better than India in terms of perceptions of corruption.

4. These are necessarily subjective rankings and their reliability can be questioned. Perceived corruption in Singapore for example is much lower using this index than in the United Kingdom, Germany and the U.S. Not surprisingly, TI's ratings are received with indignant denials by governments in many countries. It is interesting to note however that the reaction in India has been quite different. Editorial comment has focussed on the seriousness of the problem and the need to do something about it. The Prime Minister of India, in a nationally televised address to the nation on the occasion of the 50th Anniversary of Independence earlier this year spent a full fifteen minutes on the problem of corruption, and the need to take measures to combat it. Six years of economic reforms have obviously not done away with corruption nor created any conviction that it is being reduced. If anything, public concern about corruption is greater today than it was a decade ago. It is relevant to ask why this is so.

5. What causes high levels of corruption in a particular society and can something be done about it? This question is best answered by identifying the determinants of corruption and then seeing whether there is some way of influencing these determinants in a way which reduces corruption.

6. Corruption can be defined as bribing of public officials to influence their decisions in a manner designed to confer unjustifiable benefit to the bribe payer. Public officials may be bribed to confer positive benefits as a result of administrative decisions such as for example the issuing of licenses conferring various types of commercial rights which have a scarcity value, or giving access to subsidised supplies of items at prices which are much lower than the market price, or awarding government or public sector contracts on terms more favourable than commercially warranted. Officials may also be bribed to avoid or reduce "costs" which they can otherwise impose through the exercise of administrative power. Examples of this type of corruption are bribes to avoid or reduce penalties leviable for regulatory violations, or bribes to tax collection officials to lower assessments of tax dues, or petty bribes to officials simply to perform their normal duties without unreasonable delay which can at times impose substantial costs. The frustrations created by petty corruption of this type which public officials can easily impose is a common feature of many developing countries as brought out in the following description:

"You're driving in Accra, capital of Ghana, minding your own business, when a traffic cop decides you've made an "illegal" left turn. The fine? Fifty bucks, and no receipt. Your company needs telephone repairs in Beijing. The price? A fishing trip for everyone in the local telephone-and-telegraph office. You spend a day at the Venezuelan port of La Guaira, filling in forms so you can export mangoes. At the last minute, an official spots a typo. So sorry, all paperwork has to be redone; that, or pay a "special fee." Or watch your mangoes rot."

from "Corruption : How Bribes, Pay Offs and Crooked Officials are Blocking ... " by Michael Elliott, Newsweek, November 14, 1994.

7. The size of potential gains which can be obtained by influencing decisions of public officials is obviously a critical factor determining the scale of corruption. The larger the potential gains the greater the incentive for individuals to try to bribe public officials and
other things being the same, the greater the incidence of corruption. Advocates of economic liberalisation and privatisation of the public sector claim that any reduction in government controls upon commercial activity eliminates one point of interface between business and government and thus reduces the scope for corruption. In the same way, privatisation of public sector units shifts decisions out of government and reduces the scope for corruption. It is important to emphasise however that liberalisation alone cannot abolish corruption if only because the State will always retain some regulatory roles.

8. The inherent honesty of public officials is another important factor determining the scale of corruption. A more honest administration is less likely to allow corruption, and it is therefore important that systemic pressures are created to ensure that the administration has high standards of honesty. If the honesty of administration is a pre-determined characteristic reflecting established cultural or social norms, there is not much that can be done to improve the situation in the short run. However, it can be argued that the honesty of the administration itself depends upon systemic factors. It depends most of all upon the state of political governance and the expectation of honesty from the politico-administrative system. A political system which wants an honest administration can improve the honesty of the system in various ways. The track record of the administration in rewarding honesty in promotions and placements is a critical factor. The pay structure of the civil service may also be important. A structure which keeps the expected Civil Service or Public Sector pay much lower than the market wage for comparable levels of skill could discourage the flow of more honest individuals into Civil Service or public sector jobs at the entry point, and also encourage the exit of inherently honest individuals in the course of their career. This creates an adverse selection process in which with relatively dishonest individuals are more likely to gravitate to the public sector.

9. Given the scope for corruption as determined by the extent of discretionary power in the hands of officials and the honesty of the administration, the actual scale of corruption will also be affected by two other factors, i.e. the likelihood of detection and the scale of punishment on conviction. An increase in the probability of detection and ultimate conviction for corruption with a given scale of penalties or an increase in penalties for given probabilities of detection, or a combination of the two, raises the cost of corruption to public officials and should therefore reduce its scale. The probability of detection and conviction is clearly as important as the scale of punishment since draconian punishments for corruption will have little deterrent impact if the probability of detection and conviction is seen to be very low. This probability in turn depends upon two factors. First it depends upon the quality of governmental systems especially the inherent transparency of government decision making, the extent of accountability for decisions, and the existence of external audit, monitoring and evaluation. Well defined procedures with clear decision rules (e.g. competitive bidding for procurement wherever possible) combined with accountability and external review make it much more likely that malafide actions will be detected and malfeasance proved, whereas procedures which are inherently opaque and allow wide discretion, with little accountability and independent review, make it less likely. Second, and in many ways, equally important is the efficiency of legal procedures. Speedy adjudication which combines justice with fairness, is an essential element in deterrence whereas prolonged judicial proceedings with uncertain outcomes encourage corruption, especially of the hardcore variety.

10. Administrative structures of the type described above relating to systems of government decision making, reward and placement policies, civil service pay etc. do not operate in a political vacuum. It is perfectly possible to imagine the structures being in place but being subverted by political processes which in effect do not allow the systems to work. This is where good governance in broadest sense becomes relevant. Open political systems, with a high degree of people's participation and most important of all, an active and free press are likely to throw up deficiencies in the system and generate political pressure for these deficiencies to be corrected. Much of the heightened public concern about corruption in India at present reflects the operation of these factors mediated through India's democratic polity and needs to be interpreted as a positive rather than purely negative development.
2. Abolition of Discretionary Controls and Impact on Corruption

11. Economic reforms generally involve a shift from extensive use of discretionary government controls guiding economic decision making to greater reliance upon market based outcomes. This reduces the power of officials to provide commercial benefits at their discretion and therefore is expected to reduce the scope for corruption. On this expectation, India's economic reforms should have reduced the extent of corruption significantly in the past six years.

12. Two areas where discretionary control was particularly intrusive prior to 1991 were industrial licensing and import restrictions.

   i) The industrial licensing regime meant that investment to set up new projects, or even to undertake substantial expansion of existing capacity, required an industrial license from the Central Government. Government discretionary power was therefore involved in determining the scale of capacity allowed to be set up and, in the case of a new unit, its location as well. Large industrial houses needed a separate permission to ensure that the proposed investment did not lead to excessive "concentration of economic power". The criteria for granting licenses were necessarily vague because of multiple objectives pursued by government such as the desire to spread investment across all regions, minimise the foreign exchange cost of the investment, promote labour intensive technology and avoid proliferation of excess capacity. Multiple objectives means that government had wide discretion in practice. The process was non-transparent and susceptible to lobbying and pressure. It was therefore also vulnerable to corruption.

   ii) The import control regime was equally intrusive. Although there was a positive list of goods which was allowed to be freely imported (generally items which were not produced in India) most other goods for which domestic substitutes of some sort were available could be imported only against import licenses. Thus import licenses were needed to obtain raw materials, components, spares and capital goods. As in the case of industrial licensing there was wide discretionary power allowing room for judgement on whether the import was really needed or whether domestic supplies with their attendant price, quality and time delay disadvantages were adequate. The scope for corruption to obtain unintended advantages, or even to speed up decisions which could otherwise take longer, was very large.

The economic reforms sought to abolish this system of controls for two reasons. First, it was inherently inefficient because government intervention often led to decisions on location, scale of production, technology and access to imports which were inconsistent with the requirements of efficiency. Controls typically also introduced delays and inflexibility and bred a system which discouraged domestic competition for fear of creating surplus capacity and also minimised international competition by providing near automatic protection for domestic production. Second, the system spawned corruption both of the grand and also the petty variety. Since discretionary decisions on whether to allow new capacity and at what scale, or whether to allow imports or not, meant a great deal to those making the application and also to others affected by the decision. Corruption on a large scale was widely believed to be pervasive. The system also spawned petty corruption because the ability even to delay a decision often gave petty officials a potentially strong instrument to extract bribes. The vulnerability of the system to corruption is a distinct and separate weakness from its inherent inefficiency.

13. The reforms of 1991 explicitly recognised both these weaknesses and virtually dismantled the system of industrial licensing and import controls. Industrial licensing was abolished save for a handful of so-called environmentally sensitive industries. Import licensing has also been removed for all raw material, other inputs into production and
capital goods. This has eliminated whole areas of interface between public officials and private individuals which were earlier viewed as potential sources of inefficiency and corruption. It is interesting to note that while the efficiency gains from this reform are widely recognised, little credit is given for the elimination of corruption associated with the removal of these controls. Liberalisation has not led to a general perception that corruption has declined with economic reforms.

14. There are several reasons why the corruption reducing effects of liberalisation may not be perceived and indeed the scale of corruption may even appear to have increased. Efficiency enhancing reforms such as the abolition of industrial licensing and import control do not eliminate all areas of interface between government and business. There are several other layers of interface at the Central and State Government levels, including environment and pollution control, various types of safety inspections, labour law inspections, central and State Government tax collection administrations, including customs, and also public sector banks. Each of these interfaces can potentially involve corruption. Not only is the scope for such corruption not directly reduced by the abolition of industrial licensing and import control, it can even be argued that the efficiency enhancing aspects of these reforms may lead to some increase in corruption in these areas because the reforms increase the productivity of beneficiaries and thereby increase their “rent paying” capacity. This may lead to higher rents being extracted elsewhere in the system by public officials in a position to do so. Thus there may appear to be a real increase in corruption in some areas even though the total corruption in the system is actually lower if full account is taken of the controls eliminated.

15. Liberalisation eases conditions of entry and encourages new entrants in areas of economic activity which were earlier restricted. These new entrants are beneficiaries of the initial liberalisation, but having entered, they begin to experience downstream hurdles for the first time. This may create a perception of increase in corruption in the system simply because many more people are experiencing it for the first time, whereas earlier the group of participants in corruption was more limited and inclined to accept the system. Broadening of participation, which is an important objective of liberalisation, may therefore increase public perception of corruption as a problem.

16. A similar argument applies to the opening up of the economy to foreign investment. Foreign investors are not inherently more honest than others but they are aware that they operate in the glare of publicity and therefore are often more critical of departures from internationally acceptable best practice. Their presence also increases public perception of corruption as a problem and may encourage more public discussion of the issue even when there is no actual increase in the scale of occurrence.

3. Governance Issues Arising From Private Investment in Infrastructure

17. An example of new governance issues thrown up by the changing role of the State is the set of issues relating to the terms and conditions which should be offered to attract private investment in infrastructure sectors such as electricity generation, telecommunications services, roads ports etc. These areas used to be the exclusive preserve of the State until very recently but in keeping with trends all over the world, and recognising the limitations of resources in the public sector, the Government of India has opened these areas to private investment in order to encourage more rapid expansion of capacity and also to improve the quality of service. If private investment in these sectors

1 India retains import licensing for imports of consumer goods which are to be phased out over the next few years.

2 Complaints about corruption in the tax administration in many countries, which are also frequently heard in India, are a classic example of this type of problem. It needs to be addressed through reforms of the tax system to introduce greater simplicity and also reform of tax administration to reduce discretionary power.
were to take place under normal competitive market conditions no special governance issues would arise. However investment in infrastructure is not like any other investment because infrastructure sectors are typically heavily regulated, including regulation of the tariff charged. Tariff regulation can present difficult problems because the regulatory authority has to strike a balance between ensuring that the tariff is fair to the consumer while also ensuring that it is sufficiently remunerative to attract investment. This balance is difficult to strike because consumers often expect unduly low tariffs having got used to underpriced infrastructure services delivered through the public sector system, while private producers may well want higher returns than were acceptable to public sector suppliers.

18. The complexity of the governance problems that arise is illustrated by the case of the gas based power project at Dabhol in Maharashtra State being set up by the Enron Corporation. The project was severely criticised on the grounds that the power purchase agreement entered into by the State Electricity Board was unduly favourable to the power producer offering tariffs that were too high. There was also criticism from environmental groups suspicious of private sector projects, alleging that the project violated environmental norms and that environmental clearances were improperly obtained. There were also explicit allegations of corruption. The issue became highly politicised and the project was cancelled following a change of Government after elections in Maharashtra. The project also faced a series of challenges by public interest groups in the courts. Underlying these controversies was the suspicion that bringing in private sector investors would compromise the public interest and the lack of confidence in the ability of the existing systems and procedures to protect it. As it happens, the project survived all the court cases, and was successfully renegotiated with the new State Government, and is currently at an advanced stage of construction. The Enron experience shows that withdrawal of the State from traditional areas of State activity and its substitution by the private sector can generate considerable controversy unless the rationale of the new policy is fully explained to the public and the procedures governing the transition are perceived to be transparent and above board.

19. Some of the problems clearly arose because of weaknesses in the policy itself. India's policy for private sector power projects provided for tariffs to be fixed on the basis of formula which ensures that approved capital costs and variable costs are fully covered plus there is an additional element for rate of return which ensures that a stated rate of return is reached at normative levels of capacity utilisation. The capital costs used for tariff fixing approved capital costs as determined by the Central Electricity Authority. The policy was similar to the policy used for fixing public sector tariffs except that the return on equity provided in the formula was raised from 12% to 16% at 68.5% plant utilisation, with additional incentive returns for higher levels of utilisation. The independent power producers were also given the additional benefit of exchange protection covering the repayment of foreign debt and also protecting the 16% return on foreign equity. Cost based tariffs are vulnerable to criticism on the grounds of "gold plating" of capacity and this is especially so when investors include equipment suppliers as is often the case. The tariffs generated by the cost based formula in India ranged from 7 to 8 cents per kwh for the early projects which were compared unfavourably by critics with tariffs of around 5 cents quoted in many countries. It is obviously impossible to pronounce on the issue of costs of private sector power in India except on the basis of very detailed cost studies which are beyond the scope of this paper. Simple comparisons of costs at different locations and in different countries are not very meaningful because much depends upon the structure of taxes and duties which differ across countries and also on the extent of investment in associated infrastructure, which needs to be built. However, it has to be noted that most of the early projects were criticised as involving high tariffs even though these tariffs were approved by the Central Electricity Authority.

20. Interestingly, many of the disadvantages of cost based tariffs which have been highlighted in the debate & such as the tendency to overstate capital costs or to accept unduly lax performance norms & are equally valid for public sector projects. However these did not become matters of public concern as long as the sector operated as a public sector monopoly. The same formulas and procedures attracted criticism when applied to private
21. The Government responded to these criticisms by announcing in 1996 that in future private sector power projects would have to be selected on the basis of a competitive bidding under which State Electricity Boards would invite bids specifying the technical requirements which the project must satisfy and also indicating other details in terms of the risk sharing arrangements built into the power purchase agreement. Investors would be invited to bid for the projects in terms of the lowest tariff acceptable and the project would be awarded to the bidder quoting the lowest tariff. Competitive bidding along these lines would provide a transparent method of ensuring that the tariff is the lowest possible at which the plant can be constructed and would thus avoid public controversy. However competitive bidding also has its limitations. It ensures cost minimisation only if a sufficient number of qualified investors compete actively in the bidding. This may not happen for several reasons. There may be lack of information to attract quality investors or lack of clarity about various financial and legal details, without which quality investors would not bid. In such situations a process of adverse selection operates in which bidding gets limited to poor quality investors who hope to negotiate improvements in the terms of the contract after the bidding process is over. A poor quality bidding process can yield an inferior outcome to the outcome obtainable through high quality negotiations. However the great advantage of competitive bidding is its transparency, and this is often a dominant consideration in government decision making.

22. A different set of governance considerations arose in the context of private sector entry into telecommunications. A new telecommunications policy was announced in 1994, ending the public sector monopoly in telephone services. The country was divided into 20 telecommunication "circles" and for each circle bids were invited for two competing private sector cellular service providers and one private sector basic services provider to compete with the existing public sector basic service. The problem of non-competitive tariffs which arose in the power sector did not arise since the maximum tariff chargeable was the same as in the public sector system.

23. Consumers therefore viewed the telecommunications service providers as offering welcome competition to the existing public service possibly benefiting at the expense of the public sector supplier, but not at the expense of consumers. However several other problems arose which are relevant for the redefined role of the State in infrastructure development. The most important of these was the perception among the new private sector suppliers that if they had to compete with a public sector service run by the Department of Telecommunications it was not appropriate for regulatory control over private suppliers to be exercised by the Department of Telecommunications, which also controlled the public sector competitor. Private suppliers argued in favour of an independent regulatory authority which could assure private suppliers of even handed treatment in the event of disputes relating to the terms of licensing agreements. This demand was conceded in 1996 with the establishment of the Telecommunications Regulatory Authority of India. Shortly thereafter private sector operators challenged the imposition of an extra charge levied by the public sector telecommunications system for outgoing calls to the private networks. Although the charge was not levied on the new entrants or on their clients, its imposition on the dominant portion of the network would discourage the growth of inter-network traffic to the disadvantage of the new private sector entrants. The TRAI very quickly ruled in favour of the new entrants and the charge was withdrawn. This has greatly helped to establish the credibility of the new institution and improved the investment climate in this sector.

4. Governance Issues Related to Privatisation

24. As in other developing countries, India’s reform programme included privatisation as one element and this raised a number of interesting governance issues. Privatisation itself is opposed in some quarters in India on governance grounds
because of the perception that there is a continuing need for a public sector presence in many areas of the economy. This reflects a different approach to economic policy and is not discussed in this paper. Here we focus on issues raised by those who accept privatisation as a policy but are concerned about governance issues related to privatisation, such as ensuring that the process of sale is transparent, the price obtained is appropriate and the subsequent private holders of public sector equity get a fair deal.

25. The objectives of privatisation were two fold. First to raise resources for the budget and second to inject private shareholding into the ownership of public sector units to increase the commercial orientation of those units in terms of consciousness of returns to shareholders. Governance problems are involved in pursuing both objectives. Ensuring that public assets being sold fetch a fair price is clearly a critical governance issue since sale below fair market value involves a loss to the exchequer and is bound to raise suspicions about corruption and cronism, problems which have arisen in some of the early privatisation programmes in Latin America and also in the more recent efforts in former communist countries. And yet it is not at all easy to determine the fair market value of shares in public sector organisations when there is no established market price for these shares which have never been traded.

26. Pricing of public sector equity posed special problems in India because the privatisation did not involve handing over of management to a single entity. Had this been acceptable the sale could have been effected by inviting competitive bids, subject to appropriate reserve prices, for either the whole or a controlling portion of the equity. India's privatisation policy however was initially constrained to ensure that government would retain a majority stake and management control. Privatisation therefore meant that government was effectively tapping investors to pick up shares in PSUs as portfolio investment. Several problems arose in determining appropriate modalities for sale which would stand up to examination in the public and in Parliament.

i] It was difficult to fix an appropriate sale price in the absence of a market price (since there were no shares in private hands and these shares had never been traded). It was difficult to value equity on the basis of discounted cash flow methods since existing public sector managements typically made exaggerated claims about performance, based on a variety of highly optimistic forecasts. It was also difficult to do so on the basis of actual earnings performance and observed price earnings ratios in other firms since this assumed that performance would be comparable to performance in the private sector even though management was not being changed. In the absence of reliable ways of determining appropriate sale prices there was a strong preference for sale through a system of auctioning.

ii] There was a concern that government should avoid large scale cornering of shares by individual purchasers before a reliable market price for these shares had developed. The auction was therefore restricted to domestic institutional investors such as the Unit Trust of India, the Life Insurance Corporation of India and various mutual funds floated by public sector banks.

iii] Finally, there was concern that disinvestment may lead to only the shares of the "better" public sector organisations being purchased leaving shares of poorer performing units unsold. Since the policy of partial privatisation had envisaged the induction of shareholders as representing a longer term advantage for the public sector units, helping to create greater commercial orientation of these units, it was decided to sell the shares in bundles with each bundle consisting of a mix of shares of good and not so good units. The bundles were to be sold through a "dutch auction", with bids accepted for different quantities of each bundle in descending order of the bid value until the reserve price was reached.
This cumbersome procedure succeeded in raising Rs.3038 crores in 1991-92 but the first disinvestment was heavily criticised in Parliament on the grounds that the decision to sell shares in bundles led to lower price realisation. There was criticism also on the reserve prices used. With all these limitations the manner of sale chosen achieved two critical objectives. The shares purchased ended up in the hands of established institutional savings organisations and it was possible to defend the price on transparency grounds because it was determined by an auction.

27. The restrictive conditions on the sale of public sector equity were progressively relaxed in subsequent years. The bundling procedure was abandoned in 1992-93 and the auction were also thrown open to individuals. In 1993-94 the auctions were further opened to foreign institutional investors, who had by then been allowed to invest in the domestic stock market. Pricing however continued to be fixed on the basis of "dutch auctions" in which each bidder paid the bid price upto the point where bids fell below the reserve price or the quantity available was exhausted.

28. It was evident at an early stage that auctioning prevented effective marketing of public sector equity to the general public since aggressive marketing of shares of a company to individual investors can only be done at a pre-announced price. The auction alternative of publicising the positive side of the company and hoping for high bids is much less effective. It is more difficult to get potential buyers to enter an auction than it is to persuade them that a particular share is a good buy at a particular price. The method of sale therefore militated against one of the longer term objectives of disinvestment which was to develop a broad base of public shareholders. Nevertheless it was felt that until such time that a reliable record of trading with suitable trading volumes emerges it would not be possible to establish a credible price at which government equity could be offered to the general public.

However, a limited decision was taken to sell shares to workers in each enterprise at a discount of 15% to the price realised in auctions subject to a maximum number of shares per worker.

29. As it gained experience with disinvestment the government moved to establish a more transparent procedure for handling disinvestment. In 1996, an independent Disinvestment Commission was established to advise the government on these matters including the volume of disinvestment undertaken in individual companies. The terms of reference of the Disinvestment Commission allow the Commission to recommend disinvestment beyond 49% thus reducing government shareholding to a minority. The Commission has since submitted recommendations on disinvestment in 27 companies. In some cases they have recommended disinvestment of minority holdings in favour of portfolio investors. In others it has recommended sale of companies to strategic partners or even outright sale with management control. The government has also moved away from auctions to a process of sale through book building. The current policy is that the government is undertaking sales of public sector equity in international markets on the basis of a book building exercise conducted by international investment bankers, to be followed by offers of domestic sales to the general public at a price determined with reference to the price realised internationally.

30. Induction of private shareholders into public sector organisations as a result of disinvestment has also focussed attention on the need to give greater financial autonomy to these organisations to enable them to operate more commercially. The very fact that shares of public sector units are being traded in markets, including global markets in some cases, has increased the sensitivity of public sector managements to commercial considerations and specifically to earnings performance and in general market perceptions about the prospects of the company. The presence of private shareholders is also being reflected in the composition of the Board as non-official Directors are being inducted on the Board of public sector organisations to represent private shareholders’ interest. The changed composition of the Board is expected to strengthen the process of commercialisation of public sector units.
5. Financial Sector Reforms and Governance Issues

31. The state of governance in the financial system is an extremely important aspect of economic governance in general if only because of the enormous potential for misallocation and misappropriation of funds in this area. In this section we examine these issues as they have arisen in the context of India's economic reforms in the banking system and in the capital market.

32. Misgovernance in the banking system can take many forms, but to simplify matters we will define it as deliberate lending to non-creditworthy borrowers. At one extreme this takes the form of deliberate misappropriation of bank funds as when compliant managements extend loans to associated companies in the knowledge that the borrower has no intention of servicing the loan from the very outset. More commonly, it takes the form of extending loans to "favoured" borrowers with insufficient regard to the borrower's creditworthiness. Such borrowers may well intend to repay if they are able to do so, but since the quality of the loan is inferior to begin with, there is a high probability of default exposing the bank to undue risk. Such defaults are initially at the expense of the shareholders of the bank, but the process can be taken to a level where it is at the expense of the depositors if the bank is allowed to fail, or at the expense of the state if bailouts take place as they often do. The experience with many banking crises in developing countries, including the information now available about banks in some of the South East Asian countries, indicates that deliberate misdirection of bank funds through "crony banking" is not uncommon.

33. Public sector banks are also vulnerable to such governance failures for two reasons. First, public sector managers are susceptible to political pressure to lend to politically well connected business houses which may thus acquire unjustified access to bank credit and may also enjoy unduly favourable treatment in the matter of settlements of dues in times of difficulty. Second, public sector banks are often subject to government direction to undertake "socially productive" lending which may not always be commercially profitable. An example of such intervention is the directed credit regime in India requiring commercial banks to ensure that 40% of their commercial advances are to the "priority sector" (i.e. agriculture, small scale industry, artisans, etc.). Although such intervention does not directly involve malfeasance, there is evidence that directed credit programmes, often lead to corruption at lower levels. This is because the fulfilment of directed credit targets often requires some compromise with normal standards of creditworthiness and this introduces areas of discretion in determining the eligibility of borrowers to benefit from such programmes. This gives dishonest officials the opportunity to extract bribes from such loan beneficiaries. The officials concerned may include officials of the district administration involved in initially identifying and recommending possible beneficiaries, as well as officials of banks responsible for scrutinising application and final sanctioning of the loans.

34. It is impossible to determine the quantitative extent of mis-governance as defined above in the Indian banking system though suspicions and allegations abound and are frequently aired in Parliament. Critics sometimes refer to the size of the non-performing portfolio of bank assets—which is around 3% of GDP—as an indicator of the extent of malfeasance, but this is not an acceptable approximation since it ignores the fact that a large part of this portfolio may reflect poor banking policies and practices and not malfeasance as such. Whatever the true extent of the problem, it is widely believed to be extensive and it is therefore relevant to ask how the ongoing economic reforms will change the situation.

35. The major change brought about by financial sector reforms is through the impact of the new prudential norms which have been introduced as part of the new regulatory and supervisory system. These norms are broadly in line with the Basle norms and will directly improve governance in the banking system.

Income recognition norms have been introduced which ensure that banks take credit in their books only for interest income actually received instead of the earlier practice of showing interest income as received and increasing the loan outstanding.
by the same amount. Elimination of this practice of "evergreening" makes it easier to identify problem loans in the portfolio and will enable supervisors to make a better assessment of the financial performance of the bank.

Asset classification norms have been introduced which force banks to classify loan assets as standard, substandard, doubtful and loss assets according to international norms and also to make provision for all non standard assets on a uniform basis. The absence of uniform classification norms earlier had allowed banks to hide the quality of their assets. The new system, together with (i) above, gives a truer picture of the financial position of the bank and strengthens the incentives for bank managements to improve the high quality of the loan portfolio.

Banks are required to maintain a capital to risk assets ratio of at least 8%. Enforcement of this norm will force banks that want to expand lending to generate a sufficient expansion of capital internally through accretion to reserves or through external injection of fresh capital.

Whichever option is chosen, expansion in capital will depend upon commercial performance and only good performers will be able to expand. Poor performance will be punished by inadequate growth and possibly even reduction of unimpaired capital, which in turn would force such banks to curtail their expansion.

Supervision of the banks is being strengthened to ensure adherence to the new norms and to provide timely feedback to management and owners about bank performance.

The report of the Committee on the Financial System, on which the financial sector reforms were based, had also recommended a drastic reduction in the target for priority sector lending but this particular recommendation has not been accepted. The target for priority sector lending remains 40% and it is hoped that improved prudential norms combined with stronger supervision will increase the focus on the banks financial performance and this will provide sufficient incentive for managements to improve the quality of lending.

36. It is of course too early to evaluate the impact of these reforms which began in 1992. The effectiveness of banking reforms ultimately depends upon a change in banking culture, in which the changes in prudential norms and the framework of regulation are only first steps. However the results thus far are promising. The percentage of non performing advances in total advances of the banking system has declined significantly from around 24% in 1992-93 to 17% in 1996-97. Most of the banks have reached the minimum capital adequacy ratio of 8% many through then-own efforts and some through additional capitalisation by the Government. Special debt recovery tribunals have been set up to provide speedy decrees in favour of banks recovering their dues and this has helped create a climate in which borrowers take a more serious view of defaulting on bank dues. Continued supervision of banks in terms of these parameters will definitely improve governance and encourage bank managers to resist pressure for imprudent lending.

Liberalisation in the rest of the economy has also created an environment in which banks are paying much greater attention to improving their credit appraisal capacity. One of the disadvantages of the earlier system of industrial licensing was the tendency to assume that industrial projects consciously licensed by the government were in some sense part of an approved framework of capacity expansion and therefore "entitled" to bank finance. This expectation, which is a logical consequence of deliberate planning for expansion in capacity, also made it easier for license holders to bring outside pressure to bear on bank managements. Questions of viability were finessed by the implicit assumption that trade policy would provide a "tailor made" degree of protection through import licensing, once domestic capacity was set up. All this has changed with the abolition of industrial licensing and the implementation of trade policy reforms. Banks are relying upon internal assessments of viability to a much greater extent than before, and that too on the explicit assumption that levels of protection will decline over time.
The functioning of the capital market also raises important governance issues which have been addressed in the ongoing economic reforms. India has a long tradition of organised stock markets—the Bombay Stock Exchange for example has been functioning for over a 100 years—but Indian stock markets suffered from several imperfections. One set of problems arose from excessive government intervention of the wrong type. Firms could not make public issues of debt or equity without government permission and the government also controlled both the rate of interest on corporate bonds (called debentures in India) and also the price of which new equity could be issued. However, while new issues of debt and equity were subject to tight government control, there was relatively little regulation of the functioning of the stock exchanges. There was no independent statutory regulator for the stock exchanges, which functioned essentially as self regulating bodies.

Trading was based on non-transparent trading methods, and the market was widely believed to be subject to manipulation through collusive trading among brokers. Prices were easily manipulated and it was widely believed that firms approaching the capital markets for fresh issues of equity were able to generate artificial buoyancy in stock prices. There were severe settlement problems because stock certificates had to be physically transferred to the buyer and then sent to the company registrars for verification and recording of the change in ownership, a process which was very time consuming and was often plagued with problems of determining authenticity. There were also no regulatory requirements governing the operation of mutual funds to ensure transparency of operations and disclosure of net asset value.

Concern with governance issues in the capital markets was heightened in 1992 because of the "securities scam" discovered early in that year. The scam consisted of brokers fraudulently siphoning funds out of the banking system through mechanisms disguised as repos transactions in government securities, and investing these funds in the stock market for speculative gains. It was also suspected that some of these funds may have been used to manipulate particular stock prices in order to support large public issues by the concerned companies. The securities scam and the associated speculative boom in stock prices generated an active debate on the need to balance liberalisation with appropriate market regulation. There was widespread concern that liberalisation alone, especially in financial markets, would leave small investors at the mercy of speculators and market manipulators. It created a strong public demand for better regulation in the stock market in order to restore investor confidence.

A series of steps were taken to tackle these problems and establish a regulatory system in line with international practice. Government control over interest rates for corporate debt and pricing of new equity was abolished at an early stage of the reforms. The Securities and Exchange Board of India (SEBI), was established as an independent regulatory agency with statutory powers in 1992. The Board has laid down rules and regulations to be followed by all market participants including brokers, mutual funds, merchant bankers engaged in marketing new issues, etc. The trading system has been successfully modernised. The National Stock Exchange came into operation in 1994 as a nation-wide electronic exchange using the Open Electronic Limit Order Book (OELOB) system, with brokers spread out across the country, linked to the NSE computer by satellite. The OELOB system enforces price-time priority in matching buy and sell orders and thus introduces a high degree of transparency in trading. With the establishment of the NSE, the Bombay Stock Exchange also changed from the traditional trading ring with trades conducted on the basis of open outcry on the trading floor to an electronic on-line trading system. The system of settlement is also being modernised with the establishment in 1996 of an electronic National Depository operating on the basis of dematerialised shares. Major institutional investors will be required to trade only on the basis of dematerialised shares in the National Depository from January 1998, a regulatory requirement which will spur the process of dematerialisation and electronic settlement.

An important factor lending support for accelerating reforms in the capital markets was the opening up of the Indian capital market to Foreign Institutional Investors (FIIs) in 1993. Since then almost 400 FIIs have been registered to invest in the capital markets and
about 150 are active investors. The cumulative amount invested in Indian equity by all FIIs is about $9 billion, which is about 9% of market capitalisation. The presence of FIIs has increased the pressure for greater transparency and modernisation of trading and settlement practices.

**Concluding Observations**

The governance issues discussed in this paper are by no means exhaustive. The concern with governance is so widespread, and the definition of governance so broad and all encompassing, that all aspects of the effectiveness of government policies could be considered problems of governance in some sense. A comprehensive study, or even a comprehensive listing, of these problems is beyond the scope of this paper. Our effort in this paper has been only to highlight some of the important areas where governance issues have surfaced as part of the process of economic reform and to document how they have been addressed.

A common conclusion from the discussion of individual issues in this paper is that economic reforms will help to improve governance by reducing the scope for discretionary power and increasing the degree of transparency in policy and procedures. But economic reforms are no guarantee against malfeasance. Governance problems can arise in any system and improved governance is therefore only likely if the political and administrative system and civil society generally works jointly to achieve it. Whether it will do so goes beyond narrow issues of the design of economic reforms and into the realm of the functioning of political systems. One thing is certain. India's democratic politics and free press will ensure that these issues will remain in the forefront of public consciousness and therefore on the political agenda, and there will be continuous pressure for improvement.