Public Policy and Governance

Discussion of Papers by Surjit Bhalla, Bhaskar Dutta, Sumon K. Bhaumik & B.V. Kumar

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Modern researchers of corporate law, or company law as it is called in India, emphasise the importance of a single point objective. They maintain that, the only objective of such a body of laws governing the behaviour of corporations, should be that of maximising the value to shareholders. They argue that such maximisation will encourage efficient projects to be undertaken and, hence, realise the right amount of investment required for sustained growth. This focus, on the shareholders alone, is in spite of the fact that a corporation is an organisation of diverse groups, like labour, management, suppliers, consumers, local residents where the production points are situated, etc., all with very diverse interests.

The basic reason for this is a simple one. Corporate decisions are ultimately taken by managers and a large part of the laws govern *their* behaviour in an attempt to regulate the behaviour of corporations. If managers are given a multidimensional objective, and asked to look after the interests of every single group in the organisation, the entire managerial activity is trivialised. Why? Simply because, invariably, an action by the manager that is not pure fraud, will benefit at least some group(s) in the organisation and will, therefore, win the support of that (those) group(s) for the managers' actions. Thus, maximisation of shareholder value, necessary for investment, may not be achieved, leading to inefficient project choices.

One may wonder, why do I refer to corporate governance and company law when discussing papers in a session entitled *Public Policy and Governance.* Well, one of the authors, namely Bhalla, refers at the very beginning of his paper, to corporate governance and its correspondence to governance in general. I am simply subscribing to the same view and setting the framework in which the papers can be discussed. This allows me to set up a common theme for papers with such diverse topics as a *bill of rights, coalition governments,* and *crime and corruption.* Also, the papers are too well written and, were equally well presented, for me to add any further explanation about what they contain.

To finish the analogy between corporate governance and public policy, let me list some of their common aspects. In corporations, shareholders are principals and managers their agents. In public life, under a democracy, the voters are the principals and the parliamentarians, or the lawmakers, their agents. The managers choose the projects; the politicians, and/or their parties, choose the policy regimes. We want managers to choose efficient projects. This is their fiduciary duty. What do we want politicians to do? This is where the analogy seems to become strained, or even, break down. Can we say that as far as governance, or public policy is concerned, one can think of a uni-dimensional objective?

One way of looking at this problem is to go back to corporations. Various corporations undertake various projects. How can all of them be efficient? Well, they can. Some managers can handle steel projects, others chemicals, some financial companies, and so on. Yet, the goal is the same, that of maximising shareholder value. If Bhalla is to be believed, and I agree with him, then currently, the considered wisdom is that governments should maximise growth. Thus, all aspects of the government, namely the various ministries, should strive towards this single objective. Just as the common framework of the corporate institution (as defined by the company law) is to ensure that differently talented managers can all pursue a common goal, the institution of public policy and governance should also try to achieve this one goal of sustained growth.

If achieving growth, and economic efficiency, is what governance is all about, the obvious next question is how to get there. Bhalla's paper tries to figure this out. He considers the following candidates as explanators of growth: good bureaucracy, low fiscal deficit and overall economic freedom. He maintains that it is the latter which effectively gets translated into a high and sustained economic growth in a society. It is this conclusion that makes the correspondence between corporate governance and public policy so significant.

In financial markets, institutions must be developed so that the market for managers is efficient. Since managers have private information, not available to the small investors, the latter need to be convinced that managers will not be undertaking opportunistic actions that are to the disadvantage of the small investor. The laws governing corporate behaviour are meant to do this. In practice, these institutions can work in various different ways. In the US and the UK, which follows the so-called *outsider* system, a well-functioning stock market, with low costs of information,

strictures against insider trading, and the separation of commercial banking from investment banking all help in improving the efficiency of the outsider system. In Germany, the stock market is not very developed. Managers, therefore, cannot be disciplined by movements in stock prices. There, it is the banks and financial institutions, with access to company boards through the strength of their equity shares in companies and through the institution of proxy voting, who perform the role of monitors. The basic approach is to ensure that project managers do not become too entrenched and there is free entry and exit of managerial talent.

Bhalla's point is that for sound governance, as measured by economic well-being, economic freedom is a must. In other words, much like the body of corporate laws, the institutions safeguarding economic freedom must be developed. An economic bill of rights will disallow short-sighted policy makers from undertaking populist, or opportunistic actions that undermine the powers of economic decision-making of the less vocal political minority. For instance, when the government issues production licenses to some and not to others, it is restricting the feasible actions of those agents who have not obtained permission to produce! When the government introduces differential commodity taxes, it discriminates one group against another. The institution of government can be allowed to collect revenue, but it has to maintain some degree of unanimity, and uniformity, in the type of agents it collects from.

The main point is that while democracy is a good starting point, it is not enough; just as, developing a stock market requires more than constructing stock exchange buildings. Managers are elected by majority shareholders, and politicians are elected by majority voters. But once chosen as managers, various stock market regulations prevent managers from taking minority shareholders for granted. Elected politicians also need to be controlled after they win office. The bill of economic rights will play this role.

All of this may appear as a trivialisation of the most solemn concept of governance. One way I justify these analogies is to say that having been trained in economics, I am more at home working within that framework. Secondly, the part of governance I am interested in, and can comment upon, is that involving commercial law and the institutions governing economic actions.

Moreover, for those deeply involved in the philosophical issues of governance, and those convinced of the economist's ability to narrow down the focus of broad ideas to a simple economic agenda, Dutta's paper should be an eye-opener. In this paper he shows how deliberate policy distortions can be traded against electoral support, by elected politicians, what we have described as opportunistic behaviour by them. It is an excellently argued paper, though I must say that my knowledge of econometrics is very limited. (I must confess that I had similar problems with Bhalla's paper!)

Continuing with the issue of corporate governance, a large body of literature has tried to test whether certain (financial market) institutions encourage managerial myopia. What Dutta investigates in his paper is, whether or not, a similar question can be posed for the political managers of the country. His argument works best in unstable coalition governments. With unstable coalition governments, each constituent party tries to win concessions for its own vote bank, in the (expected) short duration that it is in power. Without Bhalla's bill of economic rights of citizens, this gets translated into populist policies, favouring one group against the other. In the long run, of course, this leads to an inefficient economic structure, resulting in losses to everybody. Hence, this can be termed as leading to myopic behaviour.

The conclusions of Dutta's paper ties up very well with something I had mentioned in the beginning, regarding the objectives of the manager. What happens in a coalition government is similar to what can happen in a company board which has representatives from various groups, like labour, main creditors, government, etc. Since each such board representative is looking after the interests of its own group, it can lead to certain actions by the management, who are answerable to the board, which lead to depletion of shareholder value. This possibility will be aggravated if the diverse board representatives are sufficiently powerful to force outcomes they like and block those they do not want. In political governments, this happens with what Dutta calls unstable coalitions. Loosely put, an unstable coalition is one where a defecting small party can destroy the majority of the ruling coalition.

Bhowmick's presentation, and Kumar's paper, points to an important aspect that I have not touched on so far. So far I have been implicitly assuming that once the laws, and institutions are set up, everything else follows. However, institutions and laws make sense, or are treated as being credible, only if they are enforced. A law stipulates the actions that agents

must take under certain conditions. If they do not comply, then they have to be punished. In most commerce, this punishment is in the form of economic costs, making the deviation from the stipulated action less profitable compared to compliance. By definition, this means that there has to be a system of enforcement. This is necessitated by the fact that laws come in handy whenever contracts are not self enforceable. If they were, rational agents would not need to be coaxed into these actions by the arm of law. It is here that the concept of corruption becomes important.

Corruption is essentially a breach of contract by the officials. Thus, if the licensing authority grants permits by deviating from the guidelines and procedures set up in the original policy, then it goes against the stated purpose and, hence, is a breach of trust reposed on the authority by the general public. It becomes corruption when the authority undertakes the deviant behaviour because of personal benefits from this action. Good governance is not simply ensuring that one has decision makers who understand and can follow guidelines, but also the development of institutions that punish those who do not. The costlier it is to develop these institutions, the easier it will be for corruption to flourish.

Bhowmick's presentation does an excellent job in setting this problem in the theoretical literature and then, applying the various models to actual realities and experiences in India. What I will, therefore, try to do is add a little bit to the discussion by talking about the costs of enforcement in law.

Let us take a look at contractual law. Suppose that the courts made only one law: enforcement of all voluntarily signed contracts. In other words, the legal institution of the country did not specify which contracts agents are allowed to sign, but commit to ensure that no party to any contract reneged on the agreement. Observe that, courts only come in when there is a dispute. Thus, ex post, both parties may want to nullify the agreement. In that case, the courts should not step in. Only if one party complains that some other party is not keeping to the agreement, should the court come in. In such situations, very few contracts will be broken, and the courts will seldom be called upon to act, keeping the costs of governance low. This is because, being voluntarily signed, there will be few incentives for breach. If, for some reason, breach does happen, courts will swiftly move in to prevent it. This sort of a society, will be a fully *enabling* system.

Contrast this with the other extreme where, the court specifies, or mandates, what contracts can be signed and what cannot. The tenancy law in many parts of India is an example of this; it specifies the agreement between landowners and tenants. The problem with this is that it precludes contracts that are tailor-made for agents with different needs, or preferences. Consequently, there is more reason to breach these contracts by at least one party. This implies too many disputes, long queues in courts, and a general delay in court dispensation of so-called justice. This discourages people from viewing courts as a system of redressal, with the associated high time costs. Invariably then, people operate outside the legal system, encouraging corrupt practices. The Indian system, with its plethora of laws, guidelines, and mandatory restrictions (like tenancy laws) has resulted in corruption having become a way of life.

Should we then move to the enabling system? Yes, but not fully. An advantage of the *mandatory* system, where every contract is pre-specified, is its low contract costs. Relatively uninformed agents do not have to undergo the costs of writing complicated contracts, since the courts have already written these for them, and they only have to sign on the dotted line. So, while the ex post costs are high, the *ex ante* costs are low. In the enabling system, the ex post costs are low as there is very little dispute resolution required, but the ex ante costs are high.

The way out is to have a mix of the two. This is called the enabling system with *standard form* contracts. Those who are relatively uninformed and have high contracting costs, sign the standard forms; those who are informed and find it beneficial to deviate from the standard form, sign their own contracts. The courts commit to enforce all signed contracts, the standard ones as well as the non-standard ones. Thus, there can be a standard tenancy contract, as well as those that deviate from it and are voluntarily signed by the contracting parties.

Observe that the basic point I am trying to make here is that economics thrives on differences across agents. If they are straight-jacketed into similar modes of trade, welfare is reduced and they attempt to break out of these straight-jackets. These straight-jackets are the umpteen mandatory restrictions on free trade and commerce in India. Once again then, Bhalla's economic freedom becomes an issue. A fully enabling system tries to realise this, but glosses over the issue of transaction costs (of writing contracts when people are relatively uninformed). The enabling system with standard forms, for countries like India, may be more suited. Will it

stop all corruption? No; however, it will prevent corruption from being as pervasive as it is now.

I will stop here and hope that we take an objective view of the problems raised in the papers. The economic model for analysing these issues gives a consistent framework in which to study them. These are serious issues and can be tackled only with less emotion and more objectivity.