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Rent seeking and market-oriented reform in India

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Rent seeking and market-oriented reform in India

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Abstract

This chapter shows the relevance of rents and rent seeking in post-independence India, where market-oriented reforms have substantially reduced government control over economic activities. Despite significant economic reforms, rent-seeking and corruption have been prevalent. The chapter reviews the research on rent seeking and corruption in India and outlines a new theory relating rent seeking to economic reforms. Liberal and conservative economic policies are endogenous in such a framework. We also discuss other possible relationships between reforms and rent seeking in the context of an emerging market.

Key words: Reform in a rent-seeking society; low-level corruption; high-level corruption; procurement rent seeking in a federal system of government; criminal

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1. Introduction

India achieved independence from the United Kingdom in 1947. The Indian path to development after the end of British colonial rule was one of command and control with some private participation within a framework of centralized planning, borrowed primarily from the Soviet Union. In the 1980s reforms started to favor incumbent large private firms. In the mid-1980s, imports of technology and capital goods were liberalized to some extent and technology transfer and joint ventures were encouraged. In the 1990s, significant reforms were introduced that removed barriers to trade and to new private investment. As the country began reforming its trade and investment regimes, deregulation of various kinds was implemented or attempted. Tariffs were reduced from an average of more than 200% to 25%. The so-called license raj, a term for the need for government approval for economic activity, was greatly relaxed. Access to foreign investment was liberalized, financial markets were allowed to function properly, the exchange rate was allowed to depreciate, and a regime of managed float was put in place. There are several policies in which the political process was unsupportive of needed reforms but this is not the issue on which this chapter focuses. Deregulation, liberalization, globalization and whatever be the claim to fame as the world’s largest democracy, major financial scams with political and bureaucratic involvement reveal a preoccupation with rent creation and the prominence of rent seeking in India.

The idea of rent seeking as explaining behavior proposed by Tullock (1967) and applied to India by Krueger (1974) was an appropriate characterization of the Indian economy in the pre-liberalized era of command and control.Bhagwati and Desai (1970)addressed at length the problems related to high tariffs and a license regime that adversely affected allocation of resources in Indian industries. Their research, though not specifically on rent seeking, elaborated situations that created rents due to restrictive trade and industrial policies.In other research, Bhagwati(1971) proposed government intervention in distorted markets in the context of the theory of the second best. The planning and regulatory regime thwarted efficiency and impeded growth and development. Tax evasion, bribery, and bureaucratic harassment reduce economic activity and growth.

Introduction of a liberal, market oriented and deregulated environment is a way of countering rent seeking behavior by shifting attention from unproductive rent seeking to productive profit seeking (Buchanan 1980).Did this happen in India? If so, why did India face a relentless ordeal of scams quite unprecedented in the pre-reform era, yet having experienced very respectable rates of growth?[1]

The corruption perception index (CPI) published by Transparency International shows a consistent downward slide of India in corruption ranking. Figure 1 shows the CPI

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[1]SamiaTavares (2007) has examined the effect of trade liberalization and political liberalization on corruption from cross-country data in 1980s and 1990s. The results show that undertaking both types of reforms in quick succession reduces corruption but corruption increases in countries which undertake trade liberalization after 5 years of democratization. The result appear to be consistent with the Indian case.

rankings of India over 2001-2013. In the CPI, a higher score is indicator of higher corruption in the economy.

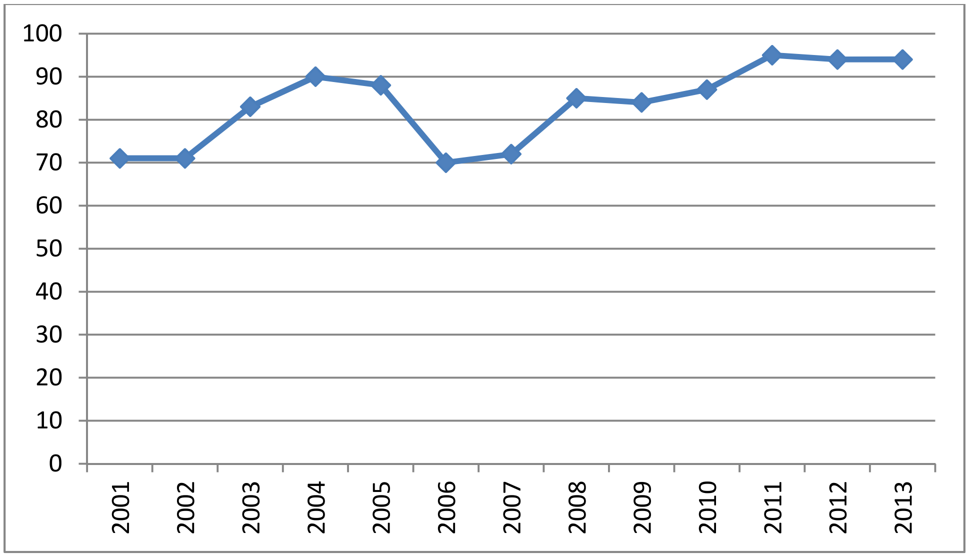


Figure 1: CPI Ranks of India 2001-2013

For analyzing the issues of a common basis for liberalization and corruption and related rent seeking, a model can be applied that defines the relationship between rent seeking and reform.The model is consistent with examples in which reform decisions are endogenous and guided by motives of rent creation and rent seeking. The inertia inherited from a regulated regime and sustained by the prior colonial ethos of bureaucratic behavior contributes to a relationship between rent seeking and reform that is more complex than rent seekingin usual models of contests (as in Konrad 2009 and Long 2013).

Section 2 of the chapter describes the legacy of past rent creation and rentseeking in India as manifested in sustained post-reform rent-seeking and corruption.Section 3 discusses the underlying theory. Section 4 concludes.

2. Rent seeking in India

Rent-seeking and corruption are expected to be more prevalent in autocracies rather than democracies because democracies have the rule of law and there are more political decision makers who need to be persuaded to do political rent-creating and rent-assigning favors(Hillman 2013). India is however a glaring exception to the prediction that democracy moderates rent seeking and corruption. India suffered from corruption under British colonial rule and the tradition of corruption continued and increased in prevalence after independence from British rule in 1947. The first committee appointed by the Government of India on prevention of corruption, in its report submitted in 1964, explored the causes of corruption in India. It observed the following:

> "Till about the beginning of the Second World War corruption was prevalent in considerable measure amongst revenue, police, excise and Public Works Department officials particularly of the lower grades and higher ranks were comparatively free from this evil. The smaller compass of State activities, the 'great depression' and lack of fluid resources set limits to the opportunities and capacity to corrupt or to be corrupted. The immense war effort during 1939-45 which involved an annual expenditure of hundreds of crores of rupees over all kinds of war supplies and procurement contracts created unprecedented opportunities for acquisition of wealth by doubtful means. The war time controls and scarcities provided ample opportunities forbribery, corruption, favoritism etc. The then Government

> subordinated all other considerations to that of making war effort a success. Propriety of means was no consideration if it impeded the war effort. It would not be far wrong to say that the high watermark of corruption reached in India as perhaps in other countries also, during the period of the Second World War."

After the War, the British left the country in 1947 with a bureaucracy not competent for controlling burgeoning corruption (Myrdal 1968) – or indeed a bureaucracy that was a primary source of corruption.

From post-independence until the beginning of liberal reforms in 1991,India followed a path of development in which the government and public-sector enterprises played a dominant role. In the five year plans starting from 1951, controls over production, prices, investment and foreign trade were deemed essential. Srinivasan (1996) summarizes:

> "The system involved *industrial licensing* under which the scale, technology and location of any investment project other than the relatively small ones were regulated and permission was needed to expand, relocate, the change of the output or input mixes of operating plants; *exchange control system* which required exporters to surrender their foreign exchange earnings to Central Bank at the official exchange rate and allocated the exchange earnings to the users through *import licensing*;*capital issues control*, under which access to domestic equity market and debt finance was controlled; *price controls* (complete or partial) on some vital consumption goods (for example food grains, sugar, vegetable oils) and critical

> inputs (for example fertilizer, irrigation water, fuel); *made-to-measure* protection from import competition, granted to domestic producers in many 'priority' industries, including in particular equipment producers. The agriculture sector was insulated from world markets, subject to land-ceiling and tenancy legislation, and forced to sell part of the output at fixed prices, but it was also provided subsidy on irrigation, fertilizer and electricity. Large commercial banks which were nationalized in 1969 were subject to directed and selective credit controls, controls on deposit and lending rates, and had to lend nearly two-thirds of their loanable funds to government through the operation of reserve requirements of various kinds."

Srinivasan (1996) also points out that all these regulations were discretionary rather than rule-based and automatic. Hence rent seeking was spawned at all layers of administration among politicians and bureaucrats.

Widespread corruption weakens the personal moral cost of being corrupt andcontributes to persistence of corruption (Myrdal 1968; Andvig and Moene 1992). On the administrative side, when suspicion of corruption is rampant, a protective device is to spread and share the responsibility for decisions to the maximum extent possible. This makes the bureaucracy slow and sluggish in the delivery of services. Consequently opportunities are created at the 'low' level of bureaucracy for rent extraction in the name of speeding the delivery of services. Ordinary consumers and firms at all levels pay 'speed money' at the 'low level' of bureaucracy, with rampant use of middlemen for bribing.Large firms including foreign multinationals pay bribes at the 'high level' of bureaucracy for influencing decisions. Small entrepreneurs can avoid formal 'licensing' by operating in an informal sector (or 'shadow' economy).[2]

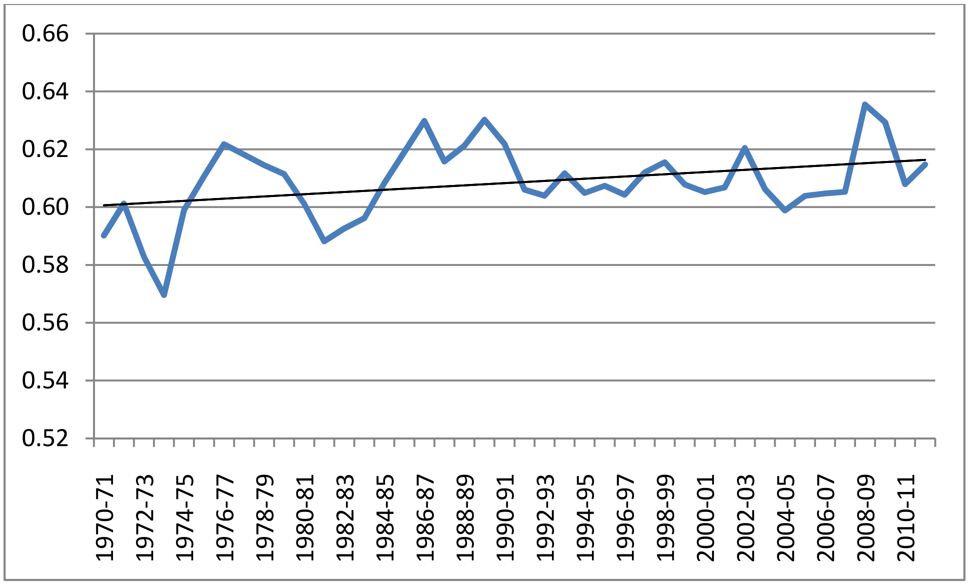
A publicized case of 'high' level bribery in the pre-liberalization period was the Bofors scandal in the 1980s, in which the then Prime Minister Rajiv Gandhi and several other ministers were accused of receiving bribes from the Swedish Company Bofors AB in return for a successful bid to provide the Indian Military with howitzers (IANS 2007). The value of the bribes was estimated at Rs. 640 million (approximately $1.4 million) (India Today 2009). There were many other similar incidents.

With regard to 'low'-level corruption, a survey comparing the extent of petty bureaucratic corruption across the Indian states found more than 60 per cent of Indians to have paid a bribe to receive a government service, amounting to bribes of more than Rs. 210 billion (approximately $4.7 billion) each year across eleven government departments (Transparency International India and Centre for Media Studies 2005). Another survey found that more than one-third of people below the poverty line had paid a bribe in the previous year to access government services (Transparency International India and Centre for Media Studies 2007). Bushell (2013) shows that the rents generated at 'lower' level of bureaucracy have been shared with the higher level bureaucrats/politicians, with bureaucrats competing among themselves for allotment of prized postings. The picture is consistent with the Hillman-Katz (1987)model of hierarchical rent seeking, in which bribes paid at lower levels of government bureaucracy filter upwards to higher level officials.

[2]Chaudhuri, Schneider and Chattopadhyay (2006) estimated the size of the shadow economy in India at the pre-liberalization period of 1974-75 to 1991-1992 at 19.97% of Net State Domestic Product of India.

Anne Krueger (1974) estimated the social loss due to rent seeking because of restrictions on international trade at 7.4% of Indian GNP. Mohammad and Whalley (1984) estimated that the social cost due to rentseeking was between 35% and 50% of Indian GNP. This range of values was based on the assumption that rents created at the 'low' level of bureaucracy were not contested; if the 'low' level bureaucracy rents were alsocontested, the estimate of social cost of rent seeking of Mohammad and Whalley (1984)of course increases.

Indian federalism is conducive to rent-seeking. There are state governments and a central government. The Indian constitution assigns the tax and expenditure responsibilities of these two layers of governments. While the central government has more of the financial power and the control over policies, the state governments are responsible for delivery of most of the services at the local level. Though there are statutory provisions of rule-based sharing of central government revenue between the centre and the states, the scope of such transfers is limited and the central government has significant discretionary powerin the allocation of the resources. This leads to lobbying of the centre by states for access to higher amount of funds as well as for favorable national and international policies. Biswas, Marjit and Marimoutou (2010) show that states' lobbying power significantly explains discretionary-fund-disbursement among Indian states. Using the share of central government consumption expenditure in the combined consumption expenditures of the centre and the states as an index of extent of centralization in Indian federalism, figure 2 below shows that the extent of centralization increased over the period 1970-71 to 2009-10, suggesting rent seeking through the type of contest among states correspondingly also increased.



Source: MOSPI (Government of India)

Figure 2: Share of central government in current consumption expenditure (centre and states combined)

Nepotism and common identity in terms of "stronger loyalty to less inclusive groups – family, caste, ethnic, religious, or linguistic 'community' and class" (Myrdal 1968),which are prevalent in a diverse country such as India,influence the distribution of fiscal favors.

Rodrik and Subramanian (2005) distinguish 'internal reforms' that started in the beginning of the 1980s and 'external reforms' that started in 1991. They point out that while the 'internal reforms' were mainly 'pro-business', the 'external reforms' were 'pro-competition'. Salient features of the internal reforms were: (i) elimination of licensing of 25 categories of industries subject to certain fairly onerous conditions, (ii)extension of delicensing in 22 industries that were previously restricted by the Monopolies and Restrictive Trade Practices Act and the Foreign Exchange Regulation Act, (iii) allowing companies in 28 industries to expand their scope of operation into related activities, and (iv) allowing companies that had reached 80 per cent capacity utilization to expand their capacity up to 133 per cent of that reached in any previous years. Note except the first, which allowed entry of new firms in certain industries and promoted competition, all other measures allowed the registered incumbent firms to operate more freely in the market. India did not extensively liberalize trade before 1991. Why did such 'internal reforms' take place?

Kohli (1989) suggested that the reforms were grounded primarily in political calculations rather than in an objective of enhancing efficiency. In Kohli's words: "in India's political culture…two packages of secularism and socialism and Hindu chauvinism and pro-business have tended to offer two alternative legitimacy formulae for mobilizing political support".

After a debacle in the 1977 parliamentary election, Mrs. Indira Gandhi, the outgoing prime-minister, realized the threat from the pro-business Hindu lobby. In returning to power in the early 1980s, she dropped the first package of secularism and socialism in favor of the second. Rodrik and Subramanian (2005) explain that the private registered manufacturing sector in Indian economy gained in the process. The productivity of this sector increased. Those states that had higher shares of private registered manufacturing to start with surged ahead of the other states,germinating the seeds of policy-induced regional inequality in India.

The 'external reforms' thatstartedin 1991 was primarily a response to a severe foreign exchange crisis. The Narsimha Rao government that came to power on June 26, 1991 took immediate steps to avoid default on foreign debt but also started reforming the

Indian economy in order to cure long-term problems associated with the Indian economic development process. An initial devaluation of rupeepaved the way for market determination of the exchange rate and abolition of import licenses, except on manufactured consumer goods. Restrictions on foreign trade of agricultural commodities also remained in place. Apart from this, as Srinivasan (1996) notes, convertibility (with some notable exceptions) of the rupee on the current account was allowed. The number of tariff lines and tariff rates and excise duty were reduced for a number of commodities. Some limited reforms in direct taxes were initiated. Industrial licensing was abolished. The requirement of environmental clearances, however, was kept for investment in certain locations. The requirements for foreign direct investment were eased. Private investment was allowed in some industries hitherto reserved exclusively for public sector enterprises. The financial sector reforms included simplification of the interest structure with elimination of interest rate floors for large loans, replacement of fixed term deposit rates by an interest rate ceiling, reduction of government preemption of loanable funds, and recapitalization of banks. In the later years this trend of reforms was pursued further. Ailing public sector enterprises were shut down. Disinvestment took place in good public sector enterprises. Except for arms and ammunitions, almost all the sectors were opened to private sector participation. The state governments followed the lead. The tax structure at the state level was simplified. For delivery of services in many states, e-governance was initiated. Under the overall control of the centre, the states were limited in competition in attracting private and foreign investment.

The economic reforms increased competiveness of the economy and efficiency. In the decade ending2012, the Indian economy maintained a growth rate at average of

7.8%per annum (data source: data.worldbank.org) compared to the pre-liberalization average growth rate, which was below 4% in most of the plan periods (Srinivasan 1996).

Was the scope of rentseeking and corruption reduced? The Indian economy has been subject to corruption scandals in the reform period. We report examples.In the state of Karnataka, two cabinet ministers were accused of involvement in illegal mining operations worth an estimated Rs. 600 billion (U.S. $13.3 billion) (IANS, 2010). There was wide-spread inflation of contract costs in the preparation of Delhi Commonwealth Games in 2010, worth an estimatedRs. 700 billion (U.S. $15.5 billion) (The Times of India, April 18, 2013). The cost of a 2G spectrum allocation scam was estimated at some U.S. $40 billion (NDTV 2010). A coal-license allocation scam was of worth Rs. 1860 billion (www.dnaindia.com 30th April, 2013).Chaudhuri, Schneider and Chattopadhyay (2006), in their estimate of shadow economy for the years 1992-93 to 1995-96, report an increase to 23.4% of net state domestic product of India compared to an average of 19.97% of the pre-liberalization period 1974-75 to 1991 – 1992 (see footnote 1).[3]

Reform changed the nature of rentseeking. With greater economic participation of private and foreign firms, the scope of rentseeking increased at the contracting level at which politicians/bureaucrats have discretion. With reform, 'high' level corruption appears to have increased. It is important to note that the Indian economy is still quite early in its reform process and anti-corruption laws do not yet exist in many cases. The 'first come first served' allocation mechanism that led to the2G spectrum and coal license allocation scams

[3]Marjit, Ghosh and Biswas (2007), in a theoretical model, show that the relation between liberalization and the size of informal sector of the economy depends on the type of reform pursued. A reduced tariff expands the size of the informal sector, whereas a reduced interest rate, possibly through liberalization of capital account, reduces the size of the informal sector. Also see Tavares (2007) for empirical cross-country evidence on the relationship between political and economic reforms and corruption.

was replaced by an auction mechanism thought to be transparent, corruption-free and efficient.

Bushell (2012) proposes that the attractions of higher rents in the new era of economic reform led politicians to make various reform decisions. Politicians pursue those reforms that cater to their targeted constituency (which is important for winning the next election) and that offer greater scope for rent seeking through the contracting process. Improving the speed of service delivery leads to sacrifice of the rents to be obtained from 'speed money' at the lower level of bureaucracy; but the loss is compensated for by higher rent to be obtained at the 'high level' and the electoral benefit. Adoption of Information Technology enabled one-stop delivery of various services, such as birth certificates, caste certificates, driving licenses, ration cards, etc., eliminating the need for 'speed money'. Bushell (2012) found that the states with higher 'low level' corruption adopted this scheme at later dates and also offereda smaller range of services. She also shows that the adoption rate was lower when there is a coalition government in a state. In evaluating perceptions of high and low level politicians in three states (Bihar, Jharkhand and Uttar Pradesh), in another study, Bushell (2013) found that respondents believed that greater rents are extracted at the policy level, compared to the rents extracted at the contract-award level (such as the contract awarded in construction of roads) and the rent extracted at the service-delivery level (such as delivery of ration-cards).

How does Indian democracy react to crime and corruption? While corruption has always been a poll-issue in elections, before 2002 there was no official way to know about criminal records of the candidates for political office, before the Supreme Court of India made alandmark judgment requiring every candidate contesting national and state elections to submit a legal affidavit disclosing his or her educational qualifications, information about personal wealth and most importantly criminal records.

Dutta and Gupta (2014) analyzed the data for the 2009 Lok Sabha elections and found that voters penalize candidates with criminal records but the magnitude of penalty decreases if there are other candidates in the constituency with criminal records. The vote shares are positively related to candidate wealth, with the marginal effect being higher for candidates with criminal records. The candidates with criminal records also have higher wealth.

The results partly explain why, despite corruption being an important issue, there has been failure to end persistent corruption within Indian democracy. It is also important to realize that the elections are not contested only on the corruption issue. Issues related to inflation, local public good provision, stability of the government, etc.,are also important. A theory outlined in the next section proposes that the issues of inflation and corruption can be independent of one other. These other issues can eclipse the corruption issue at the time of elections. [4]

3. Theories of liberalization with rent seeking

In principle, market liberalization should increase profit-seeking at the expense of rent seeking. In India it appears that liberal economic reform intensified rent seeking.

[4]An example from the 2014 parliamentary elections in India illustrates the point: for the first time in India, a party named "AamAdmi Party (AAP)" contested the election with corruption as the exclusive poll plank but could manage to win only three seats out of 541 seats in the parliament, the vote share being 2% of the total votes polled (India Today 2014).

Hillman and Ursprung (2000) have proposed that sustained political culture can result in increased rent seeking when political liberalization occurs and increases access to rent seeking. In the Hillman-Ursprung model there are initially two contests, a contest among outsiders to be insiders and contest among insiders to secure rents. After political liberalization, insider privilege ends and rent seeking is more open and inclusive, leading to more participation in rent seeking. The relevance of the model is that increased openness in access to political and bureaucratic rent creation has increased rent seeking.

Marjit and Mukherjee (2014) model a rent-extracting rent-maximizing political decision maker who chooses the extent of liberalizing market reform. In contrast to standard models of political-support maximizing regulation (Peltzman 1976) or protection (Hillman 1982; Grossman and Helpman 1994), the politician is not constrained by political support. The policy chosen affects two firms, one foreign and one domestic, with the foreign firm having a cost advantage. In this model, liberalization of trade policy (a reduced tariff/obstacle to participation of the foreign firm) increases rent seeking because the corrupt political decision maker has access to rent extraction from the foreign firm, the profits of which are increased by reduced protection. The politician is described as extracting a constant fraction of profits of the both the domestic and the foreign firm – the former trying to increase the tariff and the later trying to reduce the tariff – and hence the politician's rent-maximizing policy coincides with maximal joint profit of the two firms. Domestic policy creates the conditions for collusive joint profit maximization of domestic and foreign firms or "regulation of international industry" (Hillman, 1990). The model is consistent with increased political rent seeking and rent extraction when reforms through trade liberalization have occurred.[5]

4. Conclusions

Rents and rent seeking have been central to the Indian economy since independence and were central in the period before independence. The post-independence planning and licensing regime provided incentives for rent creation and rent seeking, but not to the extent of the planned Soviet system. India being a democracy, there were political constraints on high-level corruption but corruption was endemic in the bureaucracy, in particular at lower levels. Economic liberalization has increased rent seeking and the corruption that is the source of rents, specifically high-level corruption. There is, though less discussed, theoretical basis for predicting that trade liberalization, by increasing rents, will increase rent seeking.

There is a question why democracy in India has not been sufficient to achieve the lower levels of corruption and stringent rule of law found in other democracies. A basic source of difference is of course income. Low incomes influence rent-creating and rent-seeking incentives.

[5]As the liberalization progresses, the profit of the foreign firm increases and the profit of the domestic firm falls. Joint profit is non-monotonic in the tariff. In particular, joint profit is convex in the tariff (see also Marjit 1990; Lahiri and Ono 1999). For another model of liberalization with a domestic and foreign firm in a rent-seeking context, involving government procurement, see Long and Staler (2009). In this model, however, the rent seekers are the firms. In Hillman and Ursprung (1988), political candidates choose policies that determine profits of domestic and foreign firms competing in the domestic market and the firms provide campaign contributions that determine the candidates' probabilities of winning the election.

There are also issues of inability of the government to monitor activities that stem from reform. As markets open up and new activities are undertaken, rents can be created, for example through financial opportunism. Stock-market related and bank-related scams in India that occurred in the 1990s have subsided. On the other hand, the mechanism for implementing reforms can be deliberately flawed, such as replacing a properly designed auction process with committee-driven decisions, which is a deliberate route created for rent seeking and rent extraction.

India has a free press and offers the freedom to discuss the behavior of politicians and government officials in seeking and extracting rents. Combined with democracy, this increases the costs of political and bureaucratic opportunism. But in case of the media is controlled by political parties and big business houses, which is often found in India, it may create some rent-seeking as well. Therefore, the effect of free press on rent-seeking and market-oriented reform in India remains uncertain.

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