

Public Policy & Regulation: An overview of Indian Statutory Regulation

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(views personal)

Policy & regulation in India

- Practitioner's view grounded in economic theory
- Focus on the story line & not minute details
 - Indian macro economy has changed substantially
 - More market orientation than before
 - Generally markets work well including in India
 - In theory and in practice four reasons for market failure
 - Hence clear role for "State" including "regulation"
 - Regulation is complex and can be problematic
 - Focus today on Statutory Regulatory Authorities (SRAs)
 - SRAs are here to stay & proliferate
 - We therefore need to get this right

Structure of presentation

- Micro economics of efficient markets
- Four reasons for market failure
- Public policy & state intervention- basics
- Regulation as one form of state intervention
- The idea of SRA- the organization
- Way forward and reforms

The market economy & 'State'

- The market economy has been & is a great engine for human progress
- Self-interest drives persons to innovate and improve the world
- The market economy is not perfect
 - There are situations termed “market failures” where free market gives bad outcomes
 - In these areas lies the role for the “State”
- In most areas the unconstrained actions of individuals are fine, but where we see market failures, there is a role for the “State”

Four classes of market failures

- **Market power:** e.g. AT&T which was a monopolist in US telephony
- **Externalities:** e.g. A factory emits pollution and bystanders get sick
- **Asymmetric information:** e.g. you buy medicines at a shop but you do not know about their purity
- **Public goods:** e.g. the free market will not build the Indian Air Force

What should the “State” do?

- The four market failures add up to a conceptual frame for thinking about role of the “State” in the economy
- In an ideal analytical world, the “State” would pursue the four market failures and nothing else
- That’s not the world that we live in:
 - Implementation difficulties
 - Political considerations etc.
- Addressing market failures gives us the ideal “State” within our minds

1 - Market power

- The free market is an innovation machine – as long as incumbents have not locked up the market
- Competition policy: We use the coercive power of the “State” to force more competitive conditions
 - Break-up of AT&T in the US
 - Softer levers like forcing changes to specify business practices
 - IBM and Microsoft: Even investigation and trial had a big impact on business strategy

2 – Externalities

- e.g. Pollution control. e.g. Lehman failure imposed externalities upon the world at large
 - **Strategy 1:** Impose crude pollution control – e.g. no factory can emit more than X
 - **Strategy 2:** Sulphur di-oxide emissions dissolve in rain and give “acid rain”- Scientists determine the total SO_x that can be emitted, and tradable permits are auctioned by the Government
- This generates the best allocation of placing the emissions at the most efficient places in society
- Better than hard caps

3 – Asymmetric information

- **Strategy 1:** The government monitors the information so that consumers are fine even though they don't see the information
 - e.g. Government runs a supervisory system to ensure minimum quality standards in drugs, in restaurants, in the safety of financial firms, etc.
- **Strategy 2:** Governments undertake information interventions forcing information to be disclosed
 - IPO and bond issuance disclosures

Example of doing this wrong

- There is asymmetric information when I buy a car
- I don't fully know its safety characteristics
- Perhaps we can solve this by banning private production and having a PSU monopoly that makes cars
- Example: We mostly do this with Indian railways

4. – Public goods

- ‘Non-rival’: My consumption of safety does not diminish your consumption of safety
- ‘Non-excludable’: We cannot exclude a new born child from benefiting from safety
- Public goods are those goods & services that are non-rival *and* non-excludable
- National security + criminal justice system gives us safety, the perfect public good

Public goods examples- 1 Health

- I have a toothache- I go to a dentist
- My time in the chair come at the expense of your time in the chair- This is a rival good
- The dentist can easily exclude a new born child from benefiting from his services- This is an excludable good
- This (curative) health care is not a public good- It is a private good

2 Transport & communication infrastructure

- Excludability is most certainly assured- We can put up a gate and you cannot enter the highway
- When a highway is lightly used, it is non-rival: One more car does not diminish anyone's access to the road
- But when a highway is congested, it becomes rival
- Highways are not public goods
- Similar for all infrastructure of transportation and communication

Public policy- three step process

- The first step in all thinking about government is to identify the market failure
- Once we see a market failure, we would like to find an intervention which uses the power of the “State” to address the market failure
- Do we have the ability to undertake the intervention which will address this market failure?

Scoring what is difficult in government?

- All problems can be classified using 3 tests
 - Test 1: Does this involve discretion? e.g. polio vaccination involves zero discretion
 - Test 2: Does it involve numerous transactions? e.g. monetary policy involves few transactions
 - Test 3: Are the stakes high? e.g. the teacher who does not come to school to teach makes small personal gains but corrupt tax officer makes big gains

What is easy vs. what is hard ?

- When the car jumps a red light, a fine of Rs.100 is easy
- When the car jumps a red light, a fine of Rs.1000 is hard as the policeman faces a big gap between his personal interest and the interests of his organization
- In every country, we have to first learn how to make public administration work with easy problems before moving on to hard problems

The four hardest problems of government

- Criminal justice system
- Judiciary- justice
- Tax administration
- Financial regulation
- In these areas:
 - What is at stake for the citizen is very high
 - Officials have discretion
 - Large number of transactions

Public choice theory

- Government is not a benevolent “mai-baap”
- Politicians and officials are self interested actors
- “Politics without romance” – let’s be hard headed about the working of government
- Lack of alignment between the objectives of the individual and the objectives of the organization make things difficult

What can government do?

- In the field of public policy, there are all sorts of views about what a government can or should do, about the feasible set of actions
- Actually there are only 3 possibilities
 - A government can demand modified behaviour
 - A government can tax
 - A government can spend
 - Spending can produce public services, hopefully addressing market failure, or it can be outright redistribution
- That's it !

When do we want regulation?

- To reiterate: when faced with market power, asymmetric information, negative externalities
- Maybe you want regulation
- To induce modification or change in behaviour
- Many times, in India, we do production in dealing with these problems, and that's generally wrong

What is *regulation* ?

- The government engages in lowest-cost interventions that address market failure
- Example: You build cars as you like, but the braking distance from 100 km/hour should be e.g. less than 50m

The department of government

- Is headed by a Secretary and ultimately by a Minister
- Is by design a political instrument
- In practice, is inundated with fire fighting
- Has conventional Indian government HR process
- Is constrained on elementary capabilities
- Had a history of central planning

The idea of a *regulator or SRA*

- In the early 1990s, some people thought: “We should get away from central planning and do economic regulation”
- For this, it was felt that a new kind of specialized organization is required
- The first one was SEBI
- Now we have many Statutory Regulatory Authorities (SRAs)

SRA : Advantages I

- The law that does economic regulation will need to keep up with the changes going on in the industry
- The conventional Parliamentary process of law-making is too slow
- In addition, Parliamentarians do not know these intricacies

SRA: Advantages II

- We get to bring in modern economics knowledge, break with the culture of central planning
- Develop a specialized workforce, unlike departments of government
- It will not be yanked around doing fire-fighting
- It will not respond to political objectives in licensing, investigation and prosecution

The problem

- Rule by unelected officials without accountability
- The industry is typically submissive
- SRA tendency to block competition & change as this makes more work for officials
- Principal-Agent problem
- Parliament needs to write laws to generate performance in SRAs
- SRAs need to address legitimacy & democracy deficit concerns & Constitutionality issues

Way forward for SRAs in India

- On balance SRAs has been a good experience
- Governance and accountability issues
- Financial Sector Legislative Reforms Commission (FSLRC) was the first attempt at reforms
- This was not only sectoral but on SRA reforms
- Need to carry this forward and learn

Regulation in India

- Thanks
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