

Rethinking regulation in India

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Some economic history

Regulation at the outset

- ▶ RBI was created in 1934, in the field of monetary policy, “as a temporary measure”.
- ▶ Banking Regulation Act, 1949, put regulation into RBI.
- ▶ Little knowledge at the time about how to build regulatory organisations.

The motivation for the reforms of the 1990s

1. “Central planning”
 - (1) Government control of methods of production or technology by the state.
 - (2) A state organisation that picks winners among rival firms or rival technologies or rival methods of production.
 - (3) A state organisation that gets involved in details of technology or market competition.
2. Capabilities, manpower, organisational culture in government departments
3. These created the wrong incentives for private firms and investors.

Big insight: When a private business person spends time thinking about or engaging with government organisations, something is going wrong. Firms must focus on technology and competition, not worry about government.

The idea of regulators in the 1990s

1. Go from central planning to “regulation”.
2. Make a break with the institutional culture of government departments¹; Bring in a new breed of economists and domain experts into manning these organisations.
3. Distance between department that owns a PSU vs. the regulator
4. Foster private investment and private dynamism.

¹As an example, Damle and Burman, [2020](#) analyse intractable problems of land administration and propose solving them through a competitive industry of regulated private persons

A great upsurge of new regulators

RBI +

1. SEBI (1988-1992)
2. IRDA
3. FSSAI
4. CERC
5. TRAI
6. PFRDA
7. AERA
8. WDRA
9. IBBI (2016).

The puzzle

- ▶ The personnel of regulators has generally been outstanding
- ▶ Civil servants in regulators mean well, have achieved significant domain knowledge
- ▶ The outcomes have often been disappointing.
- ▶ Today we will talk about: How can we do things better?

A new field, State capacity in regulation

- ▶ Early policy research tended to think in terms of economics and assumed that regulators worked well. Examples: Mistry, [2007](#); Rajan, [2008](#).
- ▶ By the late 2000s it was clear that there were serious difficulties in the working of regulators. The first: Sinha, [2010](#)
- ▶ New knowledge was created about why regulators in India work poorly and how this can be done better.

Regulatory theory is domain independent

- ▶ Traditionally, the study of regulation took place within the domain. E.g. experts of electricity would think about electricity regulation.²
- ▶ This new literature draws on knowledge and experience from all domains and creates a general technology that can be applied to all domains.
- ▶ Here, we will summarise this new body of literature.

Locating this in the international literature

- ▶ The world over, there are concerns about 'the administrative state', the rule of officials
- ▶ Regulators are a prime problem of the loss of democratic legitimacy when state power is wielded by bureaucratic agencies
- ▶ There is an extensive literature and debate on this in the US, starting from the Administrative Procedures Act, 1946.
- ▶ Major recent UK committee reports on this: Secondary legislation scrutiny committee, [2021](#); Delegated powers and regulatory reform committee, [2021](#)

The administrative state problem in India

- ▶ The international discussion on the administrative state is motivated by problems that are relatively minor when compared with the material of this paper.³
- ▶ With the benefit of hindsight, we in India went into a headlong rush for power at regulators, at a time when not enough was understood about the foundations of law, economics and public administration.

³On the Indian administrative state, see the chapter *Beware the rule of officials* in Kelkar and Shah, 2019.

Roadmap

- ▶ We will show high level thinking about the problems of regulators
- ▶ We will describe the elements of high performance regulators which address these problems (Roy, Shah, et al., [2019](#)).
- ▶ At each element, we will justify the idea, and show gaps when compared with contemporary regulators in India.

The experience with regulators in India

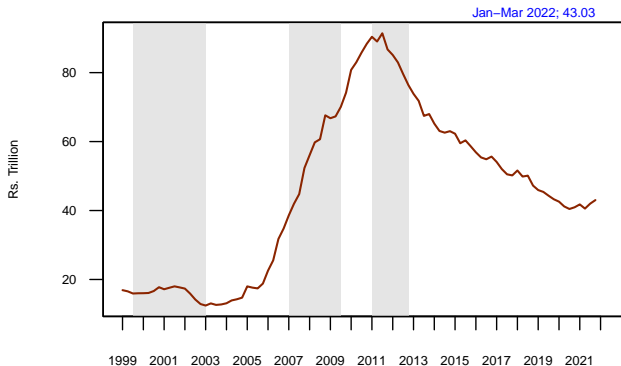
How have the raft of new regulators worked out?

All too often:

- ▶ A new level of detailed and intrusive central planning
 - ▶ Hundreds of employees in a regulator focused upon one industry
 - ▶ Detailed control of products and processes
 - ▶ All the way to control of the names of senior employees in some cases.
- ▶ Arbitrary power, failures on the rule of law
- ▶ Concerns about innovation, dynamism and private investment in many regulated industries (Krishnan, [2021c](#)).⁴

⁴For an example of the unintended consequences of faulty working of regulators, Bailey et al., [2021](#).

The most important question of Indian economics



Stock of private projects under implementation, measured in inflation-adjusted trillion rupees

Regulatory theory is part of understanding and reversing this decline.⁵

⁵On the overall phenomenon, the last chapter of Kelkar and Shah, 2019. 15/64

Insights on the difficulties

Separation of powers

- ▶ A fundamental insight from the 17th century: the power of the state must be broken vertically between the legislative, executive and judicial
- ▶ Example:
 - The Parliament drafts the IPC
 - The police enforces it
 - The judge writes the order.
- ▶ When separation of powers is lacking, there is concentration of power
- ▶ Power corrupts and absolute power corrupts absolutely.

Regulators in India sometimes fuse all three branches

- ▶ Many regulators in India combine legislative, executive and judicial powers.
- ▶ First identified by Sahoo, [2012](#). Also see Krishnan, [2021a](#)
- ▶ Questions about constitutional propriety.
- ▶ Extreme concentration of power (even if rule of law procedures were complete).
- ▶ Regulated persons cower in fear.

Difficulties on the rule of law

- ▶ All too often, the laws that set regulators in India into motion lack adequate checks and balances.⁶
- ▶ Some feel the central bank is immune to the concept of rule of law (Krishnan, [2022a](#))
- ▶ This has led to an environment where officials possess arbitrary power.⁷
- ▶ Numerous abuses of this power
- ▶ Regulated persons cower in fear

⁶As an example, Asthana, Sane, and Vivek, [2021](#).

⁷As an example, Sane and Vivek, [2022](#).

The problem of writing law

- ▶ In a liberal democracy, only the Parliament can write law (subject to the constraints of the Constitution)
- ▶ In regulators, unelected officials get to write law (i.e. regulations)
- ▶ This is “the problem of the democratic deficit”
- ▶ Solving the democratic deficit requires ample checks and balances
- ▶ As the rule of law is lacking, regulated persons cower in fear, and fail to push back against badly drafted law (i.e. regulations)
- ▶ This contaminates the regulation-making process
- ▶ Sets the stage for extreme control i.e. central planning by the regulator.

Solutions

Elements of high performance regulators

1. Clarity of purpose, precise objectives that are linked to market failure
2. Role, functions, working of the board
3. Separation of powers
4. Executive functions
5. Judicial functions
6. Legislative functions
7. Principles for penalties
8. Transparency and accountability
9. Interface between government department and regulator.
10. Process of building such organisations

E1 / Clarity of purpose

Objectives of regulation in various domains

In each domain, systematic thinking is required, starting from market failure, to articulating the precise task of regulators.

Examples:

Finance

Srikrishna, [2013](#)

Electricity

Jaitly and Shah, [2021](#).

Health

Chapter 35 in Kelkar and Shah, [2019](#).

Bankruptcy industry

Viswanathan, [2015](#)

Remove conflicts of interest

- ▶ Many organisations in India have poor design work at the foundation
- ▶ There are conflicts of interest which naturally induce inferior performance
- ▶ Fundamental concept of a principal-agent relationship: The agent should not be able to explain failure in one area by claiming to pursue another legitimate objective
- ▶ RBI, many objectives, e.g. Krishnan, [2022b](#).

E2 / The board

Role and composition of the board

Functions of the board

1. Initiate and approve all law
2. Design the organisation: organogram, processes (Krishnan, 2021b).
3. Establish targets, run the budget process
4. Hold the management accountable.

Composition

E.g.:

1. 1 MD + 2 executive board members
2. 1 representative of the parent department
3. 5 independent board members of which one is Chairman.

E3 / Separation of powers

The idea

- ▶ It is good design to not fuse the legislative, executive and judicial branches of government into any single agency
- ▶ The Western debate about regulators worries that substantial legislative powers are placed into the executive branch (i.e. under the control of officials). This raises concerns about ‘the democratic deficit’, the lack of democratic legitimacy in the actions of officials
- ▶ Public choice theory teaches us that officials will amass power, evade accountability, and engage in central planning
- ▶ In the West, judicial powers are not placed with the regulator. The regulator files a case at the judiciary.

The problems of many regulators in India

- ▶ India is remarkable in that the Parliament has not established due process governing the regulation-making process by officials in the regulator.
- ▶ Officials at the regulator have high arbitrary power on how to write law.
- ▶ Officials at the regulator also have high discretion on who/how to investigate, and where prosecution should commence.
- ▶ India is remarkable in that the judicial branch is also fused into an organisation like SEBI
- ▶ Unsurprisingly, the prosecution mostly wins in the “hearing” which takes place at SEBI.
- ▶ This is inconsistent with the separation of powers that is in the basic structure of the Constitution of India.
- ▶ Power corrupts and absolute power corrupts absolutely: In the best of times, building state capacity in a regulator is hard; in India it is even harder.

Solutions

- ▶ Majority independent members at the board
- ▶ Establish sound procedures governing the legislative function; regain democratic legitimacy in law-making
- ▶ Establish formal procedures governing investigations and prosecution
- ▶ Place the judicial branch under control of the judiciary.

These things need to be coded into the law.

E4 / Executive functions

Executive process

- ▶ Licensing, investigation, prosecution
- ▶ Formal procedures for all these
- ▶ Analogy : Criminal procedure code, Police Acts.
- ▶ Denying a license imposes harm upon the applicant: requires a reasoned order and possibility of appeal.

Indian experience

- ▶ An example from licensing: Roy and Shah, [2015](#).
- ▶ Many concerns about investigation, prosecution (Goyal and Sane, [2021](#)).

E5 / Judicial functions

Judicial process

- ▶ The accused should get an SCN and an opportunity to present his facts
- ▶ A hearing where a neutral person hears the prosecution and the accused
- ▶ A reasoned order
- ▶ Possibility of appeal: Tribunal and then SC.

Indian experience

- ▶ Inconsistent punishments
- ▶ SAT often works pretty well (many good SAT orders are overturned at the SC).
- ▶ IBBI: separate vertical has been implemented.

E6 / Legislative functions

Legislative process

1. All law should be only one legal instrument: “a regulation”
2. All regulations should only commence from an instruction from the board
3. The management must make a documentation packet:
 - 3.1 What is the problem we seek to solve?
 - 3.2 Is it a market failure?
 - 3.3 What's the proposed intervention?
 - 3.4 Does the proposed intervention address the claimed market failure?
 - 3.5 Cost benefit analysis: Do the benefits outweigh the cost?
Was there an alternative intervention which would get the job done at a lower cost to society?
 - 3.6 The draft regulation
4. Put this packet for public comment for \approx a month
5. Management must respond to all the ideas from the public
6. Go back to the board for a discussion
7. Board approves the final regulation for release
8. 3 years later, a post-mortem.

Indian experience

- ▶ Burman and Zaveri, [2018](#) measures the regulatory process in a few Indian regulators.
- ▶ SEBI/RBI/others use multiple legal instruments (Krishnan, [2021d](#); Pattanaik and Sharma, [2015](#)) and thus evade legislative process requirements.

Evolution of Indian jurisprudence

1. Clariant
2. TRAI and calls dropped (Krishnan and Burman, [2019](#))
3. RBI and cryptocurrency
4. Sane, Shah, and Zaveri, [2021](#) interprets this shifting jurisprudence.

E7 / Principles for penalties

Foundations

- ▶ Article 14: Two comparable violations should attract a comparable punishment
- ▶ Economic thinking: The purpose of punishment is to generate deterrence, not to exact retribution. The fundamental economic thinking on punishment is that if the probability of getting caught is p , and if the ill-gotten gain is X then a penalty of about pX suffices. Thumb rule: Three times the ill-gotten gain.
Public choice theory: It is hard work for the regulator to work out the ill gotten gain. Hence, regulators will favour idiosyncratic and fanciful penalties, so as to avoid doing work.
- ▶ Avoid destruction of organisational capital in the economy: The purpose of punishment is to constantly reshape the behaviour of firms, not to kill them.

Indian experience

- ▶ An order that works out the ill gotten gain is rare.
- ▶ Fanciful claims about violations, fanciful punishments (in the backdrop of very high win rates for the prosecution).
- ▶ Punishments that are wildly inconsistent : *You are banned from operating on the securities markets for n days* : these have very different implications for different persons.
- ▶ Punishments that are death sentences: The attempt is to destroy firms or individuals.

E8 / Transparency and accountability

Reporting, accountability, evaluation

- ▶ Operational metrics must be reported, that are under the control of the management
- ▶ A target-setting process to make an improvement every year
- ▶ Linked to the budget process.
- ▶ This also requires functional thinking about the budget.
- ▶ Evaluation of the working of regulators (Krishnan, [2022c](#))

E9 / Interface with government department

The role of the department

1. Give regulators the requisite authority in the law
2. Appoint all the members of the board
3. Use your membership on the board to be a full blown board member: participate in regulation-making, budget-making, targets, performance, organogram, process manuals.
4. Stay out of executive and judicial functions.
5. Do not entertain complaints from private persons about executive and judicial actions of the agency
6. Department is the Principal. Must constantly ask how the Principal-Agent relationship is working, constantly modify the contract (i.e. the law), and modify the work given to different agents.

Shah, 2016

Indian experience

- ▶ The department asks for favours on executive and judicial functions
- ▶ And cedes power on all the other things
- ▶ A notion of turf arises.

This requires design work at both ends

- ▶ The emphasis here has been upon the regulator
- ▶ But getting the interface between department and regulator right requires organisation design at the government department also
- ▶ Need to weave this knowledge into the present state of the art on rethinking the ministry, Kelkar, [2004](#).

E10 / Process of building such organisations

Better drafting of laws

- ▶ Skimpy laws are the problem.
- ▶ Words that get into trouble: “thinks fit”, “in public interest”, “appropriate”.

RBI Amendment Act, 2006:

The Bank may, in public interest, or to regulate the financial system of the country to its advantage, determine the policy relating to interest rates or interest rate products and give directions in that behalf to all agencies or any of them, dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature as the Bank may specify from time to time:

What should go into a law?

- ▶ *The law must authorise the use of State coercion.* If the law will spend public money (which is grounded in taxation which is grounded in coercive power), or if the law empowers the State to coerce a private person, then this requires authorisation of Parliament.
- ▶ *The law must address public choice problems.* By default, the men who man the State work for themselves. The law must establish machinery through which the principal-agent problem is addressed.

Insights on drafting of law

1. Express clear objectives.
2. Enumerated powers.
3. Extensive procedural detail on the working of the agency.
4. Elaborate accountability mechanisms.

Example: Indian Financial Code, version 1.1 (FSLRC, [2015](#)).

The organisation

- ▶ Too often, a ramshackle organisation is given coercive power right after a law is passed.
- ▶ This yields 'organisational rout' (Andrews, Pritchett, and Woolcock, [2017](#)).
- ▶ Building a regulator is like building a bridge, it takes about two years from idea to inauguration.
- ▶ A report which shows the design for this journey: Narain, [2016](#).

Making progress

- ▶ All too often, the regulator is in motion (in organisational rout)
- ▶ The law is faulty
- ▶ Can we make some progress?
- ▶ Ministry of Finance *Handbook* and *MIS for monitoring of Handbook* (Ministry of Finance, [2015a](#); Ministry of Finance, [2015b](#)).

Thank you.

<http://www.mayin.org/ajayshah>

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