

Governance : Weaknesses, Their Causes and Remedial Steps

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(Inaugural Speech)

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I am glad that the topic, Fiscal Policy, Public Policy and Governance, has been chosen as the theme of the symposium commemorating the 20th Anniversary Year of the Institute. In our country today when, after many mistakes and experiments, we seem to have discovered and accepted the right economic policies to promote growth with stability, problems of governance have come to the fore and deficiencies therein are tending to nullify policies or render them ineffective and thus threaten to thwart progress.

In the traditional normative theory of public economics, a benevolent state with effective means of implementation of policies was implicitly assumed and on that basis the fiscal economist proceeded to study and analyse the effects of alternative policies on the behaviour of economic agents and of the economy as a whole. Recommendations on policy were based on such an analysis. This statement can be considered an oversimplification, if account is taken of developments in the literature in more recent decades. Increasing attention has been paid to the behaviour of bureaucracies; tax administration considerations have come to play a role in the determination of sound tax policies and transaction costs are no longer ignored.

However, official economic doctrine in India has not been modified to take account of the serious problems of governance that have arisen over the years in our country. Nor have any systematic studies of tax administration's impact on the effectiveness of tax policy or of transaction costs been undertaken. One also notes that Planning Commission documents do not reflect any significant change in the nature of policies or strategies in the light of the revealed weaknesses and deficiencies in governance except for tackling delays, cost over-runs, inadequate cost recoveries, etc. Even if the experts in the Planning Commission are no longer convinced about the beneficial effects flowing from large increases in public expenditure without systemic changes, political leaders still seem to

believe that much good is coming out of larger and larger allocation of public funds to key areas even within the existing system of governance. Surely, much larger funds need to be allocated to priority sectors such as education and health but, at the same time, some of the serious weaknesses in governance need to be speedily removed.

I shall first try to enumerate the major weaknesses of governance arising from certain characteristics of the government as a performing institution in India which impinge on, and distort, fiscal policies. Next, I shall try to explain briefly how these weaknesses have arisen and in what ways they distort fiscal policies. In the last section, I shall indicate the most urgent steps to be taken to ensure that fiscal policies can be more effectively pursued and will have the intended effects.

I. MAJOR WEAKNESSES OF GOVERNANCE

Over-staffing and Tendency for Further Increases in Government's Staff Strength

The size of the staff of the government has grown so large at the level of the Central government as well as at the level of each State government that it has become virtually impossible for the leaders to exercise effective control over the generality of government servants. Hence, the low degree of effectiveness of government administration and slack implementation of policies. In terms of more direct economic costs, if we assume that the extent of surplus staff is 20 to 25 per cent, the over-staffing amounts to providing subsidy to 20 to 25 per cent of government's servants in the form of employment without work. It could be argued that the subsidy is being shared among all the government servants.

Leakages from Government Expenditure

Leakages from government expenditure are not an uncommon phenomenon as it is found to exist in most countries. But in India, as in some other developing countries, the phenomenon of leakage is substantial and pervasive and the total of leakages seems to form a fairly large proportion of public expenditure. Two categories of leakages can be distinguished: the first category consists of (a) kickbacks on large contracts, (usually defence and PSU contracts), (b) siphoning off funds allocated to construction, (c) 'cuts' on all kinds of purchases, and (d) maintenance of fictitious muster roll in respect of contractual employment of labour. The second category consists

of practices by which all facilities and means bought and maintained to provide public goods and services are illegally (that is, against rules) put to private use of the government servants concerned. Such practices are so pervasive and common that they do not now seem to be considered in any way improper and are accepted as matters of legitimate privilege. Illegally putting to private use of automobiles, telephones, xerox machines, postage and services of Group "D" employees are good examples.

Illegal Exactions

The cost of over-employment in the government sector and of all kinds of leakages from public expenditures is ultimately borne by the taxpayers. These exactions from the taxpayers are made indirectly. Another prominent feature of governance in India is the direct illegal exaction of money from the public by various categories of government servants. The illegal exaction or acceptance of money is usually called a bribe. In most cases there is some element of coercion in such exactions. It is commonly stated that there are two types of bribes. The first type of bribe is taken for performing a function which the government servant concerned is expected to perform as part of his duties such as issuing licences or registering a document or granting an approval according to rules and laws. The second type of bribe is taken for doing a favour to the briber in contravention of the law. Wherever opportunities exist tax as well as other administrators are found to practise this trade of two kinds. In effect then the citizens have to pay two types of taxes - legal taxes which go into the government treasury and illegal taxes that go into the pockets of government servants (some of these payments cannot be strictly considered taxes because the payers receive in return some favours in contravention of the law).

Remuneration and Performance

It has already been pointed out that too large a size of government staff has meant lack of adequate control and hence ineffectiveness has crept in. In addition, trade unions of government servants have more or less succeeded in ensuring that, except for lateral entries at selected levels, all advances and promotions should be primarily based on seniority. Periodic evaluation of performance is rather perfunctory. An adverse report is apparently given only very rarely. None in government service can be fired for non-performance or poor performance of duty. The general level of efficiency is understandably low because the incentive for good performance is weak. It must, however, be pointed out that there are a sufficient number of

motivated and conscientious people in government service who keep the system going. They are as good an example of conscientious public servant as one can find anywhere else. But too large a proportion of government servants have come to perform much below par.

II. HOW THE WEAKNESSES HAVE ARISEN

The characteristics of the governmental structure and operations are quite similar to the basic features of a feudal order. When India became independent, Indian society was still basically a feudal society permeated by the feudal culture. The British had done little to change the structure because it was in their interests to preserve it. The feudal values and attitudes could have changed with the development of capitalism—as ‘Marx’ had shown—accompanied by fast growth and the spread of education. However, state socialism was imposed on the feudal sub-structure. As a result, the entire public sector has been developed as a rent-seeking mechanism with services being only a secondary goal. (Feudalism was preserved in the private sector also with the restrictions imposed on competition).

Second, labour laws were enacted which gave undue protection to the organised labour with a large part of it in the public sector. Organised labour itself formed, and still forms, a small part of the total labour force but the laws protecting them influenced in shaping their attitudes and thus affected the functioning of the government sector.

Third, representative democracy in an economy with a low rate of growth but with a fairly high rate of growth of population (which in turn could be attributed to the relative neglect of education and health) generated pressures for providing employment through over-staffing in the public sector. The type of planning process adopted with the current part of plan expenditure under any given plan automatically becoming an addition to the non-plan expenditure in the succeeding plan periods, also led to a steady increase in staff.

Fourth, controls, licences and complicated procedures developed under the planning system created ample opportunities for demanding speed money as well as a ‘return’ for granting approvals, issuing licences, accepting tax returns, etc. Given the very large size of the government and the enormous scope of its activities in the context of a feudal setting, it was inevitable that the lives of the common people and their economic activities

would come in contact with a host of government officials and would be subjected to undue scrutiny and harassment.

Fifth and finally, high rates of taxes, complicated provisions in the tax laws and the total neglect of tax administration by the senior civil servants, leaders of the government and the planners, and the perpetuation of archaic methods of administration, all led to the building up of a parallel illegal tax system whose yield went into the pockets of tax collectors.

III. IMPACT OF GOVERNANCE

- ⇒ Lack of accountability and pervasive inefficiency obviously made every policy initiative yield far less than its full potential beneficial effect. This, in effect, means that the cost of performing almost every service went up.
- ⇒ In the service oriented public expenditure programmes leakages result in the intended beneficiaries receiving very little of benefit. In the capital formation oriented programmes leakages mean either higher cost per unit of real investment or lower quality.
- ⇒ The above-mentioned weaknesses of governance in many cases lead to distortions in the allocation of resources. For example, it has been alleged that engineers in the irrigation department prefer to start new projects under the plan, instead of completing the old projects or maintaining them better, because new posts of senior engineers can be created to look after the new projects. Politically, the proposals for new projects could receive ready support because a larger number of voters can be pleased. It is well known that funds allocated to irrigation have been spread too thinly in most parts of the country.
- ⇒ Because of the existence of the various kinds of leakages, budgetary figures over-state the volume of provision of public goods. On the other hand, the total payment of taxes to the government sector is under-stated because part of the money is taken illegally. The actual public expenditure (incurred for the benefit of the citizens) is to be reckoned as being total budgetary expenditure minus leakages minus the subsidy in the form of expenditure on the provision of government employment without work. On the other hand, the total payments by the people to the government for its services are

to be reckoned as the total of legally collected taxes plus illegal exactions by all types of government servants from the public.

The legal tax ratio (taking the Centre and the States together) is now around 16% of GDP, amounting to Rs. 1,70,000 crore. If a reasonable assumption is made that illegal exactions by all categories of government servants amount to between 15 and 20 per cent of the legal tax ratio, then the total tax burden on the public could be taken to be between 18.4 and 19.2 per cent of GDP, that is to say, that the citizens are paying between Rs. 25,500 crore and 34,000 crore more than the tax revenue shown in the records.

We are all arguing for a rise in the legal tax ratio which has come down from 17 per cent of GDP in 1989-90 to 16 per cent in 1994-95. But perhaps the illegal tax ratio has risen in the meanwhile, judging by the spate of scams that are being unearthed. None will dispute the statement that money is being illegally collected with impunity by a proportion of various categories of government servants today. We can more easily raise the legal ratio, if we can take steps to reduce the illegal tax ratio. Indeed, I would say nothing would cheer the general public more than the elimination or a drastic reduction of the arbitrary, arrogant and illegal exactions of money by government servants for whose salaries they are already contributing taxes. In this connection I would strongly suggest that reforming tax administration should be a major plank in the government's reform agenda.

The total salary bill of the government sector amounts to around Rs. 64,000 crore. If 20 to 25 per cent of the staff is taken as surplus, the subsidy on the provision of employment without work can be reckoned at Rs. 12,800 to 16,000 crore.

Total capital formation of the government sector, excluding defence capital outlay, amounts to Rs. 24,500 crore. Of this about 66 per cent is accounted for by construction. That comes to Rs. 16,200 crore. Leakage of 30 per cent of this amount will be equal to Rs. 4860 crore or roughly Rs. 5000 crore (Leakage out of construction expenditure of non-departmental public enterprises is not included here).

Thus, total public expenditure is unnecessarily inflated by Rs. 21,000 crore, which is about 10 per cent of public outlay excluding loans. Surely, when we talk of reducing fiscal deficit, priority attention should be given to cutting down drastically this unjustified imposition on the public.

IV. REMEDIAL STEPS

It is generally felt that the deplorable weaknesses in the system of governance in our country can only be remedied through a movement of moral regeneration backed up by sufficient pressure by the enlightened public. Certainly the moral aspect and the exercise of civic responsibility are important. However, as social scientists, we should base our recommendations on an analysis of the social and institutional forces operating in a given society. Institutional and structural changes are required in addition to moral exhortation. I suggest below some of the major changes that we should try to bring about together with the priority areas for policy action.

- ⇒ The area of governmental action, i.e., the scope of governmental activities should be narrowed down substantially; in particular the government should withdraw from the business of production of private goods which are of no significance either from the social or strategic point of view.
- ⇒ Wherever the government is in the business of production of private goods, i.e., where public enterprises operate, they should operate in competition with private enterprises and must be made fully autonomous. All autonomous public enterprises should have substantial private share-holding.
- ⇒ There should be further liberalisation and reduction in the number of controls. There should be delicensing of all industries except defence and strategic ones.
- ⇒ Governmental procedures and procedures for obtaining various types of approvals should be simplified. Strict time limits should be set for grant of approvals. For all construction on government account, there should be a system of tendering and bidding by various construction agencies. The public works department itself should be one of the bidders. In course of time that department should be pruned and should be put in charge only of maintenance; construction can be taken out of its purview.
- ⇒ With the reduction in the scope of government activities, avoidance of duplication of functioning by the Centre and the State governments and procedural changes, the size of the surplus staff in

several government departments can be gradually brought down by not filling up vacancies and redeployment of staff. Of course, there would have to be increase in staff in some social sectors like education. What is intended to be achieved is only elimination of surplus staff.

- ◊ In consultation with the unions of government employees, a system of reward and punishment related to quality and performance must be introduced.
- ◊ There has to be further rationalisation of the tax system including the system of stamp duty. All the checkpoints acting as hindrance to the flow of trade and providing an opportunity for graft should be abolished. A special programme designed to modernise and improve tax administration should be taken as a matter of priority. Corrupt tax officials and tax evaders should be punished equally severely.

V. CLOSING REMARKS

Let me close by posing a few theoretical questions to the fiscal economists assembled here. Economists normally make a distinction between private goods and public goods. Public goods are those that cannot be produced and sold under the market exchange relationship because the principle of exclusion cannot be applied to them. As such, people will not reveal their preferences for public goods and a price cannot get established in the market. It is also argued or assumed that a public good will be consumed in an equal amount by all. Defence and maintenance of internal law and order are considered pure public goods. We generally take many other government services such as enforcing certain minimum standards, registering documents, etc., as public goods.

But in India, even "law and order" has been converted into a private good. When one goes to file a First Information Report (FIR) to register a matter with the authorities, often a payment is demanded to register the case. Should we say that a public good is converted into a private good in all such cases? How come this happens? Is this due to the extraordinary ingenuity of the Indian public servants? Or is there a weakness in the economists' definition of public goods? Parallel payments arise only because there are private benefits to be obtained. What we can say is that Indian Government servants have succeeded in converting what are generally regarded as public goods into non-merit private goods. In the light of our

experience, it seems that Indian economists should try to arrive at a more satisfactory definition of public goods.

Second, we should reconsider the definition of taxes. Taxes have two special characteristics: one, they are payments without *quid pro quo*. Two, they are compulsory payments for those who fulfil the conditions laid down in the law. Thus, there is an element of coercion. The illegal tax payments satisfy the condition of coercion, but they are usually rewarded with *quid pro quo* benefits. However, since the use of the coercive power of the State is involved these payments cannot be classified as user charges.

I would suggest that a thorough study of the kinds and quantum of illegal taxes being collected should be undertaken in order to get an idea of the total tax burden on the community. Meanwhile, I shall plead that the term illegal tax ratio should be brought into use.