Process Reforms: Enabling decision-making under uncertainty

06

CHAPTER

International comparisons show that the problems of India's administrative processes derive less from lack of compliance to processes or regulatory standards, but from over-regulation. In this chapter, the issue of over-regulation is illustrated through a study of time and procedures taken for a company to undergo voluntary liquidation in India. Even when there is no dispute/ litigation and all paperwork is complete, it takes 1570 days to be stuck off from the records. This is an order of magnitude longer than what it takes in other countries.

Using the framework of incomplete contracts, the chapter argues that the problem of over-regulation and opacity in Indian administrative processes flows from the emphasis on having complete regulations that account for every possible outcome. This is due to the inadequate appreciation of the difference between 'Regulation' and 'Supervision', on the one hand, and the inevitability of incomplete regulations, on the other hand. Real-world regulation is inevitably incomplete because of the combination of: (i) bounded rationality due to "unknown unknowns", (ii) complexity involved in framing "complete" contracts across all possible contingencies, and (iii) the difficulty for a third party to verify decisions. This makes some discretion unavoidable in decision making. The evidence shows that over-regulation, not simpler regulation, leads to opaque decision making.

The problem is that policymakers, by default, tend to favour prescriptive regulation over supervision. Unlike supervision, regulation can be easily measured. After all, regulations provide criteria or checklists, making it easier for regulators to follow and reduce their accountability later on. In contrast, it is difficult to quantify the amount and quality of supervision.

The optimal solution is to have simple regulations combined with transparent decision-making process. Having provided the government decision maker with discretion, it is important then to balance it with three things- improved transparency, stronger systems of ex-ante accountability (such as bank boards) and ex-post resolution mechanisms. As an illustration, the chapter shows how the new Government e Marketplace (GeM portal) has increased the transparency in pricing in government procurement. This has not only reduced the cost of procurement but has also made it easier for the honest government official to make decisions.

THE PROBLEM OF REGULATORY EFFECTIVENESS

6.1   It is often believed that India's regulatory problems are due to the lack of regulatory standards and poor compliance to process. International comparisons, however, show that India ranks better than its peers on having regulatory standards in place and compliance to process. The real issue seems to be effectiveness of regulations caused by undue delays, rent seeking, complex regulations and quality of regulation.

6.2   The 'World Rule of Law Index' published by the World Justice Project[1] provides cross country comparison on various aspects of regulatory enforcement. The index has various sub-categories, which capture compliance to due processes, effectiveness, timelines, etc. In 2020, India's rank is 45 out of 128 countries in the category of 'Due process is respected in administrative proceedings' (proxy for following due process). In contrast, in the category 'Government regulations are effectively enforced' (proxy for regulatory quality/effectiveness), the country's rank is 104 (Table 1). India stands at 89th rank in 'Administrative Proceedings are conducted without unreasonable delay' (proxy for timeliness) and 107th in 'Administrative Proceedings are applied and enforced without improper influence' (proxy for rent seeking). This shows that, contrary to the popular belief, India is relatively good at complying with processes, but lag in regulatory effectiveness.

6.3   In fact, India's performance has improved significantly in following due process in administrative proceedings, with its rank improving from 72 in 2015 (out of 102 countries) to 45 in 2020 (out of 128 countries). In contrast, it has deteriorated over time on certain other parameters. This makes it clear that having regulations and enforcing process is one thing, whereas their effectiveness is another.

Table 1: India's rank in various categories of regulatory enforcement

	2015	2020
Regulatory Enforcement overall rank	69	74
Government regulations are effectively enforced	87	104
Government regulations are applied and enforced without improper influence	74	107
Administrative proceedings are conducted without unreasonable delay	75	89
Due process is respected in administrative proceedings	72	45
Number of Countries	102	128

Source: World Justice Project

6.4   The index shows that United Kingdom, United States, Singapore and Canada are placed much better than India in case of both, following due process and regulatory effectiveness. However, the gap between India and these counties is much wider in regulatory effectiveness than in due processes being followed. Similarly, India is placed better than other BRICS countries (barring South Africa) in terms of respecting due process, but, worse than them in the effectiveness of those standards (Table 2).

[1] World Justice Project was found in 2006 as an initiative of the American Bar Association and became an independent Non-Profit organisation in 2009. The data published by World Justice Project is used by World Bank in its World Governance Indicators.

Table 2: Comparison of regulatory standards and regulatory enforcement in 2020

Rank	US	UK	Singapore	Canada	Brazil	Russia	China	South Africa	India
Regulatory Enforcement	20	13	3	11	60	73	67	45	74
Government regulations are effectively enforced	20	11	5	12	62	47	63	92	104
Government regulations are applied and enforced without improper influence	16	9	4	8	64	83	63	59	107
Administrative proceedings are conducted without unreasonable delay	33	13	1	17	124	24	23	48	89
Due process is respected in administrative proceedings	18	12	7	5	55	97	98	25	45

Source: World Justice Project (2020)

6.5   The same conclusion can be derived from various World Bank studies. Its Regulatory Quality Index[2] shows that despite improvement in India's regulatory quality since 2013 (Figure 1), it is still much lower than UK, US, Singapore, Japan etc. (Figure 2). Similarly, the World Bank's Ease of Doing Business (EoDB) report (2020) shows that despite making huge strides in the overall EoDB rank, India still lags behind in the sub-categories 'Starting a business' and 'Registering Property' where the country's rank is 136 and 154 respectively. The report points out that this is due to the high number of procedures required to legally start and formally operate a company as well as the time and cost consumed to complete each procedure.

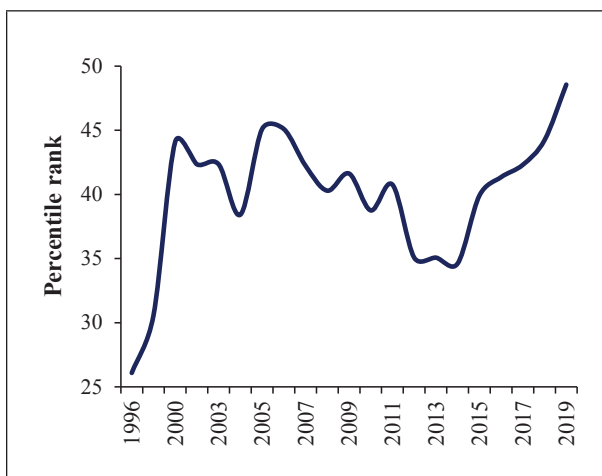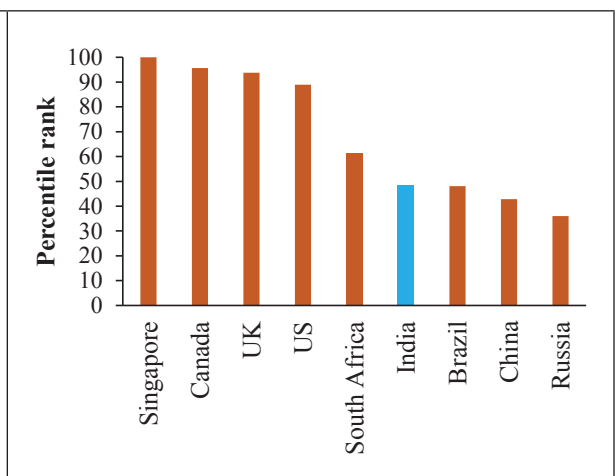**Figure 1: Regulatory Quality in India**

Figure 2: Cross country comparison of regulatory quality (as of 2019)

Source: World Bank (2019)
Note: In Figure 1 and 2, higher number indicates improvement (unlike in other rankings)

[2]Regulatory Quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5. This is a part of Worldwide Governance Indicators (WGI) of World Bank.

6.6   As an illustration of unnecessary regulation in India, take the case of voluntary closure of a company. A study by *Quality Council of India* (done for Economic Survey) shows that the time taken from point of decision of closure to actually the company getting struck off from the Registrar of Companies is 1570 days (i.e. 4.3 years), even if all paperwork is in place and the company is not involved in any litigation or dispute. This is the best possible case of a routine activity. Interestingly, out of the total time taken, about 1035 days are taken for clearances by Income Tax, Provident Fund, GST departments and in taking back security refunds from various departments (Table 3). In contrast, voluntary liquidation takes about 12 months in Singapore, 12-24 months in Germany and 15 months in UK. In Germany, for very large and active companies, it takes 2-4 years. Given the likelihood of disputes and litigation, for the comparable large cases it may take upto a decade in India.

Table 3: Timelines and procedures faced by companies in voluntary liquidation in India (even when there is no litigation/dispute)

Timeline (days)	Procedures
T	Company's decision to close its business operations in India
T +16	Passing of Board resolution by the Company to close its business operations in India
T + 20 to T + 70	Public announcement, communication to employees and strategizing transition of legal entity to liquidator
T + 70 to T + 110	• Exit by majority of employees; Communication to vendors • Identification of physical data and records and Digitization of key physical records • Introduction of professional firm for bookkeeping activity going forward • Undertaking sale/ realization and disposal of movable assets
T + 110 to T + 200	• Discontinuance of business operations and termination of contracts • Intimating income tax authorities • Exit by remaining key employees; Completion of asset disposal process • Completion of identified pending statutory compliances and closure process with government bodies monitoring industrial functions. • seeking no dues certificate from all the vendors • Identification and appointment of resident Indian director during the period of voluntary liquidation process till the order for dissolution is passed by NCLT*
T + 200 to T + 270	• Appointment of new Board members including Indian resident Director* • Cessation of banking operations in existing bank accounts to mitigate risk of financial misappropriation • Undertaking compliances under secretarial law and IBC, towards commencement of voluntary liquidation
T + 270	• Passing of shareholder's resolution for commencement of voluntary liquidation and appointment of liquidator

T + 300	• Intimating about commencement of voluntary liquidation and appointment of liquidator to Income tax, RoC, IBBI, GST authorities and PF department. • Public announcement in newspapers inviting claims • Opening a designated bank account for cash and liquid funds • Closure of existing bank account(s) and transfer of funds to designated bank account
T + 315	• Preparation and submission of preliminary report to shareholders of Corporate Debtor
T + 315 to T + 1350	**Income tax[3]** • Completion of on-going and new assessment proceedings, appellate litigation and submission of responses to various notices, simultaneously. • Furnishing a bank guarantee from principal shareholder of the Corporate Debtor with income tax authorities to obtain tax NOC. **Provident Fund (PF)[4]** • Filing for closure of EPF account of establishment with regional PF authorities **GST registration** • Periodic statutory compliances (payment of tax under reverse charge and returns filing) • Surrendering GST registration towards completion of voluntary liquidation process **Foreign exchange laws*** • Reporting under Foreign exchange laws to be verified at the time of discussions with Authorized dealers bank, for requisite documents to process final remittance to the shareholders. **Communication from ex-employees and Claims from operational credits** • Frequent requests from ex-employees reg PF portal of the company • Claims from operational creditors post 30-day claim period from liquidation commencement date **Security deposit from government bodies** • Refund of security amount deposited by Corporate Debtor at the time of registration/ obtain licenses with government bodies
T + 1350 to T + 1360	• Final remittance to shareholders and deposit of applicable withholding taxes thereon Completion of voluntary liquidation process • Closure of designated bank account
T + 1360 to T + 1370	• Submission of final report to shareholders, RoC, IBBI and NCLT (along with dissolution petition) • Filing of application with dissolution of Corporate Debtors with NCLT
T + 1430	• Scheduled date of first hearing of NCLT • NCLT's order seeking reports/ reply from income tax department, RoC and IBBI

[3]Bank guarantee from principal shareholder of Corporate Debtor was furnished with income tax authorities and tax NOC was obtained after ~ 1000 days from filing of intimation.

[4]Inspection proceedings by PF authorities concluded in ~ 370 days and subsequently, inquiry in relation to payment of interest and damages on payment of PF shortfall was initiated, concluded in another ~ 300 days.

T + 1430 to T + 1515	• Follow-up with income tax department, RoC and IBBI, confirm receipt of NCLT order and request for their timely response • Address queries raised by respective authorities
T + 1515	• Scheduled date of second hearing of NCLT • Bring on record the reports/ reply from income tax department, RoC and IBBI
T + 1515 to T + 1540	• Pass the order for dissolution of Corporate Debtor, subject to satisfaction of reports/ replies submitted by income tax department, RoC and IBBI
T + 1540 to T + 1570	• File copy of order for dissolution of Corporate Debtor with RoC vide Form INC 28 • RoC to strike-off the name of Corporate Debtor from Register of Companies

Source: QCI study for Economic Survey
Note: * Procedures are applicable only in case of an Indian subsidiary of foreign company.

THE INEVITABILITY OF INCOMPLETE REGULATIONS

6.7   The problem of over-regulation stems from not recognizing the inevitability of incomplete contracts and regulations in a world of uncertainty. Real world contracts are inherently incomplete because of three key reasons that reinforce one another's influence. First, as Herbert Simon has highlighted in his the Nobel-prize winning work, humans are boundedly rational because the future comprises of "unknown unknowns." Note that radical uncertainty of "unknown unknowns" is fundamentally different from the notion of risk as defined by Frank Knight. Second, as another Noble-prize winning work on incomplete contracts by Oliver Hart highlights, complexity in framing contracts arises from the difficulties involved in anticipating and specifying all obligations for all parties in full across all possible contingencies. In fact, with radical uncertainty, it is impossible to know the possible characteristics of all the future states of the world. Therefore, writing complete contracts that will efficiently fit every future situation is inherently impossible in the real world. Finally, because of these two features, a third party may be able to observe outcomes *ex-post* but cannot verify *ex-ante* decisions unambiguously.

6.8   Incomplete regulations become inevitable when the reality of incomplete contracts is acknowledged[5]. In theory, regulators and policymakers can choose to invest entirely in the drafting process by identifying every possible state of the world that might materialize and by specifying an appropriate solution to each state. But, in reality, they confront a vexing problem: the future is unknown and unknowable. As a result, when faced with uncertainty, it simply costs too much to foresee and then describe appropriately the contractual outcomes for all (or even most) of the conceivable states of the world. Thus, the reality of incomplete contracts leads to inevitability of incomplete regulation. This makes some discretion unavoidable.

6.9   In a complex and uncertain world, moreover, the actual outcomes or situations do not fit in the neat boxes assumed in the regulation; hence the supervisor has to exercise some judgment. There is a widespread belief, however, that ever more detailed regulations reduce discretion. On the contrary, complex rules and regulations create more discretion because of the multiple ways

5. A large literature in economics focuses on how incomplete regulations evolve from incomplete contracts. We refer the reader to Laffont (2005) for a comprehensive overview of the same

in which they can be interpreted. This is made worse by the opacity of increasingly complex rules which makes it difficult for a third party to monitor how the discretion was exercised. Black (2001) argues that "discretion and rules are not in a zero-sum relationship such that the more rules there are the less the discretion there is and visa-versa." In short, a complex, uncertain world makes discretion inevitable where over-regulation, not simpler regulation, leads to excessive and opaque discretion.

Evidence supporting the increase in discretion with over-regulation

6.10 In their book "In Regulating Aged care: Ritualism and the New Pyramid", Braithwaite *et.al.* (2007) study the healthcare sector in the United States and provide evidence that is consistent with the above thesis. The book focuses on the impact of regulating care for the elderly. It was argued that inspectors manning the aged care homes had a lot of discretion. To change this scenario and reduce their discretion, the inspectors were provided with detailed protocols to audit. These standards were further broken into sub-standards and had reached over 500 federal standards, which were complemented by some state's specific standards by 1986. For instance, the Illinois code for nursing included over 5,000 care regulations. Consistent with the bounded rationality posited above, the authors found that inspectors could not cope up with the rise in these number of standards. Most of these standards were completely forgotten and only about 10 per cent of the standards were repeatedly used to make norms. The study notes that the results depended on the background of inspectors, such that *"If you've got a nurse, it will be nursing deficiencies in the survey report; if a pharmacist, you'll get pharmacy deficiencies; a lawyer, patient rights, etc."* The complex set of rules, in fact, gave more discretion to the inspector. Because of having complex and a large number of standards to check, idiosyncratic factors associated with the narrow expertise of the inspector caused particular standards to be checked in some homes, but neglected in others. Thus, the over-regulation caused endemic unreliability and defeated the whole purpose of having detailed regulations. The timelines associated with closing a clean company with no litigation/ dispute, which is described in Table 3 above, represent an example of this problem.

6.11 Similarly, Figures 3 and 4 provide large sample evidence across Indian states supporting the thesis that discretion increases with the amount of regulation. The evidence is adapted from Raj *et al.* (2018) who use the World Bank's Enterprise level surveys for India to undertake their analysis. In figure 3, the variation among firms in the actual days taken to provide a construction permit as a function of the number of *de jure* days taken to provide a construction permit, as per the regulatory rules for the same in the state are plotted. We see that an increase in the number of regulations, which is proxied by the increase in the *de jure* days to get the permit, correlates positively with the variation in the actual number of days taken. As variation against the *de jure* norm proxies the discretion exercised across the various applications from the firms, this shows that more the number of regulations, higher the discretion in implementing them in the case of award of construction permits. Figure 4 shows the same using the days taken to provide an operating license for a facility. Collectively, both these figures provide evidence consistent with the thesis that discretion increases with the number of regulations.

Figure 3: Discretion in the granting of construction permits increases with *de jure* provisions
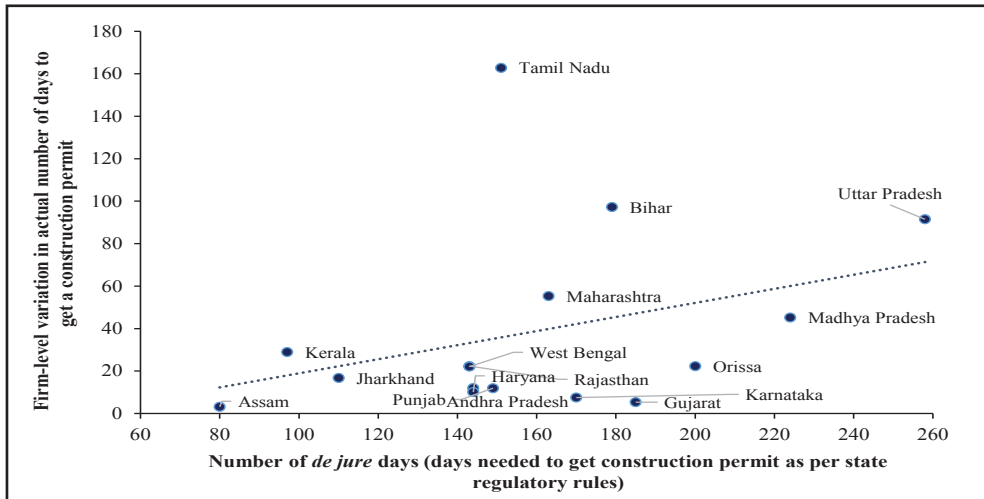
Source: *Raj et al (2018);* Firm level variation is measured by standard deviation; higher variation proxies higher discretion

Figure 4: Discretion in the granting of operating license increases with *de jure* provisions
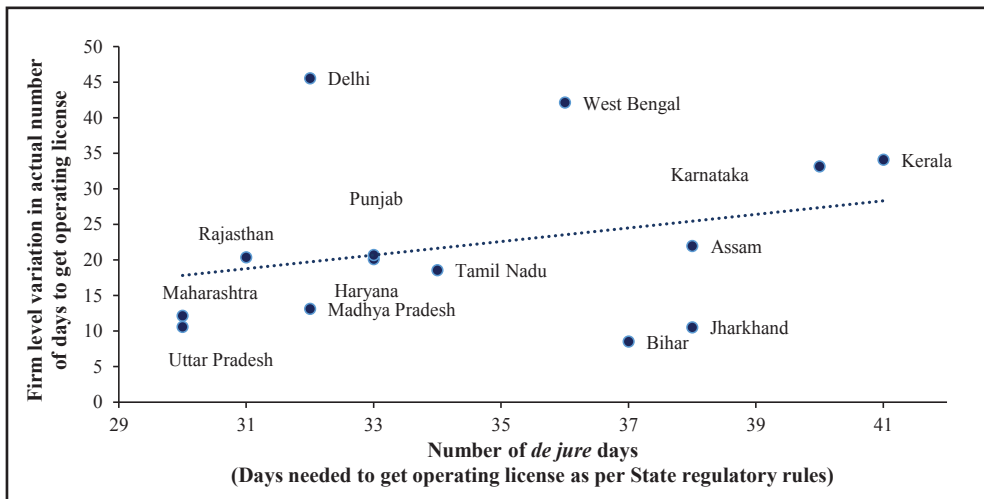
Source: *Raj et al (2018);* Firm level variation is measured by standard deviation

6.12 Kanbur & Ronconi (2016) show in their cross-country study on labor laws that the stringency of labour regulation (measured as fine for violation of minimum wage) correlates negatively with the intensity of its enforcement (measured as average medium imprisonment for the same). They argue that countries with more stringent labour codes are less likely to enforce them.

6.13 Finally, another illustration of the above thesis is the Dodd-Frank Act enacted post the Global Financial Crisis in United States, which spanned 848 pages and mandated 390 new rules. It was a well-intentioned attempt to fix what went wrong in the years leading up to 2008 crisis. One might think that this left little room for regulators to use their discretion. In fact, what happened was quite the contrary. Petrou (2012) argued that Dodd-Frank created a new kind of

risk that she labelled "complexity risk." For instance, the legislation requires bank boards to be responsible for 184 additional activities, which may be unnecessary — or even impossible.

6.14 This reveals that having more stringent regulation may actually mean that exercise of discretion on the ground is more, not less. Thus, it is clear that in a world full of uncertainty and complexity, it's not possible to substitute effective supervision with more prescriptive regulation. Note that employing third-party supervision cannot substitute the process of simplifying regulation to lower opaque discretion because as argued above verifiability of efforts and actions by any third party is minimal when contracts are incomplete. Therefore, the question then arises is how can we allow for discretion such that is not misused and leads to effective supervision.

THE PROBLEM OF REGULATORY DEFAULT

6.15 From the discussion in the previous sections, it is clear that there is a need to create simple regulation and complement the same by providing flexibility and discretion to the supervisor. However, if the legal and institutional frameworks do not explicitly limit mushrooming of regulations, policymakers may naturally drift towards more regulation, even if it is sub-optimal for the economy. While analyzing the principal-agent problem, Holstorm & Milgrom (1979) argue that multi-dimensional tasks are ubiquitous in the world and agents have to divide their time among various duties. In such cases, agents choose the tasks whose outcomes are measurable. For instance, if there is an incentive pay for teachers based on their students' test scores, then teachers will focus on the narrowly defined basic skills that are tested on standardised tests and not on the various aspects of student learning. In effect, they will focus on what can be effectively measured. Similarly, as regulation can be easily measured while supervision cannot be measured easily, regulators and decision-makers would prefer to substitute supervision with more and more regulation. After all, regulations provide criteria or checklists, making it easier for regulators to follow and reduce their accountability later on. On the other hand, it is difficult to quantify the amount and quality of supervision. Naturally, policymakers by default tend to favour prescriptive regulation. This creates a perverse incentive to keep adding more top-down regulations regardless of their effectiveness. The following section discusses this in detail.

(a) More regulation is added over time regardless of its effectiveness

6.16 Since regulation is a more mechanical, top-down approach, it often becomes the default response of policymakers. This has promoted the culture of '*regulate first, ask question later.*' (Australian Government taskforce report, 2006)

6.17 Several such examples abound in India. The Commerce Ministry's Report of the High-Level Advisory Group (2019) noted a maze of complex and stringent regulations to stop 'round-tripping' of funds. The report highlighted that '*the baggage of round-tripping cannot be used to stifle the financial services sector any more than using the risk of a traffic accident to stop construction of a key highway'.* Another example is the unintended consequences of ever-increasing bank regulations which has led to shifting of market activity to "shadow banks" (also called "non-bank financial intermediaries") where the scope for regulatory arbitrage is higher, especially as banks become more averse to lend to high-risk borrowers and/ or small borrowers. Increasing regulation in one part of the financial system has shifted risk to the less-regulated, less- transparent part of the financial system (Sanyal, 2020).

(b) Discretion is not provided or exercised even when there is a case to do so

6.18 Since regulations are defined, they are easy to measure ex-ante. Bureaucracies will naturally tend to substitute supervision with mechanical regulations and will not exercise discretion even when it is available.

6.19 As an illustration, take the case of public procurement. As per the General Financial Rules (GFRs) guidelines, the Lowest Cost Method, or commonly known as 'L1' principle is the most prevalent bidding method used for Goods/Works and Non-Consultancy services.

6.20 There is a general agreement that solely relying on L1 does not work well and various organisations have advocated the need for reforming the current procurement system over the last few years. Central Vigilance Commission in its concept note 'Alternative Procurement Strategy for Award of Works and Goods Contract' noted that although L1 may still hold good for procurement of routine works, goods and non-consulting services; but not for high impact and technologically complex procurements. Quality Council of India (QCI) conducted a study[6] on highway development sector and found that the vendors who were all awarded contracts on the basis of competitive bidding vary widely in terms of quality of work and performance which was not covered under existing bid evaluation system. The report suggested incorporating Performance Rating in Competitive Bidding to provide a quality premium to superior bidder rather than simply awarding the contract to L1 bidder and gave a formula to calculate total score as the summation of financial score and performance rating score. NITI Aayog in the concept paper 'Indian Public Procurement: Alternative Strategies and Way Forward' argue that L1 is not suitable in all the scenarios and came up with a variety of alternatives to use in the procurement process. In fact, the report also mentions that new procurement frameworks of multilaterals like World Bank, Asian Development Bank, Japan International Cooperation Agency have suitable alternative strategies for selecting bidders pointing towards needs for change and reforms in current times. They have moved from 'one size fits all' to 'fit to purpose' approach and incorporated various alternatives such as Value for Money, Rated Criteria to consider non-price attributes etc in the procurement methods.

6.21 Despite so many organizations recommending a need for allowing more discretion in the bidding process on account of technical and quality based parameters, we still mostly use L1. The L1 system persists because of the regulatory default problem. No decision maker wants to exercise discretion for the fear of future questioning. This criteria may appear simple and quantifiable, however, in a complex world where it may not be possible to define everything in the pre-procurement process, it is advisable to leave some discretion in the hands of administrators along with maintaining enough transparency and active supervision.

(c) Discretion is questioned with the benefit of hindsight

6.22 Discretion exercised ex-ante in the Initial Public Offering (IPO) of publicly listed companies often gets questioned with the benefit of hindsight when the IPO is oversubscribed and/or the first day gain is large. However, the market value of an unlisted entity is unknown. Even after employing the best of valuation techniques, effort, and resources, the actual value of an entity is uncertain until it is traded in the market. It is not uncommon to see stocks being

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[6]QCI conducted a pilot study as a part of World Bank Technical Assessment with Ministry of Road Transport & Highways (MoRTH) to rate National Highway projects

over-subscribed (or under-subscribed) and their prices move up (or down). As Figures 5 and 6 show, oversubscription and first-day gains for IPOs in the private sector are quite significant for many years; at the same time, reflecting the uncertainty involved in predicting the listing price, losses are large too in some years. Figure 5 shows the number of times Indian IPO stocks listed on BSE and NSE between 2010-2020 were oversubscribed by different class of investors. In the last 5 years, average total subscription has been 20-40 times for these IPOs though it has been lower in previous years. Figure 6 shows that most private sector IPOs in the last 7-8 years have had positive listing gains though losses have been large too in previous years. Even in 2019, nearly 60 per cent IPOs had positive listing gains. Table 6 lists the information on some specific stocks to buttress this point that the expected listing price and the amount of subscription is quite uncertain *apriori*.

Figure 5: Oversubscription of Indian IPOs listed on BSE and NSE (2010-20)
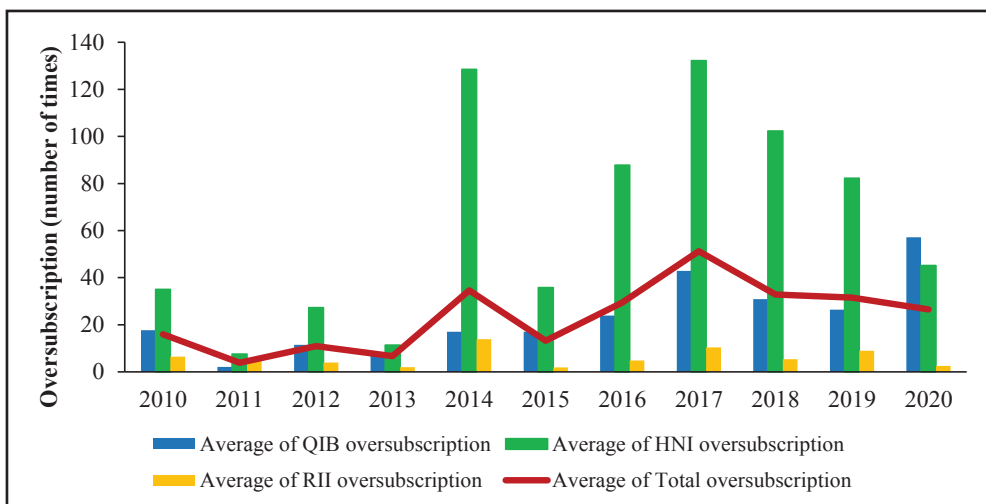
Source: BSE and NSE. Note: All Indian IPO stocks listed after 2007 are covered. QIB: Qualified Institutional Buyer; NII: High Net-Worth Individual Investor; RII: Retail Individual Investor; Total Oversubscription: Number of Times Issue is Subscribed (BSE + NSE)

Figure 6: Listing Gains of Indian IPOs listed on BSE and NSE (2010-19)
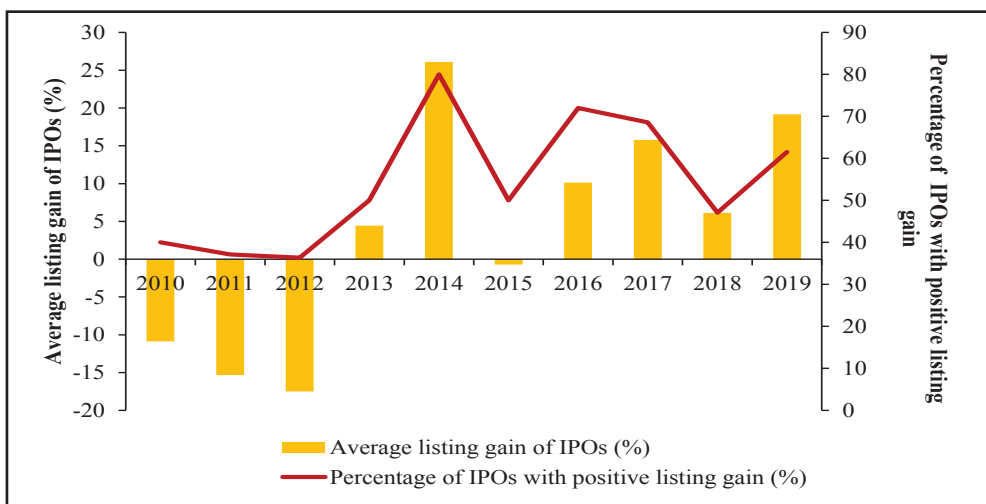
Source: BSE and NSE. Note: All Indian IPO stocks listed after 2007 are covered.

Table 4: Opening and closing prices of stocks listed on the market

Company	Date of Listing	Subscription (No of Times)	IPO Price (Rs)	Close Price (Rs)	Return (%)
Burger King India	2 Dec 2020	1.84	60	138.4	131
SBI Card	5 March 2020	26.5	755	730	-4
Ujjivan FSB	12 Dec 2019	166	37	58	56.76
CBS Bank	4 Dec 2019	87	195	274.25	40.64
IRCTC	3 Oct 2019	112	320	874	173
Sterling & Wilson Solar	6 August 2019	0.85	780	273.1	-65
Affle (India)	31 July 2019	86	745	1470	97.3
India Mart InterMesh	26 June 2019	36	973	2131	119
Neogen Chem	26 April 2019	41	215	358	66.5
Polycab India	9 April 2019	52	538	1016.2	88.88
Metropolis Healthcare	6 April 2019	6	880	1350	53.41

Source: BSE
Note: Close Price on first day of listing

6.23 In cases when government entities go public and the prices go up after the stocks are listed on the market, it is realised that the assets were worth a lot more. Commentators then with 'Hindsight Bias' remark that the assets were sold too cheap. However, it is only after the prices are listed and stocks are traded in secondary market, the actual valuation is known. It is important to note that this is not unique to the public sector undertakings but happens in the private sector as well. Not only are various IPOs over-subscribed but the close price on the day of listing is significantly different from the IPO price (Table 4).

(d) Government departments follow default precedent

6.24 Government departments take actions either to tick off boxes in checklist of regulation or follow the default precedent. Thus we see routine appeals made by the government departments against unfavourable judgements in higher courts or tribunals in order to reduce any questioning later on.

6.25 In India, there is a multi-layered system of resolving any dispute in tax-related matters. After scrutiny, the Department or assesses have the option of approaching the Commissioner of Income Tax-Appeals (CIT-A), the Income Tax Appellate Tribunals (ITAT), the High Courts (HC) and finally the Supreme Court of India (SC) in case of disputes in Direct Taxes. As per calculations in Economic Survey 2017-18, Department's appeals constitute nearly 85 per cent of the total number of appeals filed in the case of direct taxes. Of the total number of direct tax cases pending by the quarter ending March 2017, the Department initiated close to 88 per cent of the litigation at ITATs and the Supreme Court and 83 per cent of the litigation pending at High Courts. However, the department loses 73 per cent of its cases in Supreme Court and ITAT and 87 per cent in High Court (Table 5). Even though the success rate of litigation that the government enters in is very low, there is a tendency among the policymakers to appeal to the higher authority.

Table 5: Petition rate and Success rate of the direct taxes (in per cent)

Court/ Tribunal	Petition rate	Success Rate
Supreme Court	87	27
High Court	83	13
ITAT	88*	27

Source: Economic Survey 2017-18 calculations
Note: *Provisional Estimates

SOLVING FOR DISCRETION

6.26 From the above discussion, it should be clear that there is no substitute for active supervision and discretion. Specifically, *ex-ante* regulation cannot substitute for *ex-post* supervision; in fact, more *ex-ante* regulation only serves to dilute the quality of *ex-post* supervision by fostering opaque discretion. So, how can supervisors be kept accountable while giving them discretion? We explore three possible ways:

(a) Strengthen *ex-ante* accountability

6.27 The property rights literature based on incomplete contracts argues for the strengthening of governance in institutions by vesting more power in boards and then holding them accountable ex-ante. Instead of relying too much on *ex-post* audits, which anyway suffer from hindsight bias, *ex-ante* accountability needs to be entrusted with the boards of institutions. In most common law countries, there is a case law derived doctrine of Buisness Judgment Rule. The rule states that boards are presumed to act in good faith and protects companies from frivolous lawsuits by assuming that, unless proved otherwise, management is acting in the interests of shareholders. It exists in India as well, however not exactly codified in the same language. But there is a great deal of apprehension that it is not taken into account in audits and post-facto investigations.

(b) Bring transparency in the decision-making process

6.28 The second way towards effective supervision is to incorporate transparency into the decision-making process. Transparency, apart from having intrinsic value, is appreciated because it promotes trust in public institutions and makes market efficient. The discretion in the system needs to be balanced with the transparency in decision making.

6.29 The benefits of transparency can be seen from the recent reform in public procurement. The Government in 2016 had set up a dedicated e-market known as Government e Marketplace (GeM) for different goods & services procured or sold by Government/PSUs. Anecdotal evidence suggests that prior to GeM, government procurement prices were much higher than the prices prevailing in the market and there were constant complaints about inefficiency and rent seeking. As the GeM website mentions, use of this e-marketplace has resulted in a substantial reduction in prices in comparison to the tender, rate contract and direct purchase rates that were used previously. The average prices on GeM are lower by atleast 15-20 per cent than previously, and in some cases even upto 56 per cent.

6.30 A comparison of prices of various commodities on GeM portal with those of company websites and online platforms such as Amazon, Flipkart, etc is given in the table below (Table 6). For the study (done on January 4, 2021), a set of common items were identified. Effort was made to ensure that the products matched as closely as possible. The study found the prices to be in the same ballpark. On on average, the variation between the prices on GeM and other online market places is only around 3 per cent. Being an open platform alert citizens can continue to monitor it real time.

Table 6: GEM Portal Prices Comparison (as on 04-01-2021)

Name and Description (specs, model, features)	Price on GEM (in Rupees)	Price at Amazon, Official Website etc. (in Rupees)	Variation in Offer Price
Parker Jotter Standard Ball Pen	MRP: 250; Offer Price (OP): 210	Amazon.in- MRP: 250; OP: 188	+ 10.5%
Rorito Greetz Gel Pen Maxtron Gold Robotic Fluid Ink System Pen -Blue	MRP: 99; OP:87.95	Amazon- MRP: 99; OP: 64	+ 27.2%
Haier 1.5 Ton / 4500 kcal/hr High wall Split AC 5 Star Model:HSU19C-TFW5B(INV)	MRP: 65,000; OP: 58,500 Warranty: 2 year (Product), 10 year (compressor)	Amazon.in-MRP: 55,000; OP: 36,990 Warranty- 1 year (product); 12 years (compressor) Haier Website-Price: 42,990	+ 36.8%
Samsung 108 cm (43 inches) 4K Ultra HD Smart LED TV, Model: QA43Q60TAKXXL Resolution: 3840x2160	MRP: 78,900, OP: 70,998 Warranty- 1 Year	Amazon.in- MRP: 78,900, OP: 62,990 Warranty: 1 year comprehensive and 1-year additional warranty on Panel by Samsung	+ 11.3%
Omron White HEM 7156 Blood Pressure Monitor	MRP: 3,860, OP: 3,100 Warranty – 2 years	1mg.com- MRP: 3,860, OP: 2,860, Warranty – 3 years	+ 7.7%
HP LaserJet ENTERPRISE M607N Black and White Print Speed: >= 51 ppm	MRP: 1,22,921 OP: 1,10,625 Warranty – 3 Years	HP Website- MRP: 1,03,661 OP: 98,440 Warranty- 1 Year	+ 11.01%
Kores Easy Cut 871 Paper Shredder	MRP: 25,490, OP: 22,900	Amazon.in- MRP: 23,990 OP: 19,589	+ 14.5%
Hero Stainless Steel Bicycle for Men Model Name: Hero Lectro C3i 26 SS	MRP: 47,999 OP: 42,997	Hero Lectro (Choosemy bicycle.com) OP: 32,499 Croma: MRP: 32,999, OP:32,990	(Gem vs Croma) + 23.3%

Name and Description (specs, model, features)	Price on GEM (in Rupees)	Price at Amazon, Official Website etc. (in Rupees)	Variation in Offer Price
Milton 1500ml thermos	MRP: 1,560, OP: 1,100	Amazon: MRP: 1,454 OP: 1,199	- 9%
Nilkamal Dustbin 60 Litres	MRP: 3,100, OP: 1,175	Amazon- MRP: 1,990 OP: 1,448	- 23.2%
Nilkamal Veneto High Back Office Chair	MRP: 17,500, OP: 14,000	Nilkamal Website- MRP: 13,500, OP: 11,297.00	+ 19.3%
Bajaj Pulsar NS200 Motor Cycle	MRP: 1,15,250 OP: 1,15,250	Bajaj Auto website- MRP: 1,31,219 (Ex-showroom price in New Delhi)	- 13.9%
Godrej Interio Elite Mid Back Chair	MRP: 12,390, OP: 11,150	Godrej Interio website- MRP: 12,390	- 11.1%
Godrej Interio Steel Almirah 2400 mm (Slide N Store Compact Plus Wardrobe)	MRP: 31, 022, OP: 27,919	Godrej Interio website- MRP: 32,572	- 16.7%
Godrej Interio Orlando 2-Seater Sofa	MRP: 51,800, OP: 46,620 Warranty- 1 year	Godrej Interio Website- MRP: 51,799, Warranty- 3 years	- 9.99%
Godrej Interio blue Zephyr Leisure Chair	MRP: 21,024, OP: 18,921	Godrej Interio Website- MRP: 21,022	- 11.1%
Honda Activa 6G DLX BS-VI Vehicle Engine Capacity (cc) 109.51	MRP: 60,767 OP: 60,767	Bikewale.com MRP:68,930 (Ex Showroom price)	- 13.4%
Apple MacBook Pro 16 inches 1TB MVVM2HN/A, 16 GB RAM, 1 TB SSD, 4 GB Graphics Card	MRP: 2,73,800 OP: 2,45,679	Vijay Sales- MRP: 2,39,900, OP: 2,34,900 Tata Cliq- MRP: 2,39,900, OP: 2,27,900	(GEM vs Tata Cliq) + 7.2%
Dell Intel Core Desktop PC Monitor - E2720H Processor- i9 10900, RAM- 32 GB (DDR4) Expandable upto 128GB, HDD- 1000 GB HDD, SSD- 1024 GB, OS- Windows 10 Professional Graphics Card- 8 GB; NVIDIAGeForceRTX2070	MRP: 2,23,001 OP: 1,97,998 Warranty – 3 years	Dell Website (Desktop assembled with same specs)- 2,06,873 (Warranty: 3 year)	- 4.5%

Source: GeM website, Amazon, Flipkart, various companies website
Note: Prices as on January 4, 2020, OP: Offer Price, MRP: Maximum Retail Price
Variation is calculated as the percentage difference in GeM prices over the comparable prices

(c) Build resilient *ex-post* resolution mechanism

6.31 When outcomes are uncertain, it is important to have a resilient ex-post resolution mechanism. Despite having all regulations in place and best efforts to deal with effective supervision *ex-ante,* devising a robust *ex-post* resolution mechanism is imperative. Grossman and Hart's (1986) work on "incomplete contracts" demonstrates that the contracts are contingent on future states and it is not possible to write complete contracts, and by extension regulations, for every future state. Thus, adding *ex-ante* complexity to contracts and regulations, or risk analysis cannot resolve this issue.

6.32 Hence, there is a need for efficient legal systems (i.e., courts and institutions) such as Insolvency and Bankruptcy Code (IBC), Debt Recovery Tribunals etc. However, the court system remains the single most important way for *ex-post* resolution. The performance in the area of dispute resolution and contract enforcement in India remains a concern and needs to be focused on. As per the World Bank' Ease of Doing Buisness report (2020), it takes 1445 days to resolve a commercial contract in India as compared to 589.6 days in OECD high income countries and 120 days in Singapore. The report also shows that the cost of litigation in India is around 31 per cent of the claim value. This is significantly higher than in OECD countries (21 per cent) and Bhutan (0.1 per cent). The performance of India is enforcement of contracts is also seen in its ranking in World Rule of Law Index for 2020, where India ranks 69 out of 128 countries. Our performance is the worst in the category 'Civil Justice not subject to unreasonable delay' where we are placed at rank 123 falling just behind Venezuela, Guatemala, Peru, Bangladesh and Columbia (Table 7).

**Table 7: India's rank in the World Rule of Law Index (2020)**

Particulars	India Rank out of 128
World Rule of Law Index	69
People can Access and Afford Civil Justice	115
Civil Justice is not subject to unreasonable delay[7]	123
Civil Justice is effectively enforced	102
Alternative dispute resolution mechanism is accessible	88

Source: World Justice Project (2020)

6.33 The "Rule of Law[8]" indicator of the World Governance Index reiterates the same story. India is lagging behind with score '0' as compared to 1.6 and 1.5 in the UK and US respectively (Figure 7). All these points towards the need for reforming the legal structure to have an efficient *ex-post* mechanism for dispute resolution and contract enforcement in India.

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[7]It measures whether civil justice proceedings are conducted and judgements are produced in a timely manner without delay.

[8]Rule of Law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Estimate ranges from approximately -2.5 to 2.5.

Figure 7: Cross country comparison of Rule of Law indicator
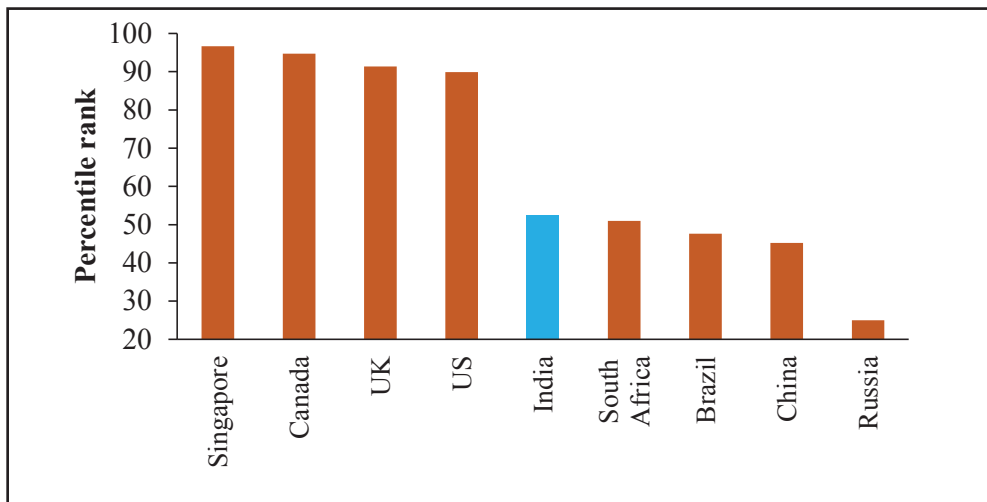
Source: World Bank

6.34 The legal system is required not to fix *ex-ante* issues in the system but to be used as an *ex-post* dispute resolution mechanism. This is just as true for government decision makers who may find their decisions questioned later. An effective enforcement system should be able to distinguish the negative outcomes arising due to uncertainties from outright frauds. There is a need for reforms in the legal system in the country as as been argued by various Economic Surveys in the past.

DIRECTION OF ADMINISTRATIVE PROCESS REFORMS

6.35 The above approach has several implications that are already informing recent reforms. Here are two recent examples:

- Labour falls under the Concurrent List of the Constitution, therefore both Parliament and state legislatures can make laws regulating labour. There were over 100 state and 40 central laws regulating various aspects of labour such as the resolution of industrial disputes, working conditions, social security and wages, making the landscape of labour regulation very complex. To rectify this, Government merged the existing 29 central labour laws into 4 labour codes. The Code on wages was passed in July 2019. In Setember 2020, three bills (i) Industrial Relations Code, 2020, (ii) Code on Occupational Safety, Health & Working Conditions Bill, 2020 (iii) Social Security Code, 2020 were passed in the parliament.

- The regulatory framework for Other Service Providers (OSP) was till recently, outdated and complex. For instance, the Business Process Outsourcing (BPO) industry increasingly runs on global cloud-based systems but Indian regulations restricted its use and insisted on a local EPABX. Further, there were restrictions on Work from Home and onerous registration requirements. Hence, to reduce the compliance burden of the BPO industry, government announced new guidelines on OSPs on 5th November 2020. Under the new regulations, the registration requirement for OSPs has been done away with altogether and the BPO industry engaged in data-related work has been taken out of the ambit of OSP regulations.

Similarly, several other requirements, which prevented companies from adopting 'Work from Home' and 'Work from Anywhere' policies have also been removed. This has significantly liberalized the regulation for the BPO sector. (See the details in Chapter No 9 of Volume 2)

6.36 The need for process simplicity extends to the institutional architecture as well. The ultimate source of supervision is public scrutiny and public leadership. Since it is not possible for the public to scrutinize everything, the focus should be on a strong but limited state, rather than weak and all pervasive state. This is in line with government's idea of 'Minimum Government and Maximum Governnance'. Since Independence, a plethora of autonomous bodies had proliferated. There is a need to prune them consistently not just from a cost perspective but in order to maintain transparency, accountability and efficient supervision. In this spirit, in the last year several organizations including All India Handloom Board, All India Handicrafts Board, Cotton Advisory Board and Jute Advisory Board have been closed. Similarly, the governement approved merger of four of its film media units, namely Films Division, Directorate of Film Festivals, National Film Archives of India, and Children's Film Society, India into the National Film Development Corporation (NFDC) Ltd.

6.37 Finally, there is a case for enacting Transparency of Rules Act to end any asymmetry of information regarding rules and regulations faced by a citizen. This was initially proposed in Chapter 8 of Economic Survey 2016-17 Volume 2. The reform solves for the problem that rules frequently change and often the citizen has to follow a long paper trail of circulars and notifications to know the current requirements. Under this act, all departments will need to mandatorily place all citizen-facing rules on their website. Officials will not be able to impose any rule not explicitly mentioned on the website clearly. Further, all laws, rules and regulations will have to be presented as an updated, unified whole at all times. This will bring transparency and simplify the understanding of regulations.

CHAPTER AT A GLANCE

➢ It is not possible to have complete regulations in a world which has uncertainty as it is not possible to account for all possible outcomes. The evidence, however, shows that India over-regulates the economy. This results in regulations being ineffective even with relatively good compliance with process.

➢ This chapter argues that the root cause of the problem of over-regulation is an approach that attempts to account for every possible outcome. This is illustrated by a study of the time and procedures needed to voluntarily close a company in India, even when there is no outstanding dispute or litigation.

➢ Both economic theory and evidence shows that in an uncertain and complex world, it is not possible to write regulations that account for all possible outcomes. This makes discretion unavoidable in decision-making. The attempt to reduce discretion by having ever more complex regulations, however, results in even more non-transparent discretion. The solution is to simplify regulations and invest in greater supervision which, by definition, implies willingness to allow some discretion.

➢ Discretion, however, needs to be balanced with transparency, systems of *ex-ante* accountability and *ex-post* resolution mechanisms. The experience with GeM portal for public procurement illustrates how transparency not only reduces purchase prices but also provides the honest decision maker with a clean process.

➢ The above intellectual framwework has already informed reforms ranging from labour codes to removal of onerous regulations on the BPO sector. The same approach is also reflected in the rationalisation of autonomous bodies.

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