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Evolving Regulatory Structures and the Receding Public Sector – Seeking a Convergence

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Abstract

Two seemingly unrelated phenomena of the post-reform India, viz. the evolution of the independent regulators and the shrinking of the public sector are discussed. Firstly, the slowing in the privatization and disinvestment drives in developing economies is recognized and explained. Taking the case of Indian Telecom, it is shown then that it was the strong lobbying of the private players and their resolve to dismantle the state-owned player than mere efficiency rationale which led to the setting up of the independent regulator. Then we link the mushrooming independent regulators and the drive for rapid privatization to the policy advocacy of international donor agencies. Further, taking a stand that the State can still deliver better, a case for significant public sector presence in a developing economy context is made. Finally, an attempt to connect both these questions through *convergence* asks for rejuvenating the public sector as much as for incentivizing the private interests through regulation. *After all, being market-friendly does not have to mean being government-unfriendly.*

Keywords: Regulation, Public Sector Enterprises

The Three Questions

What is the role of the State at the interface of business and society? Despite being a socially embedded institution with strong interplay of power and politics, the State in India plays multiple roles at this interface: - as an owner, as an equity upholder, as a service provider, an employer of large sections of population, as a whistle blower, as a fosterer of competition for citizen well-being, a regulator, a facilitator and so on. The article is interested in understanding two phenomena at this interface and the common grounds between both.

The first phenomenon is the fall of the eminence of the Public Sector Enterprises. The 'employment generators' and 'brick and mortar of economy' suddenly became 'white elephants' and 'burdens on the exchequer'. The neo economic liberals and pro-market reformists wanted them to disappear to pave way for the market forces. The treasury saw its 'mortgage or collateral value' and their disinvestment was seen as a source of revenues. Restructuring PSEs became part of fiscal reforms in order to cut down burgeoning public deficits. Striking a chord with the famous statement of Milton Friedman, it was in this juncture that the question of whether "it is the business of the State is (running) business" became an important question. This invokes a volley of questions which go back to the history, context and ideology of our economic policy making. But what we are interested is the forward looking question: - "Where is our public sector getting to?" This would warrant our interest in understanding the organizational innovations and policy reforms adopted in the post-1991 era in the domain of managing these public sector enterprises. The department of public enterprises (DoPE), the nodal co-coordinating body of the CPSEs (Central PSEs) oversees these policies. The first reform is the MoU system. This is a performance contract system mediated by DoPE between the PSE and the owner ministry according to which the management of PSE is granted considerable autonomy to strategize, decide and operate subject to achieving the target levels in a set of indicators at the end of a financial year. These targets are arrived through negotiations between the ministry officials and the PSE management. But the processes of negotiation are draped in the quintessential red tape. Hence the actual practice of the system is a far cry from the envisaged objectives of the model. The next policy is getting these firms comply with the Corporate Governance guidelines. These guidelines are not majorly different from SEBI guidelines and do not considers the difference in their mandates vis-à-vis other listed companies. And finally the

"all encompassing' criteria' for granting Ratna status is yet another innovation through offering incentives. Given this supposed waning interest in managing public sector enterprises and a historical background and ideology which led to the eminence of the Public sector, one could ask where should this trimming of the Public sector end and what should be its minimal presence in the Indian Economy?"

The second phenomenon is the evolution of regulatory structures in India. With the growth of the private and corporate sector in the economy, one witnesses the emergence of RBI as a regulator and SEBI, TRAI, CERC and other regulators coming up on the economic landscape. The emergence of new 'regulators' interests one. The autonomy and independence of these regulators and their position, scope and mandate outside the sphere of the core Government and their relation with the concerned stakeholders and its co-existence with the concerned ministries and organs of government were new facets of the economy. And more importantly, in the aftermath of the Global Financial Crisis and the meltdown, the role of RBI as a financial regulator was being increasingly lauded for effectively securing the stability of Indian financial system. But on the other hand, the scope and the role of TRAI as a regulator for Telecom were shown in a poor light in the aftermath of the two telecom scams. Certain sector-based regulators were being appreciated, some were being found to be weak. More recently, there was a critique that ministries were increasingly becoming hurdles to investment and growth by creating policy paralysis. So there was demand from certain segments for setting up newer independent regulators in sectors like environment and coal.

How are these two phenomena related? The debates on the rationale, scope and mandate of the 'Public Sector' in the post-reforms era have almost exited the policy tables. The theme of independent regulators was receiving attention in domain of business and public policy. It was being observed that State is no longer the 'owner' when it enjoyed the commanding heights of the economy through Public Sector Enterprises but today a 'regulator' The public sector was shrinking and the State needed the growing private sector to support it in carrying out its responsibilities towards achieving the national socio-economic objectives . It is in this background that we frame the three questions. Let us call them' regulation question', the' public sector question' and the 'convergence question'. As we go forward, we would like to see if we

could gradually recognize a thin connecting thread between the first two questions as one searches for ‘ a convergence’ or middle ground . Let us first articulate what these questions are:-

1. The Public Sector Question:- Shouldn’t there be a tipping point for the shrinking of the public sector in Indian context?
2. The Regulation Question:- Why did regulation re-enter the economic landscape of the once-over regulated state in the new form of these independent regulators? What was the politico-economic context in which such independent regulators were set up in India?
3. The Convergence question:- The ‘Convergence’ question explores a possible middle ground between this evolution of independent regulatory structures and the receding public sector presence in contexts like India.

Public Sector Question

To articulate the public sector question, we would not be taking a retrospective look at how public sector has evolved over time nor ponder over the founding arguments in favor of the pro-active state and PSEs enjoying commanding heights in the pre-reforms phase of Indian economy. Instead we are more interested to see the rationale and scope for a public sector presence in today’s context (read post-reforms) and its role in our economy. So our *public sector question* seeks to ask whether there exists a tipping point for the shrinking public sector presence in Indian economy and there needs to be a slowing needed in the drive for disinvestment and privatization of public sector.

Indian public sector currently contributes about a quarter of India’s measured domestic output. Administrative departments (including defense) account for about 2/5th of it, the rest comes from a few departmental enterprises (like railways and postal services), and a large number of varied non-departmental enterprises producing a range of goods and services [1]. These include, close to 250 public sector enterprises (PSEs) owned and managed by the central government, mostly in industry and services (excluding the commercial banks and financial institutions). At the state level, production and distribution of electricity and provision of passenger road transport form the principal activities under public sector, run mostly by autonomous boards and statutory

[1]Statistics as of the start of the last decade

corporations. Public investment in irrigation would perhaps rank next only to electricity in most states, and is generally viewed as public service. Besides, there are about 1,100 state level public enterprises (SLPEs) that are relatively small in size.

But this contribution of all these varied publicly owned and managed entities to national development is often shadowed by the huge concerns mounted in the name of their poor financial return. PSEs in developing countries were often critiqued as "*money-losers and that they have sucked up credit in domestic markets, that their productivity is low, that they have depended heavily on government transfers, and that they are also terrible polluters………… if subsidies to PSEs could be reduced by 5-10% by making them more efficient, the resources freed up could feed, clothe, or educate a lot of people* (World Bank, 1995). This conviction about 'the failed Public sector' was aided by the contention of government failure, i.e. the governments have failed to provide services efficiently and the phenomenon of technological change would require a change in the ownership. This viewpoint was argued as follows. Operations in most of such sectors were traditionally vertically integrated. But slowly these transactions have got decentralized and these public sector organizations, earlier based on internal hierarchies, were now based on contracts and discipline of the markets. Decentralized environment and contracting processes associated with the markets had converted these public sector monoliths into networks of units communicating with each other through standardized interfaces and architectures. These networks were characterized by new information flows. Only an efficient private sector (well regulated though) would be able to handle this situation (Bhattacharya and Patel, 2005). How is this contention of 'government failure' related to privatization and change in the regulatory philosophy? This 'failure 'of government in providing the service efficiently is traced to the inefficiencies and the problems associated with the natural monopolies. Such monopolies were brought under government ownership as against leaving it to function under unfettered markets. Here a government intervention was justified to solve problems which these markets face. But a government which intervenes through such monopolies can also face similar problems like how markets faced (Stiglitz, 1987). Moreover, the perception that there is a sheer absence of incentives for efficiency in these public sector organizations motivated the drive for privatization and restructuring of industries. There have been more and more instances worldwide which were described as 'government failures' thus paving way for privatization. Public ownership was

perceived as a threat to the dynamics of competition in the sector in which they operate because of their size, inefficiency, soft budget constraints and ill-defined objective functions (Datta and Chaudhary, 1990)

It was in this context that the macroeconomic crisis precipitated in the late 1980s. The fiscal crisis of 1991 in India which was characterized by huge deficits, inadequate revenues, prodigal expenditures , mostly under current head and low returns on private investments was perceived to be the manifestation of the inefficiencies associated with the public sector. This led to the disinvestment and privatization drive in India. But how valid were these premises of the disinvestment policy to begin with? Whether this was an act in considerations of efficiency or in order to bridge the resource gap is disputable. As large and growing share of the fiscal deficit was on account of PSEs' financial losses, getting rid of them was believed to help restore the fisc back to health. Nagaraj (1993) had shown that PSEs' financial losses were not the principal cause of the growing fiscal deficit in the 1980s, and in fact PSEs' share in the fiscal deficit had steadily declined in the decade. In other words, the government per se was largely responsible for the growing fiscal deficit, not the enterprises owned by it.

Notwithstanding, from 1991 onward, fractions of the equity in selected central PSEs were sold to raise resources to bridge this fiscal deficit. This 'disinvestment' signaled a major departure in India's economic policy and even acquired the status of public policy. This shift in policy was in line with a global transition of ownership from the public to the private which started in UK of 1970s. Structural adjustment lending prescribed by World Bank and IMF included privatization as an integral component of the policy based lending packages for the economies in financial distress. World Bank's own publication, *Bureaucrats in Business* (1995) (which is extensively quoted in this paper) spearheaded this movement. This movement (which, at times, gained the proportions of propaganda) made a serious indictment of how the extension of the State in provision of private goods and services resulted in serious loss of efficiency, waste and lost growth opportunities for many less developed economies. After the Latin American debt and inflationary crisis in the 1980s, privatization was widely advocated as a quick and sure means of restoring budgetary balance, to revive growth on a sustainable basis (Dornbusch, 1991). This change in ownership was often advocated to increase domestic competition, hence efficiency;

and encourage public participation in domestic stock market – all of which are believed to promote 'popular' capitalism that rewards risk taking and private initiative, that is expected to yield superior economic outcomes (Ramamurthi, 1999). But as experienced worldwide, even in the case of UK where this policy was pioneered, privatization has been decreed as a process without strong economic rationale. One could be show that it was seen mostly as a means of raising resources for the budget. Worse, it could be analytically shown that selling public bonds than public assets was better means for this aforesaid purpose (Yarrow, 1986). Adding to this is the fact that, internationally, economic crisis seems to be a necessary condition for swift privatization. So rationale for disinvestment and trimming the public sector seems hazy, if not short –sighted.

Whither public sector

So why is it desirable to slow down the privatization processes in our developing economy context? This is primarily because we may be missing the reforms-bus altogether. A leap to privatization without exploring the middle ground of public sector reforms is not even economic wisdom. We tend to forget the example set by China, which has reformed PSEs gradually but privatized very little. Take the case of the town and village enterprise (TVE) in China, which are controlled by local officials, whose CEOs serve at the pleasure of local leaders, and whose profits go to the town or village. Despite this kind of public control, TVEs are aggressive competitors, have grown rapidly, are efficient, and have formed joint ventures with foreign investors and Chinese PSEs (Naughton, 1994). The point to be noted from the case of TVEs is that public ownership works more effectively when there is competition or accountability is decentralized to the local level rather than centralized at the federal or provincial level. Similarly, the value of performance contracts between governments and PSEs is often understated, even though Korea seems to have had much success with such contracts. Another unexplored possibility is that of partial privatization which is politically more palatable than full privatization and can improve a firm's performance (Ramamurti 1999). Thus, if State wants to reforms its public sector, options are galore. But the sign on the wall is that government failures can vary across countries, just as market failures vary across industries and countries. And where government failures are low, PSE reform without much privatization - at least without immediate and deep privatization - may not be bad transition strategy.

More importantly, why do the developing economies like India need a significant public sector? This has something to do with the politico-economic reality of developing countries. These economies have not whole heartedly welcomed the philosophy of privatization so much so that, despite a decade of privatization in this developing world, the vast majority of PSE assets continue to be in government hands. Public Sector Enterprises have not shrunk much in importance in these developing economies in the last 30 years. The size of the state-owned enterprise sector has significantly diminished only in the former socialist economies and a few middle-income countries. In most developing countries, particularly the poorest, bureaucrats run as large a share of the economy as ever (World Bank, 1995).

So why is the shrinking of public sector not brisk as it is expected and why are the forces in these economies putting up a natural resistance to the process? Why have the majority of developing countries been pussyfooting on privatization? Often politics is identified as one reason for the slow pace of privatization. But this has more to do with the institutional and economic constraints. Success stories of privatization are rare in low-income countries, and the long-term promise of privatization in sectors posing regulatory complications remains to be established. Often the bureaucracy of the developing world are found to be far more skeptical about what the local private will be able to deliver, about their own ability to regulate privatized firms, and about how the benefits of privatization will be distributed across society(Ramamurti, 1999). Perhaps the role of the state, as reflected in public ownership, has to be bigger in poorer countries than in richer countries. History has shown that everywhere governments have taken the lead in the early stages of economic development (Gerschenkron, 1962). The umbrella term ‘developing countries’ denotes nations of widely divergent living standards. With 85% of the economy in private hands, these low-income mixed-economies are already predominantly private. The sad reality in low-income countries is that weak government is matched by equally weak markets. Privatization in these economies not only moves assets from the public to private sectors, it often also moves them from the formal to the informal sector, because much private activity is deliberately kept outside the vision of the state, which is seen “as hostile to their economic welfare”(Barad, 1994, p. 192.). So the public, the economy and the State in these economies can’t be as eager to privatization as much as the proponents of privatization.

It is in this context, one asks whether instead of seeking the reasons for privatization, one could ask why a certain firm should remain in public sector. Based on studies of privatization of natural monopolies, it is contended that sectors such as railways, however, are harder to regulate after privatization (Ramamurthi, 1997). The regulatory task can be especially difficult in sectors such as highways, or water or sewage, where competition is weak or totally absent, investments are lumpier, externalities are much more important, and pay back periods run 8-10 years or more, thereby increasing uncertainty and risk for contracting parties. Renegotiations are likely to be the rule, brought on by unanticipated developments or simply opportunism on the part of investors or governments. There are umpteen examples to show that such arrangements have fallen apart a few years after they were signed (Ramamurthi, 1999). Also, in most countries, the Public sector typically consists mainly of firms operating in four sectors: public utilities, heavy industries, financial services, and extractive industries. These firms tend to be large and monopolistic or oligopolistic. They all entail either high risks or present opportunities to earn high rents. Neither the theoretical nor the empirical literature suggests unambiguously that such firms will perform better if privatized. Hence we should admit that are genuine limitations of selling off of PSEs – core of which belong to energy, infrastructure, and industries of strategic interest in national development. The point is not that privatization is undesirable in these sectors, but that its promise is much more dubious. Therefore, privatization schemes need to be drawn up much more carefully here (Ramamurti,1999). On the contrary, what are the efficiency effects of privatization? Perhaps the most definitive quantitative account of Florio (2004) covering the longest time period of the UK experience does not show any measurable efficiency gains on account of the changes in ownership. Also Tandon (1997) categorically rejects the hypothesis of efficiency gains from privatization in less developed countries. If this selective review of evidence is anything to go by, then one should expect very modestly from whatever privatization that has happened and is happening in India.

Regulation Question

The interest in regulation is mostly in its new *avatar* of independent regulators. So naturally, the 'regulation question' is to understand what regulation in this format means to our particular politico- economical context. Why did regulation re-enter the economic landscape of the once-over regulated state in this new form of the independent regulators? What were its basis,

rationale and scope? The regulation questions try to address these queries and try to locate these new independent regulators in the post-reforms era.

Across the world, the State has moved away from being a regulatory state of 'command and control' mode to a formulation that accepts state and markets in some kind of partnership in the larger context of privatization (Baldwin et.al),. Regulation today is understood as a halfway house between direct nationalization and indirect tax based controls and the State, via its regulatory agencies, envisages achieving a certain socio-economic optima through influencing the concerned stakeholders/businesses (Stiglitz and Sappington, 1987). It is often spoken of as if it is an identifiable and discrete mode of governmental activity. Concepts of regulation has evolved from being thought of as a '*red light'* activity that restricts behavior and prevents the occurrence of certain undesirable activities towards being a '*green light'* influence which is enabling or facilitative(Harlow and Rawlings, 2009).

But why regulate? The fundamental theorem of welfare economics postulates that when an economy satisfies certain conditions (i.e. regarding externalities, full convexity) if every individual maximizes his own selfish utility, then society attains Pareto-optimality. But such competitive markets can fail. It is in order to take care of these market failures and inefficiencies that a regulatory intervention is justified. These market failures may arise due to economies of scale, technological or network characteristics and regulator is supposed to address the abuse of the resulting monopoly power and introduce competition where none existed before. Even in markets where many players can't be brought in, appropriate regulatory structures could be brought in to ensure contestability of not competitiveness (Debreu, 1959). The arguments on which the rationale of regulation is based on arguments related to economic efficiency or information asymmetry. Traditionally, the need to regulate firms such as public utilities in transportation, power or telecom has been felt on the grounds of the considerable market power such firms wielded. Then the governments chose to internalize the requirement of regulatory supervision of private monopolies by assuming ownership of infrastructure utilities and much of financial intermediation. So then the raison d'etre was to correct such market failures and ensure a level playing field. Also the vulnerability of the economy to negative consequences of the 'Too Connected To Fail' and 'Too Big to Fail' nature of financial institutions and the imperfect information felt by the investors about the financial services requires regulatory institutions to

target this systematic risk. Also the increased private sector participation in developing economics owing out of government failures was offering more opportunities for setting up such regulators. But through the eighties and nineties, there was a growing conviction in the developed world that the practice of regulation, through public control or cost based regulation was inherently flawed.

How did *regulation re-enter the economic landscape of the once-over regulated Indian economy in the form of independent regulators?* Over the past few decades, the format of an independent regulatory agency has emerged worldwide as an important institution governing utilities. The growth in such regulators has been explosive. A 2006 study of 49 country and 16 sectors (including but not limited to utilities) found that the number of such new regulators created per year burgeoned from less than 5 between the 1960s and 1980s to more than 20 in the 1990s to 2002 (Jordana et al., 2006). This trend peaked to almost 40 new regulators a year from 1994 to 1996. This phenomenon of mushrooming of independent regulators becomes more important in developing countries, where governments have adopted external models of the independent regulator for sectors in the midst of reform and often with dominant entrenched interests (Minogue and Carino, 2006). Regulatory design and process in these developing countries are shaped by features like the greater presence and authority of external actors, particularly donors, as vectors of policy transfer, the importance of consultants as knowledge carriers and as implementers, the overbearing but paradoxically also weak state, and the propensity for thin state legitimacy, robustness of existing political institutions, the reliability and credibility of the judiciary, national administrative capacity, institutional norms and practices and other related factors . The State here is self-consciously re-orienting themselves toward forms of steering over ownership, without much reflection on whether and how this shift changes the nature of politics and concerns of democratic legitimacy and accountability (Dubash and Rao, 2006). This sort of regulatory implant of an external model to the particular political and institutional contexts questions the efficacy of such independent regulators in achieving their set objectives. India offers a good setting to explore such implications. The experience of such regulation in India was quite peculiar. Independent regulators were setup in India from 1980s and coincided with the reforms (Planning Commission, 2006). But it could be contended that these independent regulatory agencies have entered India through the back door. The same donor agencies which once championed rapid privatization were found to be vociferous about setting up such

regulators. They viewed the mode of independent regulators as a way to insulate politics from decision making. On the other hand, the insiders to Indian government and administration, including some regulators and regulated, dismiss regulatory bodies as one more layer of government, barely distinguishable from preceding layers (Dubash and Rao, 2006).

A good example for this claim could be seen in the case of electricity sector which Dubash and Rao (2006,2008) extensively surveys. Independent regulation entered the Indian electricity sectors, as it did in other developing countries, as a part of a larger program of electricity reform and restructuring. Until 1991, India conformed to the then prevailing global model of vertically integrated and publicly owned-and-operated power model. Restructuring started with the opening up the generation sector to private investment. But by the middle of the decade, the focus shifted to the distribution sector. The falling quality of supply and dramatically rising financial losses accompanied by alarming levels of theft of electricity were making the sector increasingly unviable and adding to the fiscal crisis. Internationally, the sector was moving towards private ownership and market competition. The acute shortage of finance made the states to approach the World Bank which was quick to come up with a reform program. And indeed the role of independent regulation was a key component in the new reforms packages.

Regulation Question: - Case of Telecom sector

The rationale and the context of the emergence of independent regulators could be better understood through a short case study on the Indian Telecom sector. Telecommunications is found to be an ideal candidate to be uniquely qualified as an ideal site for privatization and setting up independent regulation. Its growth potential and cash flow patterns are usually outstanding, because pent up demand is large and consumers are willing to pay high enough prices to allow producers to recover their investment in 2-3 years. Regulatory problems are mitigated by competition, which is strengthened each day by technological change. Externalities are relatively unimportant and can be accommodated through light regulation and minimal subsidies. The regulatory task is manageable even in the long run and even in countries lacking regulatory experience and institutions (Ramamurti, 1996, pp. 21-34.). Still the regulatory structures in Indian Telecom sector following the policy of promotion of competition and private participation in the sector did not evolve overnight and these policies were the outcomes of initiatives, influences and pressures exerted by different stakeholders. This evolution of policies

of competition and independent regulation could be split into two phases, the first phase of promotion of competition in the sector(1990-1997) and second phase of the setting up, operation and revamp of independent regulator in the sector(1997-2012).

Competition in this sector was promoted under the influence and pressures of the foreign investors and private players firmly supported by the "political will of Prime Minister's Office (PMO) to bring policy reversal from a highly inefficient government monopoly to highly competitive sector". The role of PMO's activism in annulling the strong opposition of the Department of Telecom which was then the state owned incumbent, policy maker and regulator for the sector and promoting private sector participation is found to be significant. The ensuing competition was expected to bring in efficient outcomes in terms of greater out reach and as a powerful instrument for reforming service delivery. Dismantling of DoT's monopoly was supposed to result in cheaper and more efficient calling services, a marked improvement in tele-density and a dramatic increase in flow of private investment. Also strong was the contention that competition would reduce the meddling of DoT which was a huge public sector organization with a high staff per direct exchange line ratio eating into the consumer's surplus. This activist PMO under Rajiv (84-89) and Vajpayee (1998-2004) was conscious of the needs of effective telecommunication services for the growth of Indian industry in increasingly global environment and found the government monopoly incapable for the mission. The high level support of PMO was thus challenging the DoT's monopoly and was eventually successful at it. This clash of interests was displayed in series of certain incidents in this time period. MTNL and VSNL were corporatized despite DoT's resistance. The technological improvements within C-DoT were licensed for private telecom equipment manufacture against the wishes of DoT. PMO under Chandrashekhar passed Telecom Regulatory Commission report in favour of private investment. The dismantling of DoT, the New Telecom Policy of 1994 and 19999 and push for TRAI Act were largely aided by private interest groups. And it was an open secret that PMO was easily accessible for such corporate pressure groups. Although corporate strategists laud PMO of being instrumental in whittling away of the power of vested interests in DoT which was clearly opposed to every semblance of reform, the question of vested interest groups within PMO which was actively supporting the private sector at the cost of thinning of one's own departments and a public sector organization cannot be always treated as a sheer love for more competitive and efficient outcomes.

But what is responsible for the present market outcomes in telecommunications? Is it this competition or the huge technological change in telecommunications? It is quite proven fact that technical change had led to reduced costs, had aided the complete unbundling of different segments of the industry, led to a convergence of computers (digital), communication (analogue) and media (video) and is close to eliminating the "natural monopoly" traditionally held by the local wire line network or 'basic service[2]. But how much the competition to account for these developments has has to be looked at separately. But were certain state objectives downplayed in this process. The line of thinking that ' better connectivity through better outcomes' having consequences that of a public good and competition benefitting all was not validated later. There are empirical observations that rural tele-density has lagged tremendously behind the urban tele-density even after the so called telecom revolution.

Now let us examine those factors which led to the setting up of the regulator and evolution of the regulatory structures in the sector in the time period of 1997-2002. The regulatory authority in Telecom has a spectrum of tasks and functions ranging from licensing (fixed voice and mobile voice telephony), license oversight, merger approval, interconnection charges, dispute resolution, spectrum planning and allocation, numbering planning to price regulation. Such a regulator was supposed to control the government monopoly and to balance the interests of private players and State owned telecom player. In our Indian case, the entry of private service providers and the inflow of FDI and domestic investments as a result of National Telecom Policy (NTP 1994) in the sector necessitated independent regulation. The Telecom Regulatory Authority of India (TRAI) was, thus, established with effect from 20th February 1997 by an Act of Parliament, called the Telecom Regulatory Authority of India Act, 1997, to regulate telecom services, including fixation/revision of tariffs for telecom services which were earlier vested in the Central Government.

The mandate of TRAI is to "*create and nurture conditions for growth of telecommunications in the country .....*" and more importantly, *"to provide a fair and transparent policy environment which promotes a level playing field and facilitates fair competition*". But deep within the mission statement is the emphasis on the strong objective of de-monopolizing the government player and supporting private players to play on the same platform with the government player.

[2] Dr. Arvind Virmani, ***Telecom Policy For High Growth*** , December 14, 2001

This is evident when TRAI prides itself is of having been the force behind, "the evolution of Indian telecom market from a Government owned monopoly to a multi operator multi service open competitive market". But Department of Telecom was apparently 'not happy with the new independent regulator'. So, right in the first days of TRAI (Mar 1997), DoT took an adversarial stand and almost took every order of TRAI to court. Such an adverse stand was largely attributed to its fear of loss of dominance from the erstwhile combined policy maker, operator, licensor role it enjoyed.

Private players believed that regulatory autonomy could reduce DoT's constant maneuverings. The idea being promoted then was to make the regulator independent and of making the regulator accountable to government policy. For this, the regulator needed financial independence, technocratic hiring policy and checks on regulatory integrity. But the private sector started complaining of insubstantial regulatory powers of TRAI vis-à-vis an adversarial DoT . Now the newly powerful industry turned against DoT. This even precipitated in an investment crisis in 1999. Here again, PMO was quick to attend to these private interests and legislated in their favor through the NTP 1999, TRAI act 2000 and creation of TDSAT. The first TRAI got terminated in 1999 and was split into regulator (TRAI) and adjudicator (TDSAT) on 24 Jan 2000 through the TRAI amendment act. Thus the creation of stronger regulatory mechanism in the form of restructured TRAI was also to propitiate the private interests. Even then the private players 's demand for a strong autonomous regulator was on the grounds that an independent regulator could only support the private players to compete on more equal footing with public sector providers . But underlying were their interests associated with those mechanisms for spectrum allocation, universal service and universal licensing in the mandate of the regulator which were crucial for further expansion of private sector.

The bottom line is that the demand for independent regulators, as shown in this case on Indian telecom sector, was made by the private players so as to effectively counter the strengths of the state owned enterprises and to ensure a level playing field. Often the economic rationale of tackling market power and ensuring competition so as to usher in efficient outcomes form the key arguments for independent regulation. The intense lobbying of these private interests with the state (here PMO) was successful in countering and sidelining yet another state apparatus (the public sector entity). Further, these private interests were successful in bringing in an

independent regulator and then revamping it to the extent that this ‘ independent regulator’ became an instrument for furthering the interests of the private interests as the latter 2G and 3G scams revealed.

The ‘Convergence’ Question

Till now we tried addressing two seemingly unrelated questions. One was on why there should be a slowing in the shrinking of public sector and why do we need a minimal public sector presence in Indian economy. We also tried to see how autonomous regulation evolved and what the context in which they were set up was. Now we would like to ask whether there could be common grounds where these two concerns converge. These two phenomena, i.e. the ‘shrinking of the public sector’ and ‘emergence of independent regulators, ’ were emerging in the same epoch . Both these policies were openly advocated by international donor agencies, especially World Bank and pro-market voices. Also the newly set up independent regulators had to deal with PSEs among the regulated firms (e.g. TRAI and BSNL and State Electricity Regulatory Commissions and State Electricity Boards). The commonalities do not stop at this.

Consider the two entities, an independent regulator and a state-owned enterprise (the PSE). A regulator, in spite of its autonomy and independence from the larger government, is a new form of governance and hence is related to the Government. Public Sector Enterprises are the undertakings of the Government and are the state-owned players in the economy. The mandate of both entities is directly or indirectly connected with the objectives of public policy with respect to their own particular sector or broad macro goals of the state policy. These are the relationships which warrant our attention now. And we would be bringing these relationships into an ‘agency theory’ apparatus to understand principal-agent relationships among the various stakeholders. According to this theory, the principal is expected to induce the agent to act in a manner in which the principal wants and there is crucial role of such contracts and incentives and presence of hidden information in these dynamics.

Consider regulation. The motivation for establishment of independent regulators in developing countries is often located within such a principal- agent framework (Levy and Spiller, 1994). A government chooses to delegate authority to a regulator to resolve credible commitment problems, overcome information asymmetries, and deflect blame for unpopular decisions (Thatcher

and Stone Sweet, 2002). Alternatively a regulator could be seen as an agent of consumers appointed to protect consumer's interests and maintain market integrity (as in the case of financial markets). Or even the regulated industry could be seen as an agent whose performance is overseen by the regulator principal (as in telecom and other infrastructure sectors).

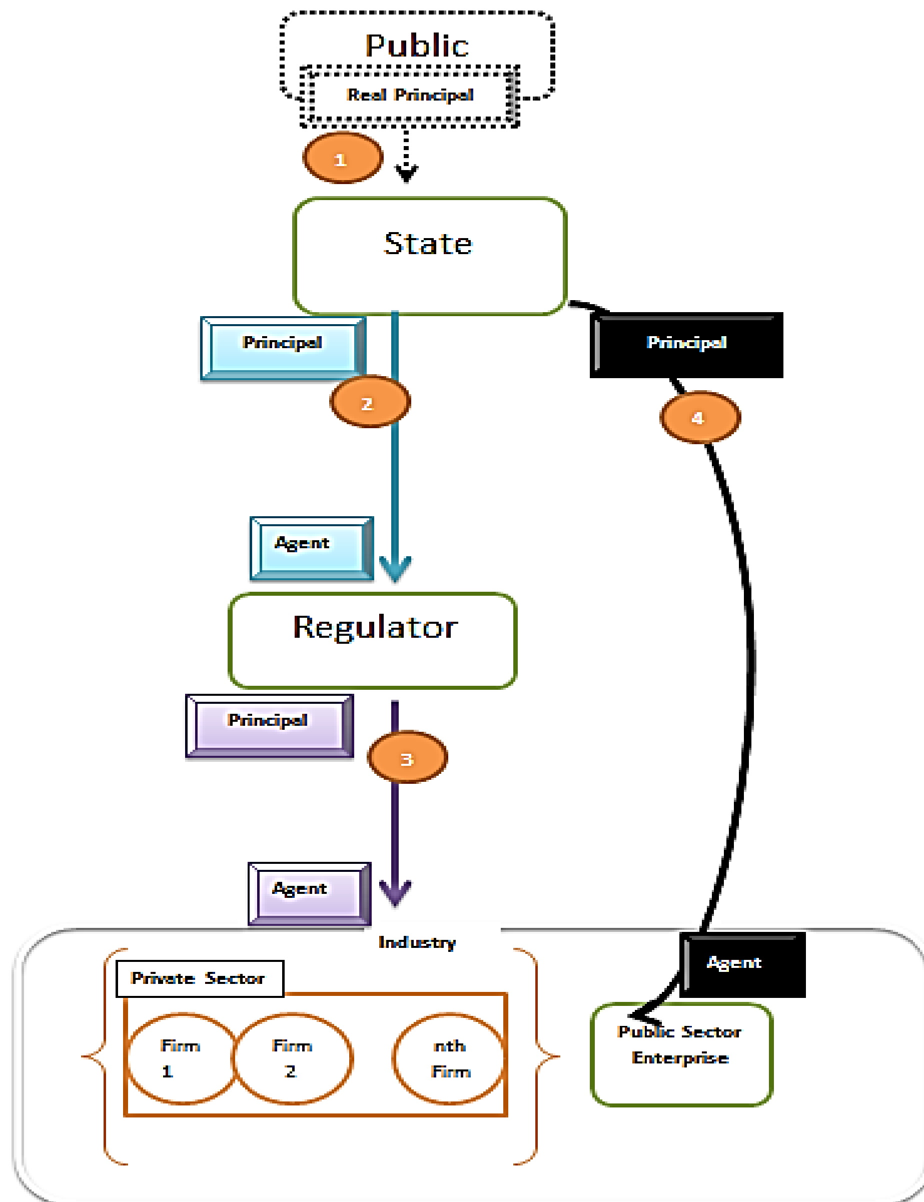
Now consider the domain of PSEs. A simplistic version is that the management of PSEs could be seen as an agent and government as the principal. But it could be easily seen that there are too many principals for the PSE as an agent as we find the PSEs answerable to too many organizations within government. Also, the populace as a whole could be the principal, with a variety of agents viz. various government ministers, members of parliament, managers of firms, and so on acting on its behalf. All these agents are in fact a coalition - a group working together who share *some,* but not all, goals (Aharoni, Yair, 1982).

Now we need to create a common platform where we could discuss our 'convergence' question. This implies that we need to assume a certain simple model which captures the Indian context well and specifies relationships among three key stakeholders of our analysis, namely, the State, the independent regulator and the PSE of a given sector. This simple model brings together four basic principal-agent relationships (depicted in the Fig. No. 1 below):-

1. Public or populace as the real principal and the State (discharging its role as a representative for the Public). Here we wish to bring home the fact that PSEs or regulators are basically public institutions where the public is the key stakeholder.
2. Government as the Principal which has delegated the regulatory function to the independent regulator which now becomes the agent. This is the first principal-agent relationship which could be seen as an adaptation of a view that Government is a 'super-Principal' in the role of licensor and policy maker (Bhattacharya and Patel, 2005)
3. The independent regulator as the Principal and the industry as a whole (including the private sector and public sector enterprise) as the Agent

4. Government as the Agent in the role of Public Sector Enterprises (PSEs)/ Publicly owned utilities

Figure 1



What entails from such a model? One key implication is that the behavior of the regulator principal (in the relationship no.3) will be modified by the constant threat of radical action by the super-principal Government (in the relationship no.2) in the face of inimical action. This may hint at the limits to the scope of a regulator's autonomy. The fact that there is a sheer absence of independent appellate bodies e.g. in the case of issues coming up before SEBI, the appeals go to the Ministry of Finance of Government of India. This shows the limits to autonomy. The second implication is related to a widely heard apprehension that the 'independent' regulator often favors the state player (PSE). As shown in the interaction of relationships no. 3 and 4, the public sector enterprises belongs to the State and hence the regulator may become lenient to these PSEs which are both at the same time its agent and its principal. But this goes against the idea that an independent and autonomous regulator has to avoid political interference and ensure level playing field between state player and the private players.

It is with respect to this second implication that we wish to locate our 'convergence question'. The question is plain and straight-forward. At the face of new circumstances and constraints in the newer marker environment, shouldn't the public sector enterprises or public utilities be benefitted by some leniency from the state and the regulator? After all, the PSE or the utility belongs to the State and the Public. Does this demand lack legitimacy? This demand arises from an ideology, fading in significance in the post-reforms era, does not trust the markets in its ability to deliver for the larger public. But it feels that State, in spite of all its deficiencies, can deliver better. In this perspective, public systems are the last resorts for the public when markets fail and the absence of a public player in a sector is often found as a disturbing void for an economy like India. Choosing to conform to this view, one looks forward for a consensus among the State, the public sector enterprises and the regulators.

Earlier we found that developing economies with widely diverse population in terms of living standards like India need to have a significant public sector and that the shrinking of the public sector should slow down. Public sector does deserve a second chance or life support before being sent to euthanasia. Then we saw that the regime of independent regulators was a response to the demand for separating political and economic decision making in the developing economies. Often also 'level playing field' arguments were employed by the private sector to effectively counter the support enjoyed by the state owned incumbent. For these new private

firms, 'independent regulators' compared to the 'regulatory state' was more approachable and trustworthy in ensuring this level playing field. This makes a thin connecting thread. The privatization drive under the tutelage of the international donor agencies led to the decline of public sector enterprises (some of which became the state owned incumbents) in most of the segments of industry including utilities and public services. In order to ensure level playing field among the new private players and the state owned incumbents in some cases and also to keep the new private players sheltered from political interference and perhaps state's excessive demands, these donor agencies stipulated the setting up of independent regulators as a necessary condition for sanctioning their reform packages.

Hence 'convergence' question, rooted in an understanding that "State shall deliver' and identifying the philosophy behind the shrinking of public sector and setting up of new independent regulators, asks for a middle ground. The 'agency theory platform' where we developed this 'convergence' question, clearly shows that both the independent regulator and the state owned entity are agents of the state/public and hence are committed to the goals of the State and achieving objectives set in view of wider public welfare. The regulator has to engage with the regulated viewing these wider state objectives. This requires a consensus among the Government, the Regulator and the PSE. So the independence of the regulator should keep a regulated private firm from political interference, but should not allow the private firm from wavering in its commitment to the State's objectives. The survival of a public sector enterprise could be viewed as such a public policy objective in the mandate of the State and the regulator. This means that we must continue to search for ways to make governments more effective, not only in their core functions, but also in their various business roles which include managing effectively their public sector enterprises, even as we search for ways to make markets more effective (Ramamurti (1999)).

The Convergence Question- Case of Financial Sector

So the convergence spoken above is about arriving at a consensus among the state, the public sector and the independent regulators. Let us bring few perspectives from the Indian Financial Sector to bring some concreteness to this idea of consensus. Reserve Bank of India as the regulator for the sector gives substantial importance to furthering of two important public policy objectives. First is the maintenance of financial stability which is key to the macroeconomic

stability of the nation given the central role that financial intermediation plays in any economy. Second public objective which has huge significance in the developing economy's context is financial inclusion, i.e. the access of their population to financial and banking opportunities. Thus financial stability and financial inclusion becomes two important objectives which the financial sector regulator in India wishes to focus on. And hence Indian financial sector becomes the potential site for understanding convergence of a need to check the shrinking public sector and look out for the possibility of a consensus. A quick survey of the Indian financial sector and review of the evolution of the banking system over the last 20 years of economic reforms as shown in Fig.1, Fig.2 and Table no.1 could show the dominance of public sector [3].

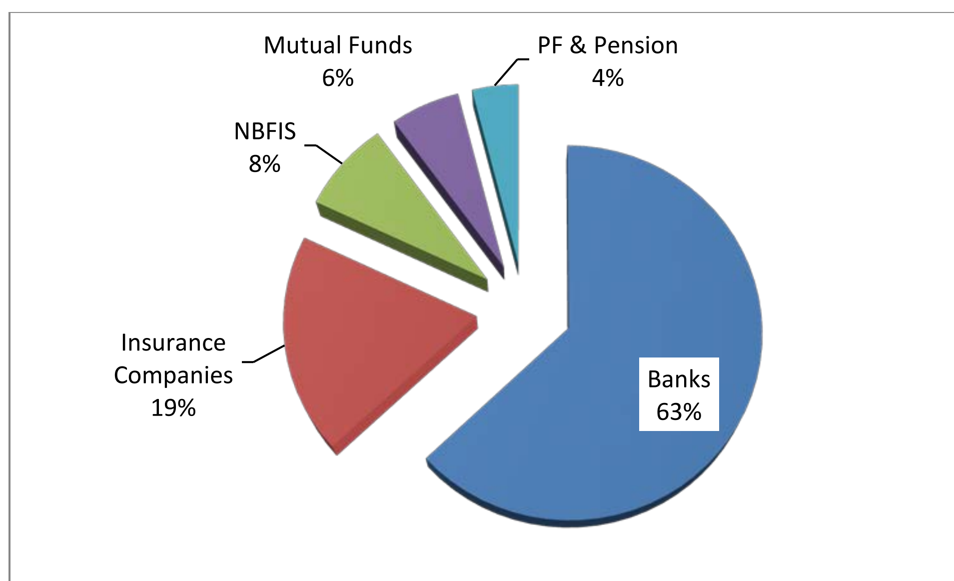


Fig 2- **Indian Financial System - Share by Asset Size – 2012**

[3]Duvvuri Subbarao- Banking Structure in India -Looking Ahead by Looking Back, RBI Governor's speeches

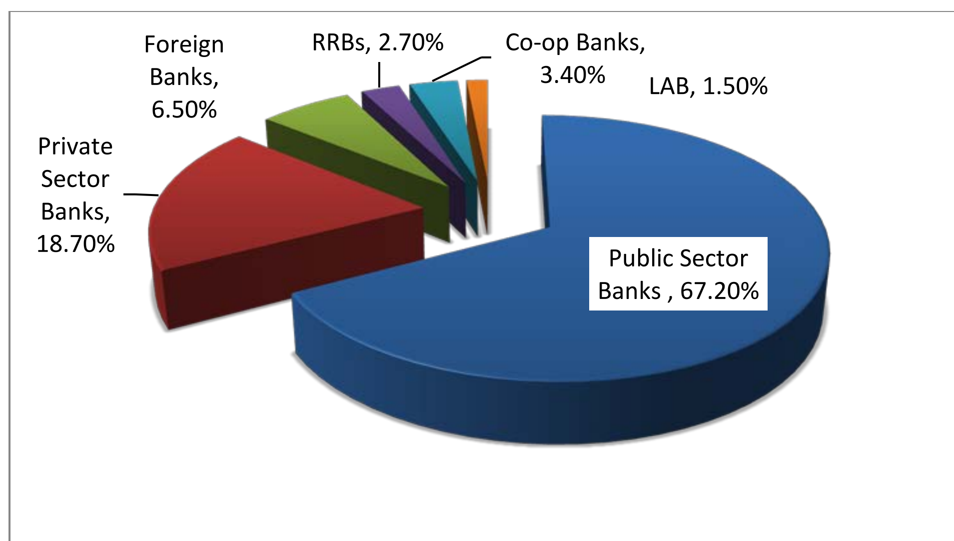


Fig 3- **Indian Banking System - Share by Asset Size – 2012**

Type of Banks	Number of Banks	Number of	Percentage Share of Number of	Market Share of Assets
Public Sector	26	67,466	83.0	72.8
Private Sector	20	13,452	16.6	20.2
Foreign Banks	41	323	0.4	7.0
Total	**87**	**81,241**	100.0	100.0

Table 1- Share in the Banking Space (source: RBI)

The banks dominate the Indian financial system and the banking system is dominated by scheduled commercial banks. More importantly, within the banking system, public sector banks (PSB) continue to dominate with 73% of market share of assets and 83% of branches. And the public sector banks have more branch presence relative to their share of assets. Also the rural and urban co-operatives banks, in spite of having a relatively small share in the system, play a key role in providing access to financial services to low and middle income households in both

rural and urban areas, given their geographic and demographic outreach. Similarly, RRBs play a key role in promoting financial inclusion. Unfolding is an evidence of effectiveness of the state-owned banks in furthering state objectives of ensuring equitable access and financial inclusion, which is one of the two key public objectives of the regulator.

But how did this scenario of public sector dominated banking come about? This has to do with the policies of bank center financial sector development and nationalization of banking sector in the 1960s. Since nationalization of 14 major commercial banks in 1969, followed by nationalization of another 6 banks in 1980, Indian banking system has expanded rapidly. The impact of these processes of nationalization is on various statistics is presented in the Table No.2 below. One could see from Table No. 2. that the number of bank offices increased from about 8,000 in 1969 to over 100,000 by 2012. The average population per branch office has sharply declined from 64,000 in 1969 to 13,000 today. Both per capita deposit and per capita credit have expanded about 600 times. Even accounting for inflation, this is significant expansion.

Statistic	Years			
	1969	1991	2007	2012
No. of Commercial Banks (incl. RRBs and LABs)	73	272	182	173
No. of Bank Offices	8,262	60,570	74,563	1,01,261
(of which) Rural and semi-urban bank offices	5,172	46,550	47,179	62,061
Population per office	64,000	14,000	15,000	13,000
Per capita Deposit of SCBs	88	2,368	23,382	51,106
Per capita Credit of SCBs	68	1,434	1,7541	39,909

Table-2- Expansion of Banking Since Nationalization (source: RBI)

The purpose of bringing up the above statistics is to clearly highlight an underplayed fact about the Indian financial sector. This is the fact that the domination of the public sector and strong public sector presence especially in the banking domain have, not done any harm to the economy, but rather played a strong supportive role in the pursuit of the state for growth with financial stability. This is in spite of the burden of non-performing assets[4].

It is in this context that one has to view the recent proposals to increase the private sector and foreign bank presence in Indian banking sector through issuing licenses for the industrial houses and inviting foreign banks to operate through the Wholly Owned Subsidiary (WOS) mode as against the earlier branch presence mode. So in February 2013, fresh guidelines for licensing of new banks were issued, inter alia permitting business/industrial houses to promote banks with a capital requirement of `5 billion (A license enables the bank to do banking and other financial services activities listed in the Banking Regulation Act). On the same lines in 2011, RBI invited foreign banks to set up WOSes through their new scheme.

RBI had permitted privatization in banking sector by taking measured steps in 1991 and 1998 as per Narasimham I and II Committees. So how should one respond to this new privatization drive, given our interest in maintaining a significant public sector presence in such key sectors? How should the independent regulator (RBI) and the State respond to it, given our objectives of financial stability and financial inclusion? The understanding is that in banking sector, private ownership brings competition, professionalism and operational efficiency while public ownership makes it easier to pursue social objectives such as mass banking, financial inclusion etc. But we already saw that PSBs dominate the banking sector in India and will continue to be dominant in the foreseeable future. However, these banks require substantial capital to support growth. The critical question is whether the Government, given its limited fiscal space, can meet the enhanced capital needs of public sector banks under the Basel III capital regulations[5]. It is in

[4] NPA burden is often alleged to have accumulated due to high political interference and the ‘loan melas’ targeting poor and farmers, but there exists a counter claim that these have a lot to do with the corporate clients who defaults much more

[5] The estimates suggest that the Indian banks will require an additional capital (on top of internal accruals) to the tune of ₹4.95 trillion; of this, non-equity capital will be of the order of over ₹3.30 trillion, while equity capital will be of the order of ₹1.65 trillion. Specific to public sector banks, the estimates suggest that public sector banks would require an additional capital to the tune of ₹4.15 trillion; of which equity capital will be of the order of ₹1.43 trillion, while non-equity capital will be of the order of ₹2.72 trillion. The Government’s contribution to the equity capital of PSBs would be of the order of ₹900 billion at the existing level of shareholding of the Government. The Government’s contribution will come down to approximately ₹660 billion if its shareholding comes down to 51%.

this context that we ask whether the Government would be able to enforce its rights and obligations as the owner of PSBs through the Board or through other means of interaction. This new proposal for privatization in banking is linked to this incapability of the Government as the owner to take care of these capital requirements. Finding resources to meet these capital adequacy requirements is, of course, an issue. But equally important is the strategic relevance of maintaining a strong public sector presence in the sector, given that PSBs have a better track record in adhering to the conditions leading to financial stability and pursuing goals of financial inclusion. Often private banks and foreign banks engage in 'cherry picking' by skimming the urban/industrial/rich segments while faring badly in inclusive and social banking. Their geographical outreach and spread in branch presence is considerably low compared to that of PSBs. Even today, India predominantly lives in its villages and small towns and is poor and still out of banking net. And access to finance is a vital pre-requisite for development and as a media of new cash transfer mode of state support to the poor. Hence maintaining and supporting the Public Sector Banks which has a better track record in social banking and financial inclusion and rewarding them for their financial discipline and aid to RBI's pursuit for financial stability during Global Financial Crises , the regulator and the State should be supportive of the PSBs . After all, the developing India still needs to prioritize rewarding a track record of furthering equity and stability objectives over being lured by promises of efficiency, given that inclusive growth with financial stability is our larger goal.

Convergence

To conclude, what is this idea of convergence? It was 'Government failure' that the public sector is not being able to deliver efficiently which led to the privatization drive. Then it was the 'market failure' which became the rationale for the setting up of regulators. Now we need to complete this cycle by bringing in mechanisms to address a possible 'regulatory capture' of this regulator by the regulated firms. What if the regulator cannot influence the regulated private firms to achieve certain social optimum set by the policy maker? Can't the public sector firms fit in this void and address this potential problem? After all, sustaining public sector firms and allowing them to function along with private firms in certain domains won't be a bad idea.

Building up public sector firms and public systems needed huge time and effort, but privatizing and selling off their assets was lot easier. And these firms were shown to be not that inefficient as market liberals argued. Thus a convergence calls for rejuvenating the public sector as much as for incentivizing the private interests through regulation.

After all, being market-friendly does not have to mean being government-unfriendly[6].

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