The incentive structure for investment in India An illustrative application of New Institutional Economics approaches

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The purpose of this paper is to illustrate how conceptions and lines of investigation developed by New Institutional Economics (NIE) may be applied to studies of the institutional framework for industrial development. It is beyond the scope of this presentation to go into any great detail. The basic idea is rather to provide a broad outline that can promote debate about the applicability of NIE approaches in the context of development studies.

The exposition concentrates on the incentive structure for investment in India. The aim is to discuss this incentive structure within the conceptual frameworks developed by adherents to the NIE, particularly Douglass C. North, Oliver E. Williamson and Harvey Liebenstein.[1] I will try to illustrate the kind of conception and mode of reasoning applied by the NIE approaches - and at the same time try to contribute to the general understanding of the Indian incentive structure.

The presentation is organised under the following headings:

1. Incentive structure for investments: General remarks
2. Institutional prerequisites for industrial development
3. The industrial approval system in India as an institution
4. Institutional obstacles to industrial development
5. Concluding remarks

1. The incentive structure for investment: General remarks

To simplify the argument let us look at investment transactions from the point of view of financial managers who consider investing

[1] See the selected list of references under the names of these authors.

in a foreign country. The basic line of reasoning applied here may also be used for national companies with certain modifications.[2]

When financial managers consider investing in a particular less industrialised country, they have to take into account that their primary responsibilities are to allocate limited financial resources among competing investment projects, and to choose the least costly methods of financing new and on-going operations.

In a wider perspective this implies that the company will make the investment only on the condition that the country concerned offers a certain minimum of advantages and politically determined incentives. In the financial managers' comparatively narrow perspective, this minimum is translated into the minimum acceptable rate of return on investment, based on considerations of capital costs and the specific risks inherent in the proposed investment. But not only that. The financial managers also have to consider the proposed investment against alternative uses of the investment funds, i.e. the opportunity costs. In other words, the minimum required will depend on conditions prevailing in the country considered as compared with conditions prevailing in other countries, where the company could alternatively place its investment.

These conditions may be referred to as the comparative incentive structure. Now, what constitutes this incentive structure? I believe there are two major components:

(1) Society-generated attractiveness

- actual and potential market size;
- the factor and resource endowment of the country;
- the relative price structure, including the prices and availability of relevantly qualified labour;
- the basic infrastructure and communications system;
- basic attitudes to work; etc.

(2) Politically or state induced incentives and disincentives

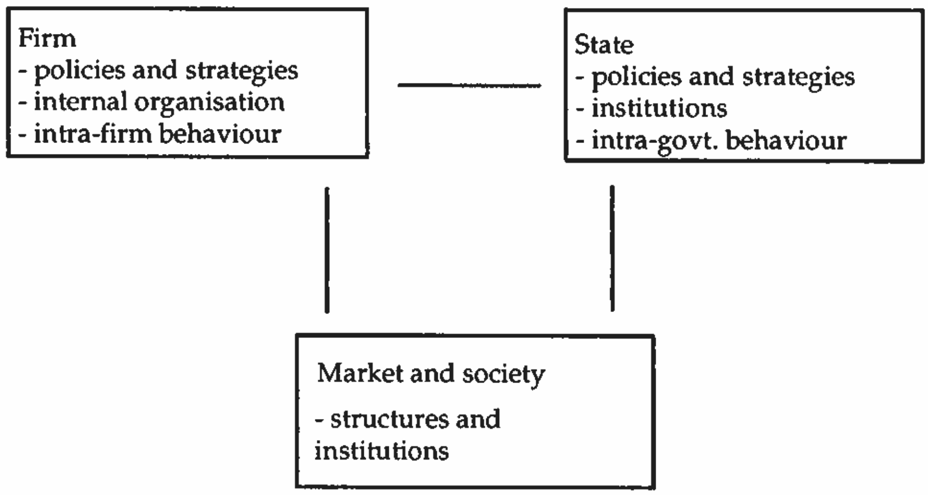
- government economic policies in general; and

[2] A more elaborate argument may be found in Martinussen (1988), Ch. 1.

- the political institutions through which these policies are being implemented.

I don't think one should waste too much time trying to draw a clear demarcation line between the two aspects of the incentive structure. The demarcation is blurred - partly because the society-generated attractiveness can be influenced in the long run by government interventions; partly because the state-induced incentive structure may be heavily influenced by traditions and institutions in the society.

In keeping with the approach of the new institutional economists we further have to take into account that the internal organisation and procedures of the firm are aspects of the overall incentive structure when considering individual transaction decisions. The following picture then emerges:



Traditional economic theory - both micro-economic and macro-economic theory - is concerned only with firm behaviour; not with behaviour inside the firm. This is exactly what some of the new institutional economists have added to the perspective and analysis. Williamson and Harvey Liebenstein are some of the well-known proponents of this approach. Their major point here is that firms do not operate internally in terms of a competitive price system (Liebenstein, p 1362). Intra-firm behaviour is not determined primarily by the market but rather by the firm's own organistional set-up and procedures. This will be considered more closely when I come to discussing the response of firms to the Indian incentive structure.

It should be added here that the behaviour inside the government bureaucracy is also not determined primarily by the market. Non-market interactions here are determined mainly by hierarchy and rules in combination with society-generated traditions and institutions.[3] Some of the new institutional economists, like J. M. Buchanan, assume that bureaucrats (and politicians) are all essentially trying to serve their own particular interests and that this self-seeking behaviour is a major reason for government inefficiency. This position, however, will not be discussed further in the present context.

2. Institutional prerequisites for industrial development

Before we take a closer look at the incentive structure prevailing in India, let me briefly summarise some of the major prerequisites for industrial development identified by Douglass North and others. They include:

* *Security of property rights*

Emphasised by North as the basic incentive structure of an economy (North, 1990, p112). Security of property rights has also been Emphasised by the OECD (1989 Report): "Without titles, people hesitate to invest and property cannot be used as collateral."(Ibid., p 16).

* *An effective and impartial judicial system*

* *A transparent regulatory framework*

Laws and regulations must be adopted after a transparent process. The mode of functioning of the state bureaucracy must be transparent. Discretionary powers must be limited by clearly stated rules and regulations and by opportunities for appeal to higher authority or the judicial system.

3 A good collection of texts dealing with the various major forms of 'coordination' - markets, hierarchies, and networks - may be found in Grahame Thompson et al.

** An institutional framework that promotes and permits complex impersonal exchange*

This includes the establishment and enforcement of contracts; the establishment of limited liability corporations; entry and exit regulations for private firms; etc.

North adds to these prerequisites some other like a fiscal system in which expenditures are tied to tax revenue; a private capital market; patent laws and other instruments to promote the growth of innovative activity; etc. He also emphasizes that the incentive structure as a whole should reduce rent-seeking behaviour.

The aim here is not to work out a comprehensive list of institutional prerequisites for industrial development, but merely to indicate the kind of reasoning applied and to point out some of the prerequisites which may not be present in sufficiently developed form in India.

It is interesting to note in this context the comparison North makes between Britain and Spain in the 16th and the 17th centuries (North, 1990, p 114 ff). Britain, of course, is the case where the prerequisites are found, while the opposite is true with respect to Spain. Now the point is that the description of Spain during that period may be applied to some extent to India during the last four decades. Let us, however, approach the whole matter from a somewhat different angle - using the Indian industrial approval system as our point of departure.

3. The industrial approval system in India as an institution

The industrial approval system was introduced in India in 1951 under the Industries (Development and Regulation) Act. The provisions of this Act made it obligatory for all manufacturing companies to obtain written permission from the Government for (a) establishing a new industrial undertaking; (b) taking up the manufacture of a new article; (c) substantially expanding the capacity of an industrial undertaking; and (d) changing the location of an existing manufacturing unit. Exemptions from these licensing provisions could be granted only to certain categories of industrial undertakings, primarily small-scale and auxiliary units.

The overall objective of the industrial licensing under the said Act was to allocate investible resources according to priorities fixed in the development plans and other policy statements. The system was supposed to ensure the appropriateness of the proposed manufacturing activities.

The industrial licensing system was combined with other controls relating to financing, capital issues, imports, foreign exchange, foreign ownership, and monopolies.

Most of these controls were abolished when the Indian Government, in July 1991, announced drastic changes in its industrial and foreign trade policies. The following paragraphs, therefore, refer to the situation as it prevailed during the four decades from 1951 to 1991.

There is no need to go into details here. What I want to stress is that the whole industrial approval system as it existed during that period may be looked at as an institution within a NIE conceptual framework. As such the industrial approval system was supposed to structure and determine repeated human interaction relating to investment decisions and investment interactions.

Two major questions arise within a NIE conceptual framework:

- How could the origin of the approval system be explained?

- How could the actual mode of functioning of the system be explained?

Let us deal with these questions in turn.

3.1. Origin

Within a NIE framework I believe that we have to search for reasons partly in the market, partly in the political system.

From the point of view of 'pure' transaction cost and information cost theories institutions are expected to emerge in order to reduce these costs. However, North very explicitly state that institutions which restrict entry may rather increase costs (North, 1990, p 63 *et passim*). If this statement is accepted, the origin of the industrial approval system in India with its several restrictions relating to both entry and exit of private firms probably cannot be explained by 'pure' cost considerations.

As a general alternative, North proposes to explain the origin of institutions which do not reduce transaction and information costs with reference to the bargaining strength of the major actors involved in the political process.

Applied to the case of the Indian industrial approval system I propose an explanation along these lines at two different levels: The first level may be referred to as the perceptions and objectives of the leading decision makers. The investigation here would imply identification of the actors who would promote and the actors who would oppose the establishment of an approval system. The second level is then where the bargaining strength of the contending actors is revealed. This could also be viewed as the relative power positions of contending socio-economic forces - but that would probably take us outside the NIE framework and more into the conceptual framework of development sociology.

(a) *Decision makers' perceptions and objectives*

From writings by the first Indian Prime Minister, Jawaharlal Nehru, it is apparent that he looked upon the market as inadequate to promote India's economic and social development. One could say that based on his assumptions about the self-seeking behaviour of individuals and firms he came to the conclusion that competition would result in waste of effort, waste of very scarce resources and skewed industrial development without backward and forward linkages within the Indian society and without the diversification and deepening of the industrial base which in his opinion were required to enhance the country's economic independence.

This line of reasoning resulted in the elaboration of the import substitution industrialisation strategy - the ISI strategy for short. This strategy aimed at accelerating industrial investment primarily for the home market through heavy reliance on government manipulation of market prices, barriers to entry and restrictions on access to imports and finance.

The particular Indian version of this ISI strategy - which was embodied in the industrial approval system - aimed at accelerating investment in general, but at the same time tried to promote the following objectives:

- to ensure industrial diversification in a national context;
- to catch up with industrialised countries in terms of technological development;
- to prevent and even reduce concentration of economic power in the private sector; and
- to promote development of small-scale industry.

(b) *The bargaining strength of contending actors*

At this second level of explanation we have to look closely at the interests and strengths of the various contending actors just after independence, when the industrial approval system was introduced. Again without going into detail, I think it would be safe to argue that:[4]

- Indian industrialists as a group favoured heavy government regulations mainly to enhance their weak competitive position *vis-à-vis* foreign controlled companies. They also needed expanding

[4] The observations following may be substantiated with reference to extensive research, including some of my own research work in India, but this is not the point in the present context.

opportunities in a domestic market protected from new foreign and Indian entrants.

- The Indian bureaucracy as a group favoured the government regulations because they would preserve and enhance their position as key decision makers who, with the approval system, would command considerable discretionary powers.

- The organised trade union movement favoured the regulatory regime mainly for ideological reasons - as part of their overall preference for government ownership and control over private ownership and control.

Combined, these actors - or social forces - held enough bargaining strength - or power - to introduce and enforce the industrial approval system. This is how, in a few statements, one could apply the line of investigation proposed by some of the new institutional economists.

Now, let us turn to the second question: How to explain the mode of functioning of the industrial approval system. This presupposes an analysis of the actual mode of functioning - of the actual impact of the system.

3.2. Mode of functioning of the industrial approval system

It should be noted at the outset that the performance and efficiency of the industrial approval system can be judged at least in three different ways:

(a) Against the stated objectives;
(b) Against theoretically defined objectives, e.g. based on a theory about prerequisites for industrial development (which may or may not coincide with the stated objectives); and
(c) In terms of the impact upon transformation and transaction costs.

It is obviously the analysis of the impact upon transformation and transaction costs which is the most central to some of the NIE approaches. This is, however, beyond the scope of the present exposition. Instead, I will confine myself to briefly summarise the conclusions that have emerged from a large number of studies regarding the performance against stated objectives.

According to these studies, the industrial approval system has functioned in the following way:

* It has contributed to industrial diversification in a national context. India has achieved a much more diversified industrial structure than previously - and in comparison with other large less industrialised societies - with indigenous control over strategically important basic industries. It has become apparent, however, that this development has been attained at unjustifiably high costs. It seems very likely that the comprehensive regulatory framework has increased both transformation and transaction costs.

* The approval system has not reduced the technology gap. It has not contributed to India's catching up with industrialised countries in terms of technological development. Actually, it may have slowed down progress in this area considerably.

* The approval system has not prevented concentration of economic power in the private sector but probably reinforced such concentration.

* And finally, the system has not promoted development of small-scale industry, but rather acted as an entry barrier for new-comers.

We cannot go into all these aspects of the approval system's performance and impact. Let us try to illustrate the NIE approach by limiting the discussion to the effects on concentration and small-scale industries.

I propose to explain the observed deviations from stated objectives with reference to the influence from other institutions and their determination of bureaucratic and intra-firm behaviour (cf. the figure above).

The industrial approval system was just one aspect of the broader incentive structure in India. As already indicated, it may be an aspect which has primarily added to the costs of transacting investment and may thus have functioned more as a disincentive. Incidentally, this would be in line with the general proposition forwarded by the 'new political economy' theorists that Indian regulations have promoted rent-seeking behaviour, rather than reduced it (cf. Toye, Ch. 6).

This may be partly a product of the approval system itself. But I do believe that the major reason should be sought not in the system itself but in the wider institutional framework within which it has been implemented. Let me explain that.

The approval system was been implemented by and through bureaucratic institutions which may be described in the following manner:

* Although separated from the rest of society by effective socialisation processes and specific rules which govern their behaviour, government officials in general remain loyal to outside social networks. They are inclined in general to favour members of their own social network. Others who do not belong to these networks have to pay extra to obtain similar favours - not necessarily in the form of simple bribes but more often in more subtle forms of reciprocal exchange of services and favours.

* The individual government official at higher levels of the hierarchy is vested with considerable discretionary powers in his discharging of administrative functions. This has increased the scope for outside influence and for discrimination based on personalistic relationships.

Essentially, the same personalistic relationships are found within the private companies. In a sense, one could say that the same society-generated and very basic social institutions have invaded and captured both the bureaucracy and the firms and thus effectively influenced the intra-bureaucracy and the intra-firm behaviour.

This, in turn, has significantly influenced the non-market transactions between bureaucrats and managers. They have tended to approach each other partly or perhaps even mainly on the basis of personalistic relationships. Managers have tried to influence government officials by appealing to their sense of commitment to outside social networks. When this has not been possible or appropriate, managers have used their command over resources to influence the discretionary decisions of government officials.

These types of relationships have benefited managers of large established firms and industrial houses. They belong to the most powerful social networks; they have had the necessary resources to support their claims for action and privilege; and they have been in a position to wait. Managers of small companies and newcomers, on the other hand, have suffered from disadvantages on all three counts.

This line of reasoning appears to provide a substantial contribution to explaining the actual functioning of the industrial approval system in favour of large established companies.

The implied kind of explanation, however, is not the invention of new institutional economics. The old institutionalist, like Gunnar Myrdal, have proposed similar explanations as have proponents of the dialectic modernisation theories, like F. G. Bailey, and scholars influenced by Marxist thinking, like Hamza Alavi and Christopher Clapham. The same applies to proponents of the 'New political economy' like A. O. Kreuger (cf. also Toye, p 120 ff.). Still, I think the NIE approaches, if applied in a stringent manner, can add further to our understanding.

Moreover, I believe that approaches like Williamson's can add new dimensions. Let me briefly indicate how.

Williamson's overall objective is to identify, for each type of transaction, the most appropriate and economical governance structure - i.e. the institutional framework within which the integrity of a transaction is decided (Williamson, p 102).

It is as a result of this exercise that Williamson has produced his comprehensive theory about economic organisation, in particular his theory about vertical integration of production within the firm.

My point in the present context is that some of Williamson's hypotheses may be used to further explain why the industrial approval system in India has promoted - rather than impeded - concentration of economic power within larger and larger industrial conglomerates. According to Williamson, vertical integration and thus expansion of the firm can be conceived of basically as a transaction cost reducing strategy. This strategy becomes particularly relevant when market transactions become more expensive. This may happen for a number of reasons. One of them is government interference with the price mechanism. The strategy also becomes more relevant when transactions become dependent upon government approval.

The incentive structure introduced by the Indian Government in 1951 and maintained for four decades comprised both these features. According to Williamson's theory, therefore, the industrial approval system has itself acted as an incentive for increased vertical integration and expansion of firm size. The 'low-trust' culture prevailing in Indian business dealings with Government has further added impetus to this vertical integration trend because increasing size could be used as a risk-aversion and risk- dispersion strategy.

Let me conclude this presentation by briefly comparing the institutional framework in India with the earlier stated hypotheses about the institutional prerequisites for industrial development.

4. Institutional obstacles to industrial development in India

* *Security of property rights*

Property rights are essentially secured in India in the narrow sense of the concept. However, the regulatory framework has interfered to such an extent with the right to make use of private property that some degree of insecurity has been added. This has not seriously affected big companies. They have been in a position to extract from government all the necessary approvals - or they have simply circumvented rules and regulations (cf. Martinussen, p 84 f.). But the insecurity has affected small companies and investors trying to set up new undertakings.

** An effective and impartial judicial system*

The Indian judicial system may be characterised as impartial, but certainly not as effective. Enforcement of contracts, in particular, is very poor and extremely slow.

** A transparent regulatory framework*

The mode of functioning of the state bureaucracy in India is not transparent. Discretionary powers are not limited by clearly stated rules and regulations and by opportunities for appeal to higher authority or the judicial system.

** An institutional framework that promotes and permits complex impersonal exchange*

As we have seen, the industrial approval system was to such an extent embedded in societal institutions which prescribed personalistic relationships that this prerequisite remained absent. Further, the incentive structure as a whole did not reduce rent-seeking behaviour but rather promoted such behaviour within networks of interaction characterised by personalistic relationships.

5. Concluding remarks

This very brief and sketchy presentation of NIE approaches as they could be applied in an Indian context, to investigate the incentive structure for industrial investment, should be seen as only an appetizer. I think some of the concepts and some of the approaches developed by new institutional economics can be applied fruitfully in a Third World context when studying institutions and other societal phenomena at a level between micro phenomena and human behaviour and macro level structures. This is not substantiated in the above presentation. But I do hope that I have managed to show that it may be worth while trying to find out more about the applicability of NIE approaches within development studies.

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