

Leveraging Economic Growth Through Better Regulation

Introduction

The recent financial meltdown and the global recession have highlighted the inability of markets to function on their own. The recently highlighted logic for regulation of financial markets can also be brought to bear on infrastructure sectors to yield sound policy advice. The important lessons that can be gleaned from the recent recession are: it is important to have fair competition, not totally free competition; it is equally important to have appropriate market correcting regulation, not over or under regulation.

Given that the regulatory apparatus is a necessary and important component of the system of economic governance in any country, it is important to evaluate its features: its adequacy as provided by law, effectiveness after being set up, awareness of consumers and other stakeholder groups about its availability and usefulness and their perceptions about regulatory effectiveness. The series on *Competition and Regulation in India*, serves the mentioned purpose for the Indian economy. The first report in this series, released in 2007, lay down the rationale for a holistic competition policy and law regime in India and elaborated on anti-competitive practices hampering the functioning of the economy as well as

needed remedial action. For the first time, an attempt was made to assess the awareness, knowledge and perceptions of Indian stakeholders about competition and regulatory issues.

The second report in the mentioned series, *Competition and Regulation in India, 2009* focuses on the evaluation of quality of regulation (Box 1) in five sectors:

- Power;
- Ports;
- Higher Education;
- Agricultural Markets; and
- Civil Aviation.

Transition from the 2007 to 2009 Report

The 2007 Report accomplished a lot for a single volume. But uncovered ground still remained. Competition law and policy which was the principal focus of this report is only one component of the regulatory structure that binds the functioning of the economy. Equally important are sector regulators – individual sectors have their own technological characteristics (existence of a natural monopoly, the structure of a network industry, propensity to generate asymmetries of information etc.) which, in turn, determine the nature of regulation. The second report makes sector regulation its primary focus. It also goes much beyond depicting the state of the world in sectors and tries to pinpoint the institutional and other root causes of that state.

The state of each sector and its regulation is determined by the state of the economy (average level of affluence, income distribution etc.) and polity – in short, political economy issues. Such political economy issues not only determine the content of regulations on paper but also their implementation. Political economy and implementation issues thus form an important part of the 2009 report.

As was the case for the 2007 report, the results of a perception survey were also included in the 2009 report. But the scope of this survey far exceeded that of the previous one. Not only was the awareness of people

Box 1: The Quality of Regulation – Key Attributes

- It should be appropriate as both under and over regulation are dangerous, i.e. regulation without market failures or its absence in the presence of market failures might be harmful for the economy and impede economic growth.
- Successful implementation of regulation requires financial and functional autonomy of the regulator (which, in turn, depends on security of tenure of members, a mature political system as revealed by an arm's length distance between the line ministry and the regulator, earmarked sources of funds for the regulator etc.) as well as effective coordination and delineation of functions among sector regulators and competition agencies.
- The pro-competitive nature of regulations.

about competition and regulatory issues gauged and their opinion about the state of competition in India elicited, a separate section summarising their views about the state of regulation and needed remedial action was also included. The results for perception and awareness relating to the state of competition, when compared across the two reports, show a significant improvement over time.

To summarise, the 2009 report tries to examine the evolution of regulation/regulatory problems from a political economy perspective and assess the quality of regulation in terms of the suitability of content for tackling market failures, the effectiveness and independence of the regulator and the extent to which the set of sector regulations fosters competition.

Policy Recommendations: Sector Specific

Higher Education

It was found that the higher education sector is beset by major problems. There are problems of quality – higher education being offered is of mediocre or poor quality with the exception of a few institutes such as the IITs and IIMs. There are imbalances in demand and supply – a large army of graduates in non-technical areas faced with scarcity of employment opportunities co-existing with excess demand for technical skills despite the spurt in vocational education.

There are problems relating to competition – government offering subsidies to select institutions coupled with fee control for all violates the principle of competitive neutrality – as a level playing field, where private educational institutes can compete with government supported ones, does not exist. This limits competition by restricting private entry and reduces quality of education. The situation has been exacerbated by restrictions placed on foreign players in terms of fees charged and the content of syllabi. This has discouraged foreign entry into the Indian higher education sector.

The study feels that opportunities for profit making and reinvestment of surpluses coupled with quality checks would enhance both the quality and quantity of education supplied. The study also points to two important sets of factors impeding progress: political economy problems and those of regulatory design.

In regard to political economy, while government patronage is often necessary for the development of higher education because of the considerable externalities characterising this sector, the role of politicians and bureaucrats in the evolution of this sector has been far from positive.

In regard to regulatory design, there has been considerable overregulation of ‘whom educational institutions can teach’, the content and quality of their syllabi and fees charged. On the other hand, there has

been an under regulation of teachers, teaching and research.

In short, the study concludes that there is a need to undertake a complete overhaul of the regulatory regime to facilitate both autonomy and clarity in its mandate.

Box 2: Key Recommendations

- To dismantle regulations that deter entry into the sector and reduce flexibility in curricula.
- To introduce a strong accent on accreditation and regulation of quality.
- To ensure strict adherence to the principles of competitive neutrality.
- To liberalise fee control and recognise the right of educational institutions to make profits.

Power Sector

Power is often considered a core infrastructure component as well as a driver of rapid economic growth. The current availability of power in any country provides an idea about its economic prospects in the near future (say next five-six years) in terms of growth, employment, industrialisation, urbanisation etc. Therefore, most developing countries are taking steps to add to their electricity generation capacity not only to fulfil present requirements but also sustain future economic growth.

Lack of competition still continues to hamper the growth of this sector. The objective of introducing competition into generation and distribution segments has often been frustrated because of several reasons. First, the poor financial position of distributing state companies often deters private entry into generation as payments for energy sales are considered insecure. Second, open access to the common carrier for all industry players is often not available and deters competition. Though the Electricity Act, 2003 requires the Electricity Regulatory Commissions (ERCs) to facilitate open access, implementation till date has been poor.

The study also points out gross inadequacies in regulatory autonomy on the ground. The Electricity Act 2003 requires constitution of an independent committee for the selection of regulators (through a stipulated process within a stated period of time) and grants members immunity from removal except in the case of proven misconduct. However, such provisions are often flouted: vacancies continue to exist indefinitely and politically motivated appointments to the ERCs are common. Merit is given the short shrift.

The lack of financial autonomy of ERCs also prevents their independent functioning as most of these have not utilised the right provided by the Electricity Act, 2003 to raise revenues through levy of license fees, regulation fees etc. Capacity building is consequently adversely affected.

Lack of regulatory autonomy has adverse implications for regulatory quality: Though the national tariff policy requires regulators to fix tariffs on the basis of sound economic principles such as efficiency and elimination of cross subsidies, there has been very little progress in tariff rationalisation due to political pressures.

Box 3: Key Recommendations

- Civil society, which has been empowered by the Electricity Act, 2003, should play a more important role in regulation to prevent regulatory capture.
- ERCs should make use of provisions for financial autonomy to leverage functional autonomy.
- The appointment of regulators should be neutral and based on merit.
- Competition in distribution and generation should be facilitated respectively through open access to the common carrier and access to fuel markets. The state should withdraw totally from tariff policy to prevent its manipulation for political purposes.

Agricultural Markets in India

Agricultural markets in India are characterised by fragmentation and the presence of long chains of intermediaries linking the farmer to the ultimate consumer. Moreover, fragmentation provides a bargaining advantage to buyers/traders of produce who extract surpluses from sellers/producers because of their advantageous positions. The actual producer, the farmer thus gets only a small proportion of the expenditure incurred by the consumer. This implies that he is often pegged back to a subsistence level of revenues. Reinvestment into agricultural activities is poor and therefore technological dynamism is lacking.

Quite obviously regulation can play a remedial role in this regard by facilitating competition and regulating middlemen. Better infrastructure and information flows can also bring about better integration of hitherto fragmented markets. This should result in higher prices at the farm gate which in turn can bolster the income levels of farmers and farm investment.

Regulation of agricultural markets is governed by the Agriculture Produce Marketing Committee (APMC) Acts.

Box 4: Key Recommendations

- It is essential to remove the restriction on mandatory selling and buying in regulated markets. Instead regulated and unregulated markets should be allowed to co-exist.
- Farmers should be provided with information about alternative options to sell.
- Improvements in physical infrastructure need to be rung in to give farmers quick and easy access to several markets.
- Farmers should be given the option of postponement of sales after harvest through provision of warehouse facilities and facilitation of credit.

The basic objective of these acts was to provide fair competition through mandatory auctions of produce in regulated markets. However, implementation has left a lot to be desired though these acts have conferred some benefits on the seller through the use of accurate weights and scales, a fair dispute settlement mechanism, better storage facilities and reduction of levies. Traders have to buy licenses in order to trade in regulated markets, a fact which limits their number and therefore competition for farm produce.

Ports

All Major Ports are administered by an autonomous body called Tariff Authority for Major Ports (TAMP) constituted in 1997 while minor ports are administered by the state maritime boards. TAMP regulates both vessel and cargo related tariffs and stipulates conditions governing application of such rates. Usually cost plus methods, which do not provide enough incentives for efficiency improvements, are used to fix tariffs.

In view of the growing importance of ports as a medium for container trade and increasing globalisation of the Indian economy, there is a need to have a unified authority to regulate all Major and Minor Ports in the coastal region of the country and also Dry Ports (such as Inland Container Depots and Container Freight Stations) to facilitate efficient multimodal transportation in the country.

Regulation should ensure a proper balance between long-term public responsibilities (safety, environmental protection etc.) and normal shorter-term business objectives, and promote competition. Competitive neutrality has to be enhanced. A level field for all players – government, private domestic and foreign, both in the port as well as the associated shipping sector – is needed to raise efficiency levels.

Box 5: Key Recommendations

- There should be a greater homogenisation of tariff and other regulation across the various Major and Minor ports in the country; at present uniformity is lacking as the 187 Minor Ports in the country are regulated by individual state maritime boards.
- TAMP needs to shift from cost plus norms to normative methods for fixation of tariff ceilings in a bid to encourage efficiency.
- There is a need for greater autonomy of TAMP as the employment conditions of officials/members are currently controlled by the government.
- There should be a level field for all relevant players in the port as well as associated shipping sectors.

Civil Aviation

With the termination of government monopoly in the airline sector and its opening up to private competition, certain positive changes have been noticed: increase in passenger traffic and reduction in fares.

However, the competition generated has been marked by various imperfections. While traffic on profitable popular routes has increased considerably that on less profitable routes has contracted. Government airlines still continue to be associated with staff strength completely out of proportion to fleet size, i.e. these have not responded adequately to competition from private airlines.

Private operators have taken advantage of lax competitive response from government airlines by fixing their tariffs just below government tariffs for equivalent service or by providing slightly better quality of service for the same tariff. Casual empiricism seems to indicate that competition has failed to maximise efficiency and minimise costs in this sector.

Important regulatory changes are in the offing with the passing of the Airport Economic Regulatory Authority (AERA) Bill which has set up an AERA. However, the accent on inclusion of retired government servants in the regulatory authority and significant powers provided to the Central Government to remove AERA's members from office implies that in reality such autonomy would be absent.

Box 6: Key Recommendations

- Institution of a comprehensive regulatory/policy framework that stimulates cost cutting, price reducing and quality enhancing competition through an integrated coverage of aviation and airport infrastructure issues.
- Rationalisation of pricing of Air Turbine Fuel.
- A careful look at the costs and benefits of entry of foreign carriers into domestic aviation.
- Multi-airport approach for large urban areas which can accommodate competition among airports.

Conclusion

The 2007 Report was focussed almost entirely on the state of competition in the economy. Evolution of competition law and policy in the Indian economy was studied and recommendations were made for the future, taking into account the strengths and weaknesses of the economy and past history, particularly with regard to anti-competitive practices. However, the focus of the 2009 report was on sector regulation in due recognition of the important role played by such regulation in maximising economic welfare in concert with competition law and policy. The common thread between the two reports was the activity of undertaking perception surveys. A

comparison of survey findings reveals an improvement over time in the stakeholder awareness of competition and regulatory issues as well as their perception of the regulatory climate in the Indian economy.

In general, there is a consensus among the findings/ recommendations made by the sector studies and those expressed through the perception survey. For example, in agriculture, license requirements for traders were considered by both the study experts and stakeholders as competition reducing. In ports, the experts and stakeholders both favoured the creation of an umbrella regulator. Excessive subsidy to certain groups in the supply of power was again criticised by both and also considered an impediment to the expansion of private capacity. In higher education, loans for needy students were advocated by the sector study as well as the stakeholders as a means to balance access, quality and cost. This consensus in the recommendations and views expressed through sector studies and surveys reinforce our belief in the usefulness of both.

To summarise, the quality of regulation is seen as varying a lot from sector to sector by this study. Thus, some sectors like civil aviation, ports and power have made some headway in modernising regulation while others like higher education and agricultural markets lag behind. Though so called 'independent regulators' have been established in all mentioned sectors barring the last, in reality functional and financial autonomy in regulation are lacking in all of these.

The task accomplished by the two volumes in the *Competition and Regulation in India* series has been considerable; however, the unexplored terrain still remains vast. Many sectors remain unexplored – petroleum and natural gas, coal etc. While the volumes researched thus far have concentrated on infrastructure sectors, it has to be recognised that other elements of the economy have to be nurtured as well to support the development of infrastructure. Two issues which deserve special attention, as highlighted by recent events, are corporate governance and financial regulation.

There is also substantial scope in future volumes to explore research methods pertaining to competition and regulation that remain unused in the Indian context as well as new methods of collaboration between private and public parties.

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