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Governance and Development: A Comparative Economic Organization Approach

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Abstract

Governance of economic and political activities both by private and public institutions is an important source of economic development apart from the conventional sources such as technological progress, capital accumulation and endowment of resources of a nation. China and India are the two largest emerging economies with different governance mechanisms of political communism, democracy and capitalism. China has been able to achieve extraordinary economic growth rates since 1980 under communism while India's growth has been under complex democratic institutions. This paper develops a simple theoretical framework of comparative governance and applies it qualitatively to China briefly and India in detail.

Key Words: New institutional economics; transaction and information costs; governance; development; China and India

1. Introduction

By the year 2018 China and India are two fastest growing large economies with contrasting political and economic systems. In 1979, China's Deng adopted free market mechanism and openness to international trade and investment retaining political system of totalitarian rule of communist party for augmenting economic growth rates with great success of achieving annual growth rate of about 8 per cent for forty years. On the other hand, India remained a democracy but adopting Fabian socialist policies until 1991 with an average growth rate of 3 percent since its independence. India initiated economic reforms in 1991 which increased annual growth rates.

This paper examines governance and development through comparative economic organization of the new institutional economics (Williamson, 1985) with focus on functioning of government organizations. The job of governments is basically provision of the rule of law, regulation, and provision of public goods. Improving governance can be considered as reducing transaction and information costs in these spheres. The rules of the game in provision of the service are defined by formal institutions of constitution protected by an independent judiciary. Enforcement of the rules of the game through governance involves organizational arrangements, hierarchy and associated bureaucracy, delegation and moral hazard outcomes, incentives and penalties, effectiveness of judiciary, team work and free rider outcomes, dealing with numerous ways of informational imperfections and so on. Owing to these numerous factors, we do not have a theory of optimal institutions and governance. At best we can compare across countries and historically in evaluating the relative efficiency of governance which can be a bench mark for reforming governance in a comparative economic organization way (Williamson, 1991). Institutional change can take place if one of the elements are changed which triggers other changes. For example, the governments' efforts at improving literacy has large scale effect of reducing informational imperfections. When societies are trapped in 'prisoners' dilemma' of social norms, exogenous shocks can break the feudal norms and bring in positive or negative changes.

The logic of comparative economic organization is drawn from the insights of the New Institutional Economics which emphasizes importance of transaction and information costs in functioning of a market economy (Coase, 1937; Williamson, 1985; North, 1990; Stiglitz and Weiss, 1981; Akerlof, 1970; Spence, 1976; Dixit, 2003). According to Williamson's logic of economic organization (governance) economic actors choose markets versus organization of economic activity within the boundaries of firms and public bureaus in response to extent and dimensions of transaction costs. In a market economy, allocation and utilization of resources depend both on market signals and hierarchy of organization. Transaction and information costs are determined by institutional environment. The institutional environment deals with formal and informal institutions. Formal institutions are the constitution, the legal system, judiciary, polity, and property and contract rights. Informal institutions are the embedded conditions of customs, traditions and norms. North makes a distinction between forms and substance. Forms (organizations) can be engineered or copied from other countries, but the implementation of the rules depends on embedded norms which evolve over a period of time.

In this paper, our concern is the governance of the government implementing the rules of game, the rule of law and provision of public goods. While firms' objective is maximization of profits, the government's objective is to maximize welfare of the public. Improvement in governance should result in increase in welfare.

Coase (1960) theorem shows that in the presence of zero transaction costs there is no need for government intervention in defining and enforcing property rights. Private agents can get into collective bargaining for efficient utilization of scarce resources. Several economists misinterpreted Coase that he argued for no government intervention even for such a basic feature of property rights. In contrast, transaction costs are real and pervasive in an economy. Government intervention is necessary for enforcing property rights and regulation when total transaction costs of a group of private agents' collective bargaining among themselves is higher than those of the government. Private agents act autonomously or as a group. If a large number of private agents act autonomously, the sum of average transaction and information costs of markets is higher than if one large agent pools these costs and realizes economies of scale. The government performs this job: the tax collected from each agent could be lower than the average information and transaction costs of private agents. On the other hand, in countries such as India the government might have ended up imposing high transaction and information costs on private actors such that the government and powerful private agents could derive rents.

History shows that countries that had strong states in defining and enforcing the rules of the game effectively and minimizing state capture by powerful agents were able to achieve economic progress (North, 1989&1990; Olson, 1965 & 1982; Acemoglu and Robinson, 2012). The US became a superpower in the early part of the last century because the state with a broadly defined constitution of federal democracy, was able to provide the rule of the law, regulations, and public goods, provision of free and universal primary and secondary education, and land grant universities, National Science Foundation and institutional conditions for innovation. In the case of Russia, after the communist revolution in 1917, it transformed itself from an agrarian system to rapid industrialization and the Russian economy was immune to the Great Depression of the 1930s. After the Second World War, Russia had universal basic and higher education and technological achievements in space and military technology and a large resource base. However, the state (the communist party) destroyed individual incentives. The main stream economists including those on mechanism design attribute the subsequent decline of the Russian economy to inability of the centralized planning system to coordinate economic activity (Hayek, 1945). At the time of the late 1980s, when the Russian communist party under Gorbachev decided to implement economic reforms towards a market economy under the World Bank and IMF structural adjustment policies, Russia had hundred per cent literacy, some of the best technical manpower in the world, a large industrial and natural resource base. The structural adjustment and stabilization policies resulted in disastrous outcomes of its economy collapsing because of absence of basic institutions of capitalism. The powerful communist party members confiscated most of the public sector assets and there was emergence of mafia in enforcing property rights. The Russian economy despite having rich endowment of resources and human capital still struggles because of inefficient governance. Similar is the case of several nations in the African continent.[1]

Olson (1982) and Acemoglu and Robinson (2012) show that nations decline when a few powerful groups could get into effective collective action by restraining free riding within the group. These groups derive rents at the cost of diffused groups.

China presents a unique case of combining political communism with elements of capitalism since the late 1970's. On one hand, the state (Communist Party) yields extraordinary powers at the center and at the same time there is a degree of decentralization of townships and village enterprises. By combining political dictatorship with elements of capitalism, it has been able to achieve high

[1] Dixit (2003) observes that countries in Africa and Eastern Europe differ in the level of economic development and in endowments of market, political, and legal institutions. For example, in several countries in Asia, Africa, and Latin America, informational imperfections arise in contractual formulations and enforcement because of poor administration and in service enforcement because of low levels of education, technology and communication infrastructure. In the case of the transition economies of the former USSR, education levels and physical infrastructure endowments are high but the capitalist institutions such as property rights are underdeveloped.

growth rate and lifted about 600 million people out of poverty. The other large developing economy India has been a federal democracy with independent judiciary since its independence from the British in 1947. Although the government imposed several commands and controls on economic activity (Mohan and Agarwal, 1990) for developmental goals, there has been a thriving private sector with well-defined property rights system and independent judiciary. The institutional change and associated improvements in governance are a result of inter-play of political interactions between different groups; some are powerful small groups and others are the dispersed public and electorates.

In the 2014 general elections of India, prime ministerial candidate Narendra Modi of the Bharatiya Janata Party (BJP) campaigned for his candidature with the main theme of: 'Maximum governance with minimum government'. Subsequently, he was elected prime minister with majority in the parliament. [2] Improvement in governance is expected to reduce transaction and information costs of business and promote growth and employment to millions of young people coming to workforce every year. The outcome of 2014 general elections was a result of powerful industrialists, middle-class and poor demanding improvements in governance in reducing corruption and generate employment for large number of young people coming into the workforce every year (Chibber and Verma, 2014).[3]

In this paper, I develop a simple theoretical framework of governance drawing from the new institutional economics in the following section. In section 3, I bring forth qualitative empirics with the case of China and India and at micro-level I will study functioning of government bodies in India in provision of rule of law, provision of public goods. I draw from the past about the governance failures or successes and their implications for the improvement of governance in the future. This is because we do not have a theory of optimal governance. Efficiency of governance should be examined in comparative economic organization of bench marking from history and across countries (Williamson, 1991).

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[2] The share of the BJP vote in the 2014 Lok Sabha election was approx. 31%. A "plurality," yes but hardly a clear majority, although the number of seats is exaggerated by India's single-party district system.

[3] Chibber and Verma observe that the BJP, despite its image of a Hindu party, stitched together an unprecedented coalition of social groups- upper castes and other backward classes, scheduled tribes and scheduled castes.

2. Theoretical Framework

Hayek (1945) posed the problem of optimal use of information dispersed across individuals. In decentralized frictionless markets, prices solve this problem by transmitting relative scarcity and productivity of resources in an economy. This approach to free markets assumes zero transaction costs and no informational asymmetries and imperfections. As mentioned before, transaction and information costs are real and pervasive in an economy.

In this context, the governance issue is reducing transaction and information costs and asymmetries for efficient functioning of the market. Efficiency of markets would not reflect Pareto efficiency because of transaction and information costs. The government and private actors have to make governance mechanisms to reduce them as much as possible. Pareto optimality conditions also will not be met because government has to play distributional role of providing basic social security, universal free primary and secondary education and health to the public. Provision of these services involves transaction and information costs.

It is important to note that all types of transaction and information costs are not detrimental to relative efficiency of economic activity. As an economy develops, specialized intermediaries and new markets emerge. This, in turn, increases transaction and information costs of formulating and executing contracts. If the total economies of specialization (division of labor) are higher than the total transaction and information costs, these are beneficial to the economy. In other words, if reforms benefit economic efficiency, average transaction costs go down.

Coase (1937) who laid the basic foundation of organization economics argued that market mechanism is subject to the friction of transaction costs of search, formulating and executing contracts. Owing to transaction costs, a firm as an organization comes into existence to economize on transaction costs of markets. The firm internalizes economic activity until marginal internal bureaucratic costs of hierarchy are equal to the marginal transaction costs of the market (boundaries of the firm). Once the economic activity is internalized, it is hierarchy that governs resource allocation, but not strictly price mechanism. In other words, in capitalism both the price mechanism and organizations (private and public governance) play a role in efficient utilization and allocation of resources.

Williamson (1985&1991) conceptualized different elements of transaction costs through the lens of incomplete contracts. Transactions costs are in terms of frequency, uncertainty and asset specificity. The behavioral assumptions are bounded rationality and opportunism. Opportunistic behavior is conceptualized in terms of self-interest with guile. At the *ex ante* stage of a contract, the market is competitive. Once two agents get into a contract, it becomes a bilateral monopoly. Guile implies that when contracts are incomplete, agents renege on their promises when the environment changes or when one realizes that the other party has invested in assets specific to the contract. Williamson's behavioral assumption of opportunistic behavior does not mean that all agents are opportunistic. If one or few powerful agents (or groups), both private and government behave opportunistically, a large section of the public pays the price. Several financial crises, insider trading in capital markets, and large ticket corruption by government agents are some of the examples. The 2008 financial crisis of the US is a good example of Wall Street bankers generating asymmetric and imperfect information and the mortgage bubble (Stiglitz, 2012). Extending this logic (of incomplete contracts and safeguards) a country has to generate institutional arrangements such that they prevent and penalize opportunistic behavior of private and public agents at a broader level.

The differential dimensions of transaction costs determine the choice of governance structures; markets, hierarchy (internalization of economic activity within the firm), hybrids (such as franchisees) and public bureaus. For investments with high degree of asset specificity, the preferable governance is integration. The alignment of property rights and their enforcement by government agencies or by private ordering (groups) is determined by transaction costs. Williamson explains boundaries of firms and the associated mechanisms of governance. This can be extended to the government.

The concepts of uncertainty, frequency and asset specificity are relevant to governance of the government and its effect on economic efficiency. High degree of uncertainty in terms of frequent changes in the policies discourages investments in durable assets. A governance framework that requires frequent exchanges with the governance bodies increases transaction costs. In several instances, the government has to get into contracts with private agents for example in provision of public goods. If these provisions have natural monopoly property, the private agents have to invest in asset-specific investments which could result in hold-up and opportunistic behavior by both private and government agents. In order to avoid these outcomes, the government and private agents have to invest in comprehensive contractual safeguards that can be protected by the judiciary. This requires efficient functioning of the judiciary in settling disputes. High costs of contractual safeguards result in inefficient governance mechanism.

NIE forms the link between institutional environment and institutions of governance (Williamson, 1991). The institutional environment implies the formal and informal rules such as the constitution, norms and traditions. The institutional environment determines the extent and different dimensions of transaction costs which, in turn, determine the governance mechanisms. North (1989&1990) focused on evolution of institutional environment of capitalism in the Western countries. He observes that institutions are “the humanly devised constraints that structure political, economic, and social interactions. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitution, laws, and property rights).” In this schema, a fine line between individual incentives and constraints for collective good determines economic development. There is no theory for this fine line. As mentioned before, this has to be evaluated in a comparative economic organization way.

As mentioned before, the institutional environment determines the rules of the game. The effective implementation of the rules depends on both the formal structures of the government and also embedded norms and customs. The play of the game is economic organization of contracts and governance structures; mostly of managing transaction costs and seeing economic activity through to completion (Williamson, 1991). The inter-play of these factors determines the institutional evolution. Institutional environment changes gradually and also suddenly owing to political and economic crises and shocks. The reforms of China in 1978 could be treated as a response to large-scale costs of the cultural revolution of the 1970s. In India’s case, the 1991 major market reforms were made possible because of the balance of payments crisis. The subsequent reforms depend on how fast the positive gains of the reforms are realized and who are the sections that derive the benefits and their political power. This is determined by the initial conditions at the time of the reforms.

Institutions have to provide a degree of certainty with low transaction costs for economic agents to participate in market exchange and undertake productive investments. Flexibility aspect refers to ability of institutions to change in response to exogenous influences and endogenous effects of technological and market change dynamics (Davies, 2010). Institutions have to change with changing moral landscape (for example, the effect of abolition of slavery on property rights and the US economy), market dynamics (for example, emergence of complex financial derivatives) and technology (for example, the implications of the internet on governance of transaction and informational costs). When the institutional environment changes, governance mechanisms change which, in turn, change the rules of the game. For example, if institutional environment improves property rights and contract laws, the need for incorporating exhaustive contractual safeguards decreases and thereby increases economic efficiency.

The basic argument of information economics is informational imperfections and asymmetries in an economy are pervasive: credit and capital markets, labor markets, product markets, insurance markets, contracts and the government regulation and provision of public goods. The common thread of Williamson's work and informational economics is the arguments regarding incomplete contracts. As mentioned before, in the case of autonomous agents' interactions in exchange, contracts are not pertinent, but information and transaction costs are relevant: for example, informational imperfections between large number of producers and consumers and large number of small investors in the stock markets.

Informational asymmetries between economic agents result in one agent reaping rents from agents with no or little information. For example, what is the real value of the product he/she would like to sell? Imperfect information also results in 'adverse selection' of good quality agents not participating in the market. Examples are rural credit markets, insurance markets and markets with differentiated quality products (Akerlof, 1970). One way the adverse selection outcome can be avoided is by incurring costs of signaling quality of the product (Spence, 1976). However, these costs could be high for single or small agents in the market. This is where the governance issue of reducing informational imperfections becomes relevant starting from investing in primary and secondary education to the masses, transparency of the rules and government contracts, making the public aware of their rights and obligations, generating institutions that help private agents to acquire certification of their skills, and products and nurturing civic societies. When corporations internalize economic activity to overcome market transaction and information costs it results in increase in boundaries of the firms, consequent overload of information at the top and associated bureaucratic costs. One of the ways of dealing with this is decentralizing governance within the firm (*M-form* organization, Williamson, 1985). It has implications on governance in general in terms of decentralization of government agencies for achieving higher degree of efficiency and accountability of implementing the rules and provision of public goods.

Social choice theory (Arrow, 1951) shows that it is not possible for collective action-based rules to reflect diverse individual preferences perfectly. One of the ways of reducing these outcomes is decentralization. Collective rules based on decentralization of governance tend to have high probability of degree of individuals' preferences to reflect in collective action rules. Decentralization of the government agencies, combined with reduction in informational imperfections, increases interaction between government agents and the public and increases accountability of the government agents. Decentralization of governance could contribute to economic development. There could be a two-way relation between decentralization and governance. Decentralization improves governance and improvement in development indices such as literacy and awareness further improve governance as the public will become increasingly aware of their rights and obligations.

Corruption

Corruption is a major issue of governance. Corruption is generally defined as "misuse of public office" to extract an illegal rent. The sources can be traced to scarcity, property rights and their enforcement, transaction costs and information asymmetries, and political position (Patibandla, 2013). One can approach corruption from the demand and supply framework (Dixit, 2015). Demand for corruption is from the public offices such as legislature, executive, bureaucracy and judiciary. Supply comes from the public. The public could be autonomous agents and collusive groups.

The equilibrium price of the bribe is such that if a government agent demands a high bribe total amount of bribe goes down. To give a simple example, when a private producer pays a bribe, she/he will pass it onto the public which means the demand for the output goes down. In extreme cases, the producer may not undertake the investment. With the same logic, if economy grows, the price and total amount of bribes increase. For example, as the Indian economy's growth rate increased in the early 2000s, there were big stake corruption scandals worth billions of rupees. However, subsequently the growth rate declined. It was attributed to the corruption arising out of the lack of procedural transparency and regulatory predictability owing to missing institutions which discourage investments in durable assets.

In the case of scarcity, an example is the industrial licensing policies in the past in India which created monopolies restricting output at monopoly price levels. India's well-developed property laws are blunted by transaction costs, unacceptable delay and corruption in securing settlements. Informational imperfections operate at several levels such as tax evasion, insider trading by managers of public limited companies, and an illiterate poor person's ability to avail public goods such as the ration cards. A government agent could impose a transaction costs in providing public goods (ration cards, driver's license, etc.) such that it is equivalent or slightly less than the opportunity costs of the private agent, such that he/she pays the bribe. Political position as a source of corruption can arise if rules of the game are vaguely defined, distributional politics, and collusion between opposing political parties on certain issues which are of mutual self-interest but detrimental to the public interest. An example from India is the political parties (both the ruling and opposition parties) not implementing police and judicial reforms. A convicted politician can come out of prison on bail. The settlement of the case takes years because of the judicial process and shortage of courts and judges in India.

The organization of the government bodies determines corruption in the different layers; at the top, the middle and the bottom. A private agent may have to pay bribes at all the layers. If paying bribes clears the project fast, it can be termed as efficient corruption (Bardhan, 1997). However, even after paying bribes if the project clearance involves long delays, it is detrimental to efficiency. Even if the ruler (the executive) wants to improve governance to reduce corruption it is likely bureaucrats could distort information to gain maximum rents.

The extent of corruption depends on the discouraging and monitoring elements of governance. Discouraging incentives are that the marginal cost of taking a bribe is higher or equal to marginal price of the bribe. If the expected gains of corruption are high and the expected costs are low, it encourages corruption (Debroy and Bhandari, 2011). This takes place if government controls the investigating agencies. The trade-offs are benefits of decentralization and increase in the different layers through decentralization. Giving greater powers to states in a federal democracy in making decisions in clearances of projects, it is possible it reduces the corruption at multiple layers. In the case of China, large projects are cleared by the center while regional governments have the powers in clearing smaller projects. In case of India, large projects need clearances both at the center and state levels; owing to this, there are long delays in implementation. Apart from this, project clearances involve numerous bodies such as environmental agencies and land acquisition rules which results in corruption in the different government bodies. The issue here is 'double marginalization'; one bribe-taker does not internalize the effect this has on other bribe-taker, so in their Nash equilibrium they demand bribes that are too high (Shleifer and Vishni, 1993; Dixit, 2015).

As far as monitoring agencies are concerned the issue would be how autonomous they are so that they would not be captured by the powerful government and private agents. The example in India's case is the central body, the Controller and Auditor General of India (CAG), established by the constitution, which audits all receipts and expenditure of the central and state governments and also government-owned companies. If investigating agencies are not autonomous, they could be captured by the government and powerful players. In India's case, even the prosecutors are controlled by the government, which, in turn, makes judiciary process ineffective.

The other issue is the costs of monitoring for efficient governance. There has to be a fine balance in transaction costs imposed on private agents and effective outcome of monitoring (Becker, 1968). In democracies, free press can play an important role in monitoring and exposing corruption. However, there has been an increasing trend in many countries that the press is owned by powerful business groups.

3. Qualitative Empirics

I bring out qualitative empirics by discussing the institutional frameworks of China briefly and India in detail in this section. As mentioned, this is done to understand governance in comparative economic organization way across countries and over-time.

China

Until 1978, China was one of the most autarkic economies in the world. Although the communist state caused some degree of industrialization and spread of literacy to the masses, its economy stagnated. The cultural revolution of the 1970s put China 20 years backward in science and technology. This prompted the Chinese government under the leadership of Deng Xiaoping to open its economy to the outside world in the late 1970s. At the time of the reforms, the initial conditions were wide spread literacy and health to the masses, and wide spread electrification of the rural areas. Apart from this, in the early 1980s the state undertook land reforms for allotting land to rural households as a form of social security and village officials were provided with incentives under decentralization to perform (Bardhan, 2012). Although the Chinese government sought advice from the World Bank at the time of implementing the reforms (Spence, 2011), it did not follow the typical structural adjustment and stabilization policies. The Chinese state, in its' attempts to retain the communist philosophy of state ownership of capital, undertook external reforms of opening to foreign capital and trade first and kept the internal structure unreformed. Consequently, it created a peculiar institutional framework. The state bestowed private property rights to foreign capital but not to local agents. Limited property rights given to local agents are termed ambiguous property rights (Li, 1996). The Chinese State created a political pecking order in which at the top were the state-owned enterprises (SOEs) and the foreign firms at the middle and at the bottom were the private firms (Huang, 2002). The major component of the non-state sector (private) was the collective enterprises. China attracted large inflows of foreign capital for production and exports of manufactured goods owing to low wage costs of literate work force and its institutional mechanism of fast clearances of projects. Corruption was generally more at the *ex post* stage than at the *ex ante* stage of investment.

Private agents in the industrial sector were denied private property rights until 1998 and access to capital was made very difficult for them. Under China's decentralized economic system, local governments restricted trade and capital flows to other regions: domestic firms were not allowed to invest outside their regional jurisdiction, while there were no similar restrictions on foreign firms. This created peculiar incentives for local private firms to convert their businesses into foreign ones to obtain legal property rights and to gain access to capital. The private firms, therefore, took their limited capital out to neighboring countries such as Hong Kong, Taiwan and Singapore and brought it back as foreign capital to be recognized as foreign- owned firms. Private firms also got into equity arrangements with small foreign firms mostly from neighboring countries in order to gain access to capital and obtain formal recognition as foreign firms (Huang, 2002). For many years, a much of Western investment into China was channeled through intermediaries in Hong Kong, who dealt with the western investors on the basis of formal rules that were common to Hong Kong and US/British legal systems and dealt with producers in mainland China on relational basis (guanxi) (Shaomin Li et al, 2000). John McMillan (2003) observes that even though local bureaucrats in China might have been tempted to violate foreign investors' property rights, the top-level party leaders realized that they had to deliver good economic outcomes to stay in power and they had to protect investors' property rights to achieve good economic outcomes, and they were effectively able to control the local bureaucrats.

SOEs had generous access to capital from the state, but most of them were operationally inefficient. In order to overcome the operational inefficiencies of SOEs, the state used the foreign firms to privatize them. Despite high domestic saving rates in China, the Chinese institutional mechanism caused large flows of foreign capital which was used to achieve high growth rates through production and exporting of labor- intensive manufacturing goods. The Chinese government created 4 major SEZs to attract foreign capital. In the mdi-1980s, the Shanghai stock market was opened. Owing to soft budget constraints for SOEs, China had a large amount of non-performing assets. As a part of privatization process, the Chinese government reduced the number of SOEs to 48 percent by 2008.

The centralized nature of the decision- making for clearance of large project FDI proposals in China provides a clearer signal for the target of negotiation for investors. Secondly, government contracts are not subject to litigation by private parties. The centralized decision-making increases the contractual hazards of cancellation as the judiciary and different layers of government do not provide safeguards to contracts. Ahlstrom, Bruton, and Lui (2000) show that in China, firms can be given permission to operate in a certain market and a year or two later that permission can be withdrawn arbitrarily. Corporate assets can be seized while disputes are resolved. If a court judgment was given in favor of a private firm but local officials do not agree with the ruling, they can refuse to comply. The Communist party members had the powers to confiscate land from private agents with no serious checks and balances.

Irrespective of its unique institutional framework, China has been able to achieve rapid growth since 1980s and build world class infrastructure in major cities. China's growth lifted close to 600 million people out of poverty.[4] China's private sector has started play an important role in China and the world market. At present, China exports both low-end and highly sophisticated manufactured goods to the rest of the world (Rodrick, 2006). One of the reasons behind this is the large- scale investments by the Chinese government in higher education producing highly specialized skills and doctorates. Consequently, China has both high literacy rate and a few world class higher educational institutions.

India

Despite its diversity, complexity and large size, India has remained a democracy since its independence in 1947. Its growth, unlike in the East Asian countries and China (with hard-states), is a result of inter-play between different political actors with diverse interests in status quo and reforms. Although, the Indian economy declined under the British rule, the basic features of capitalism such as legal system, property rights, and contractual laws took root under the British rule from 1857 to 1947. At the time of independence in 1947, as Desai (2002) observes, India had one of the oldest modern industries in the developing world. It had the largest group of native modern capitalist entrepreneurs, the largest jute industry, and a globally competitive cotton textile

[4] Chinese government did not implement effective labour and environmental standards. If one takes account of the negative externalities, China's real growth rate will be lower than 10 percent.

industry. There was a modern legal system, which recognized property rights, independent courts and a well-trained legal profession (Williamson and Zaga, 2002). At the time of independence, only 18 percent of the population was literate.

After independence, India adopted the parliamentary system of federal democracy mostly based on the British model. The Constitution of India is the supreme law, which guarantees the basic rights of individuals and rationalizes the powers and functions of the various bodies at the center and state levels. Any law enacted by the government, both at the center and state levels, that infringes on these rights, when challenged, is liable to be quashed by the courts. The constitution acts as a political as well as a financial document. The legislative powers are distributed between the center and states with each assigned right to enact laws based on the delineation. Commercial laws are mainly enacted by the central government.

The government adopted a development role of Fabian Socialism of five-year planning under the first Prime Minister, Nehru. At the beginning of the development strategy, the state implemented select land reforms of abolishing the Zamindari system of land ownership and not universal land reforms. Basic primary and secondary education was left in the hands of state governments and most states failed to implement universal primary education and health care. However, the government heavily subsidized a few higher educational institutions. There was a benign neglect of agriculture and rural economy until the late 1960s. In the 1950s, India achieved an aggregate growth rate of 6 per cent. In the following decades, the growth rate declined to 3 percent as the state started to impose several controls and transaction costs on economic actors. Nevertheless, the state did not destroy capitalist institutions of private property and allowed a thriving private sector along with the public sector. In the name of socialism, the state ceded enormous powers both in the legislation of acts and the administrative apparatus. The government enacted a plethora of rules, laws and bye-laws. Since the independence, the central and state governments introduced about 30,000 laws (Patibandla, 2013).

Under the Fabian socialism of 1950-91, the political process was mainly distributional. Under this, corruption becomes a means of distributing income between different powerful and cohesive groups such as the large-scale family business, the politicians and bureaucrats and organized labor, while the majority of the population mostly in the rural areas were left behind (Bardhan, 1984).Wide spread intervention of the state in the economy in the name of socialism turned out be basically redistribution of wealth from the poor to the rich, as the family businesses built family empires with tax payers money (Patibandla, 2006&2006a).

By the middle of 1980, the middle class became politically relevant constituency. This prompted the central government to implement reforms, especially on the domestic front of removal of industrial licensing and capacity restriction policies and reduction of import duties and partial liberalization for entry of multinational firms. This initiated increase in growth rate. However, this also led to increase in imports without corresponding increase in exports and capital inflows which led to the balance of payments crisis of 1990. The government of India implemented further reforms both on the internal and external fronts on the basis of World Bank and IMF structural adjustment program. These reforms resulted in positive outcome of increase in the annual growth rate of 6 percent in the 1990s. This is because India had certain basic elements of capitalism such as property rights, contract laws, and independent judiciary and also a critical industrial, technology and human capital endowment acquired from the past.

One important outcome of the reforms is the technological and organizational change in business operations in response to entry of multinational corporations (MNCs). On the product market front, the entry of MNCs had a significant effect on competition and organizational and technological change of local firms. For example, the entry of Japanese and South Korean firms in the automobile and electronic industries forced Indian firms to upgrade technology and organization. Prior to the reforms, the Indian family businesses reaped monopoly profits from consumers and ill-treated managers and workers and stock investors. Apart from this, they used to impose high transaction costs on the small scale-suppliers (Das, 2000). The MNCs brought in organizational practices of developing suppliers and transferred technology. Consequently, it resulted in emergence of a vibrant auto-component industry. The organizational practices of MNCs were copied by the Indian firms which further developed the supplier industry and its bargaining and overall efficiency. Furthermore, competition from MNCs made Indian family businesses to reduce feudal behavior and become more professional (Patibandla, 2006). So far, the government has not made the Competition Policy Commission effective in restraining monopoly behavior. The Indian courts, both high courts and the Supreme Court have been settling commercial disputes among private business and also between the government and the business. Consequently, the courts are clogged with a large number of cases.

In 1992, there was a major stock market scandal when billions of rupees of the public were destroyed. This prompted the government to implement institutional reforms. Until 1993, the stock market was monopolized by the Bombay Stock Exchange dominated by the ethnic group of Gujaraties. Most of the trading was among this group adopting insider trading practices. In 1992, a large stock broker Harshad Mehta entered the market and created a stock market bubble with dubious deals of securing money from banks and investing in the stocks and selling them once they reached a peak. Once his deals were exposed, the stock market crashed destroying billions of rupees of public saving. This prompted the government to introduce institutional reforms through setting up of the National Stock Exchange (NSE) to destroy the monopoly power of the Bombay Stock Exchange and to bring forth transparency of the market. Secondly, the government established Securities Exchange Board of India (SEBI) to regulate the market and improve corporate governance practices of firms. This reform reduced transaction costs to individual and institutional investors in a big way. The transition from physical share certificates to depository settlement resulted in loss of thousands of middlemen jobs. Since the early 1990s, there has been an increase in the presence of financial intermediaries such as mutual funds, investment banks and foreign institutional investors. Increase in the presence of intermediaries cause economies of scale of transactions, and reduction in informational imperfections. The financial reforms of the Indian government of can be considered a success story (Dossani, 2008).

The Provision of Public Goods

One of the important issues with regard to labor markets is universal provision of primary and secondary education and health to the masses. Increase in literacy improves governance by reducing informal imperfections. As mentioned before, at the time of independence, India's literacy rate was about 18% and it is about 73% in 2015. The provision of the primary education was left in the hands of the state government. Different state governments showed different levels of interest and motivation in providing it. In backward states, on average, 25% of teachers in government schools are absent on a working day. The Supreme Court of India ruled that all governments must provide mid-day meals to children. However, in several states, it is plagued by corruption in delivery. One of the outcomes of the poor performance of the government is the private order solution of private schools coming into existence to cater to the poor (Tooley, 2000). However, the private order solutions as a respite for the failures of the public institutions can play only a limited role.

Major part of the labor in India is in the unorganized sector (about 84 percent) where the workers do not secure basic welfare benefits. The organized sector is composed of employees of the public sector and large-scale private sector firms. Before the reforms, the government stipulated that an employee could not be fired if the company employs more than 100 people. This limit was increased to 1000. As the economy grew, to overcome the labor market policies, the corporate sector increasingly resorted to employing temporary workers who are denied basic welfare benefits (Aannavahjula and Surendra, 2012; Nagaraj, 2004). This led to emergence of specialized contractors who supply unskilled and semi-skilled workers to companies reducing transaction costs to individual job seekers. There are no formal institutions at large that give skill certification to semi-skilled labor such as carpenters, plumbers, etc. Consequently, the transaction and information costs for employment search for individual agents tend to be high which can be used by the contractors to derive high bargaining power.

In 2005, the central government enacted ‘Mahatma Gandhi National Rural Employment Act’ (MGNRE) as a social security measure to the rural workforce by providing 100 days guaranteed employment in a year. A part of the funds is provided by the central government to be enhanced by the state governments. Village- level officers implement the scheme. It is interesting that Dutta, et al. (2012) show that some of the poorest states have low participation rates and high level of unmet demand. They attribute this to the poor states not having enough funds and weaker capacity and empowerment of people for administering such a scheme. On the governance front, there is a cost of bribery in the flow of funds from the center all the way to the NREGA (National Rural Employment Guarantee) employee. However, a recent study by National Council for Applied Economics Research and the University of Maryland shows that MGNRE reduced poverty by up to a third and gave a large number of women their first opportunity to earn cash income (Rukmini, 2015).

The central government started to implement the Unique Identification Project (UIP) in 2006. This allows all citizens of India obtain a digitalized identification card. The objective of this project was that welfare schemes of the government should reach the poor by minimizing the role of middlemen. The subsequent government under Prime Minister Modi has launched a major scheme of helping the poor to open bank accounts across the country. These schemes can help the government to transfer money directly into the bank accounts of the poor. Apart from this NREGA scheme can be modified such that the government makes cash transfer worth 100 days wages without obligation to work as a basic social security. In other words, this will provide basic social security and incentives to work to augment income. The Public Distribution System is a nationwide network for provision of subsidized food grains to the poor. The major problem with the system is inefficient delivery institutions which results in close to 70 percent of the food grains being siphoned off by intermediaries (Balasubramanian, 2015). Apart from this, the quality of food grains supplied in these stores is generally of very poor quality. Gangopadhyay, et al. (2014) show that direct cash transfers to the poor is a better governance mechanism in enhancing food security.

Property Rights

In the Indian constitution, the standard property rights system of capitalism is adopted and protected by the independent judiciary. However, the powers of the government to acquire land are still governed by Land Acquisition Act of the British times of 1894. Under this, the state has preeminent right to decide what constitutes ‘public interest’. With this provision, the government displaced mostly large number of rural population to build big dams, mines, government factories in the name of development during the Fabian Socialist times. The previous (UPA) government brought in the land legislation. According to this, depending on the type of the project, up to 80 per cent of land would have to be acquired with consent. However, the price paid to the landowners was determined by the government and not by the market. The land acquisition act of 2013 was quite draconian. In 2015, the central government formulated a land acquisition act that promotes investment for development and at the same time protects the land rights of the people which is blocked by the opposition parties. However, the state governments such as Tamil Nadu (TN) amended the 2013 act to make land acquisition more flexible in fair compensation, rehabilitation and transparency. In other words, state governments can formulate their own law instead of depending on the center.

The constitution of India protects the land (forests) rights of the tribal groups in India. For example, the diversified mining company Vedanta has operations in the state of Chhattisgarh. It was accused of taking away the tribal lands in the past. In 2013, the company attempted to procure more land from the tribal groups. The Supreme Court intervened and passed the rule that the company could acquire the land only if the village councils give permission. The ruling puts village council at par with statutory and regulatory bodies. It provides a broader prism of rights to indigenous communities by defining the Forest Rights Act as more than heritable property. Subsequently, the people voted that they would not forsake the land. Nevertheless, several state governments give public land at the subsidized rates to the big business to generate investment and employment.

Corruption

During the Fabian Socialism period, there was corruption on all fronts such as scarcity, informational asymmetry and political position. After the reforms, some of the scarcity corruption declined- for example securing a telephone and cooking gas connections and buying durable and non-durable consumer goods. After the reforms, the major source of scarcity-related corruption has been land acquisition and converting agricultural land into urban land owing to land and building laws (Debroy and Bhandari, 2011). Immediately after the reforms, the other source of corruption was the privatization process of public sector companies- for example, extracting bribes for delaying the project in question until the winning bidder paid a bribe (Khanna and Melito, 1997).

As the economy started to grow during the post-reform period new sources of corruption arose owing to emergence of new markets and technologies. The prominent cases are the allocation of 2-G spectrum and the coal blocks. The allocation of 2-G spectrum by the telecommunications ministry was a clear case of rigging the bidding process by the ministry to collect huge bribes. The spectrum was allocated to preferred companies in 2008 on the basis of 2001 prices. The CAG audited that it accounted about 30 billion US dollar loss to the public. As mentioned earlier, the outcome of the 2014 general elections were a result of the public desire for institutional change and improvement of governance and reduction in corruption. The outcome of the elections can be interpreted as a signal from the public that they would not tolerate corruption. Consequently, the present government announced a slew of measures to improve governance that minimizes corruption and transaction costs for clearing investments in various sectors and effective delivery of welfare and public goods to the poor. For example, the allocation of coal blocks was subject to non-transparency under the previous government. Since the current government taking over the office, coal blocks have been allotted in a transparent way. The government also announced implementation of the ambitious Digital India project to make all public services available to the public in transparent way across the country in both rural and urban India. If information technology increases the flow of communication and thereby enlarges the sustainable social network, then the payoff from dealing within the network will increase and the bribes the formal legal system can extract will decrease.

One of the important changes in institutions is improvement in “ease of business ‘.In 2014 the World Bank ranked India at 142 out of 189 countries for starting a business and it declined to 76 by 2018 which is considered remarkable improvement. However, this does not mean removal of regulations but improvement in quality of regulation. Furthermore, according to global consultants Brand Finance India has moved up one position to become the world’s seventh most-valued “nation brand” with an increase of 32 percent in its brand value to $ 2.1billion- the highest among all the top 20 nations on the list. During this period, there has been flow of $ 50 billion foreign direct investment (George, 2015). Competitive federalism is driving reforms in several states. For example, Andhra Pradesh has put in place a single-window mechanism that offers all clearances to set up an industry within 21 working days.

4. Conclusion

This paper has developed a simple theoretical framework of comparative organization of governance from the lens of NIE and qualitatively applied it to China and in more detail to India. China presented the case of high growth rates by adopting an institutional framework of combining political philosophy of communism with elements of capitalism. China's approach of setting up of the initial conditions of universal literacy, land reforms, health care and minimum social security are relevant to India. Other aspect is combination of centralization and certain degree of decentralization. Although India is a Federal democracy, governance is still has centralization features. Improvement in governance requires increasing decentralization of governance. However, the other governance mechanisms of the Communist party members yielding extraordinary powers in implementing economic policies although gave advantage in clearing large scale investments quickly it also resulted in corruption and laxity in standards. India's independent judiciary provides checks and balances on government in maintaining certain standards on investments sensitive to environmental factors and also large scale corruption.

For a longtime, China sacrificed environmental and labor standards for achieving high (nominal) growth rates. However, China's attitude towards environmental issues has been under change for the last five years. For example, per capital consumption of coal is decreasing after achieving a critical level of development.

It is important to realize that good governance does not imply fast clearances of investment projects with lax environmental standards especially in the consumption of coal (coal constitute for 61 per cent of total energy consumption). Transaction and information costs in regulation have to be minimized without sacrifice of the standards. Furthermore, the government's ability to acquire private property for development has be to subject to checks and balances so that people cannot be displaced from their land. Since India has augmented its growth, environmental damage increased. Here, India could learn from recent developments in China.

The current government of India at the center has been able to implement few governance reforms such as allocation of coal blocks in transparent way. In few states ruled by BJP, labor market reforms are implemented. It has encouraged the poor to open bank accounts to transfer welfare benefits directly into their accounts by eliminating middle-men. Furthermore, the ambitious Digital

India initiative is announced to make government services transparent. However, this can be effective if literacy levels are improved. Owing to information imperfections arising out of illiteracy, corruption at the bottom of bureaucracy persists.

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