

ILLUSTRATION BY AJAY MOHANTY



# Cultural mismatch

Public sector-style anti-corruption is not appropriate for private firms

**T**he term “corruption” is about decisions in the public sector. We do wrong when we extend it to the decisions of private firms. Private firms are efficient because they are able to empower employees with decision-making powers, which draw on diverse considerations including past experiences, references and trust. If we make private sector firms behave like the public sector, we will lose economic dynamism. The checks and balances that generate probity in private firms require strengthening, but the required policy reforms are completely unconnected to the public sector anti-corruption machinery.

The word “corruption” is about personal benefits that influence a civil servant or politician. In the public sector setting, the tools for reducing corruption are reducing discretionary powers; increasing transparency, formal procurement process and other decision processes; and finally the anti-corruption machinery, which includes the Prevention of Corruption Act (POCA). Many in India are now ready to carry this machinery into the private sector.

The world of decision making in private firms is completely different from that seen in the public sector. It is characterised by high levels of informality of decision making. Factors that matter include opinions and experiences of friends, past experiences and trust. All contracts are incomplete, and in the private sector, trusted counterparties are expected to continuously negotiate in good faith and modify the terms of the contract on an ongoing basis.

A great deal of good decision making by private firms involves friends and family. Business goes to

individuals who have a track record of good behaviour in past dealings. There are three elements of economic logic which support this. First, there is reduced asymmetric information when dealing with known people. Second, behaviour is improved by being in a repeated game. Each person exhibits greater fair play on one given contract when a much bigger relationship is at stake. Finally, there is the problem of incomplete contracting and poor contract enforcement. In the Indian business environment, there is greater uncertainty, and the Indian judiciary delivers weak enforcement. This increases the value of dealing with trusted friends and family where contract terms are modified continuously in good faith.

For people who come from a public sector background, this cronyism may seem to be a recipe for failure. What keeps the private sector honest is the pressure of competition, quarterly reporting of profits, and daily reporting of the stock price. When a firm makes bad decisions (for whatever reasons) it loses market share, suffers weak revenue growth, loses profit, and gets a lower stock price. This should set off alarm bells for shareholders and the board, and kick off a process of addressing the failures.

Public sector contracting is different in three critical ways. First, the accountability from measuring market share, revenues, profits and stock prices is missing. Second, the repeated game that elicits better behaviour is constantly disrupted by staffing changes in the government. Third, contracts are taken literally and there is an absence of continuous renegotiation in good faith. These differences motivate a very different world for

the public sector in terms of transparency, due process and anti-corruption enforcement.

There are, of course, situations where employees of private firms make bad decisions for personal considerations. The way this is dealt with in a private sector setting is an internal investigation; sacking, leading to reputational damage, which harms career prospects; and the pursuit of civil liabilities in court. The key ingredient that shapes the effectiveness of this process is the powers of independent shareholders and independent directors versus the insiders, i.e. the management which runs the company on a day-to-day basis.

We should understand and strengthen this institutional capacity in private firms. This cannot be done by mechanically transplanting the public sector anti-corruption machinery. If the Prevention of Corruption Act is extended to decisions in private firms, this will inevitably be followed by the public sector machinery of transparency, formal procurement processes, etc. This would be a bit like converting private companies into public sector companies. The essence of the private sector — intelligent and flexible decision making — would be lost. This is particularly important in the field of finance, where good decisions are heavily about judgement.

What is the way forward? The first element is conceptual clarity on the line between the state and private firms. Private firms should be obliged to obey regulations which address market failures. For example, a refinery should not pollute. When a violation is detected, financial penalties should be inflicted. The state should not go into the question of how the bad decision was made in the private firm. Fault finding and consequential sanctions, within the firm, should be the preserve of the board and the top management.

Second, the one thing that can keep private banks honest is banking regulation. When bad loans are given, and banking regulation is sound, the bank rapidly suffers from losses because those bad loans are recognised and conservatively provided for. This would create immediate feedback from bad loans into quarterly reports of profit, and the stock price, which would jolt the shareholders and the board.

Third, we need to do more on competition policy. When competition is weak, individuals in private firms can make bad decisions without an impact upon market share or profits. Entry into banking by domestic and foreign players would put greater pressure on private banks.

Fourth, we need to do more on the powers of minority shareholders and the working of the board. The healthiest firms in India are those where the powers of the chief executive officer are limited.

The Ministry of Finance (MoF) must play a leadership role on this problem. As an example, roughly a decade ago, there was a similar discussion between the Central Vigilance Commission (CVC) and MoF on mutual funds, and the CVC was satisfied that the governance mechanisms of mutual funds were adequate. In addition to the four elements described above, a work programme needs to be initiated at the MoF to get employees of private banks out of the Prevention of Corruption Act.

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