

Black Incomes from Public Expenditure

1. Introduction

THE examples and estimates of black income generation discussed in the preceding chapters have largely dealt with the private sector of the economy. The operations of the public sector also afford large (and perhaps growing) opportunities for reaping black incomes. The nature of such opportunities is extremely varied and diverse. Very broadly, we can distinguish between black income generating opportunities created by:

- (i) public controls over private sector activity,
- (ii) direct public sector participation in economic activity.

The first category encompasses the entire gamut of public economic controls on private economic activity. At the national level it includes all aspects of industrial licensing, controls over foreign trade and payments, controls on price and distribution of a wide range of commodities and services, controls over the operation of the private capital markets (e.g., through controls on interest rates, regulation of capital issues, etc.) and a wide variety of requirements relating to registration and conduct of various economic activities. State and local governments also exercise discretionary

control over economic activity through numerous departments and inspectorates which issue and renew permits of one kind or another. The sub-national levels of government play an especially important role in regulating the use of land, especially urban land, and all aspects of construction activity.

We shall return to the role of economic controls in generating black income in Chapter 9. Here we simply observe that controls typically spawn scarcity premia for the licenses, permits and quotas, through which they are exercised, and both the pursuit and realisation of these premia (whether on import licenses, building permits or cement allocations) often involve black income generation.

In this chapter we are more concerned with the second way in which the public sector spawns black incomes, namely, in the context of direct public sector participation in economic activity. In particular, we deal with the generation of black incomes through public expenditure. The reason for dwelling on this type of black income generation is that there is increasing evidence, mostly of an anecdotal nature, pointing to its growing importance in recent years.

2. Some Examples and an Unifying Concept

To concretise the subject it is useful to consider some examples of black income generation through public expenditures;

- (i) In the construction of an irrigation dam a significant percentage of the expenditure takes the form of illicit payments to contractors and officials. The mechanisms include substandard work and materials, inflated bills, false muster rolls for labour and kickbacks to the sanctioning officials. The net result is that the actual materials used and work done is less in quantity and quality than that billed for, with the difference accruing—in the form of black incomes—to contractors and officials of the irrigation department. The same techniques are used to defraud the government in the case of public funds allocated

for operation and maintenance (O&M) of such public projects.

- (ii) In the purchase of major civil or defence equipment from abroad the vending company makes payments—usually into accounts held overseas—to key participants (or their agents) in the decision to award the contract. These participants can include both officials and ministers. The amount of such payments is, naturally, built into the price of the equipment in question. Hence a part of the full price paid by the government or public sector agency corresponds to black incomes paid to those who colluded in the award of the contract.
- (iii) Substantial proportions of government expenditure on various anti-poverty programmes, such as Integrated Rural Development Programme (IRDP), never reach the designated beneficiaries. Collusion between functionaries of the district administration and local banks effectively siphons off these amounts in the form of explicit or implicit “cuts”. What is true for special anti-poverty programmes is often also true for regular government expenditure on social welfare: for example, medical supplies for rural clinics often do not reach their destination or are illegally sold off by the compounder and shown as “dispensed”.

Such examples can be readily multiplied. Nor is the phenomenon new in India. Twenty years ago the Santhanam Committee (Government of India, Ministry of Home Affairs, 1964, p.10) observed: “We were told by a large number of witnesses that in all contracts of construction, purchases, sales, and other regular business on behalf of the Government, a regular percentage is paid by the parties to the transaction, and this is shared in agreed proportions among the various officials concerned. We were told that in the constructions of the Public Works Department, seven to eleven per cent was usually paid in this manner and this was shared by persons of the rank of Executive Engineer and below down to the Mistry, and occasionally even the Superintending Engineer might have a share.” The Committee’s report

did not add the obvious, that such payments by contractors to officials in the form of cuts or kickbacks were, presumably, built into the cost structure of the works executed.

The common features of these examples merit emphasis. First, the illicit payments received clearly constitute black income in the hands of the recipients.¹ More importantly, these payments can be characterised as *illegal transfers from the public account* to individuals. They differ in one important respect from bribes between individuals. In the latter case a bribe by A to B reduces A's disposable income by the same amount that B's increases. Hence the bribe does not, conceptually, alter the total of gross personal income in the economy,² But in the case of the illegal transfers that we are considering here, that is those from public expenditure, the *total* of gross personal incomes increases by the extent of the illegal transfer.

Thus, in the context of the exercise conducted in Chapter 5 the full amount of such illegal transfers should be conceptually added to the total gross personal incomes computed from national accounts data by considering only *legal* transfers. Of course, the extent to which this income is taxable (and hence tax-evaded) depends on its distribution across income classes.

3. The Scale of Black Incomes from Public Expenditure: Some Piecemeal Evidence

It is widely believed that the scale of "leakage" from public expenditures is substantial and growing (in proportionate terms) over time. Our own informal interview information is consistent with this view. But, given the nature of the subject, it is extremely difficult to marshal quantitative support for these impressions.

The most persuasive empirical work on the subject that we have come across is a remarkable article by Robert Wade (1982), which delineates the character, extent and consequences of institutionalised corruption in the O&M divisions of canal irrigation in a "South Indian state". Before we summarise his principal findings it may be salutary to quote

some of his remarks on the basis of his evidence (p. 291): "Obviously one cannot work towards an understanding of the phenomena discussed here by the familiar methods of random sample, the formal interview and structured questionnaire. One has to use, rather, more informal, more "anthropological" means. The material on which this paper is based was collected in the course of six periods of field-work in the same small area of south India between 1976 and 1981, each of between one and four months' duration." Wade's primary objective was to understand the functioning of canal irrigation systems. In the process he came to recognise the great importance of the corruption "system", which permeated most aspects of canal operation and maintenance. This realisation led him to conduct informal interviews with dozens of irrigation engineers, other government officials and farmers, which formed the basis for his findings. As he emphasises, his findings are "based on prolonged residence and repeated enquiry, on *both* sides of the farmer-official transactions." Wade's main conclusions of particular interest to us are summarised below.

First, irrigation officers in the O&M divisions could and did raise enormous amounts of "illicit revenue" through abuse of their offices. The two principal sources of illicit revenue were the "works budget" from the "selling" of water to the farmers. The former, representing as it does leakage from government expenditure, is of direct relevance to our concerns in this chapter.

Each canal Division (headed by an Executive Engineer (EE) with Assistant Engineers (AE) in charge of Subdivisions, and Supervisors in charge of Sections) gets a regular grant for annual maintenance which is used to finance the necessary maintenance work by private contractors. Apparently, "by long established tradition" $8\frac{1}{2}$ per cent of each contract is kicked back to the officers and clerks of the O&M Division: $2\frac{1}{2}$ per cent going to the EE (the tender-accepting authority in most cases), 1 per cent to clerical staff, and the remaining 5 per cent being split between the AE and the Supervisor.

This $8\frac{1}{2}$ per cent is, however, the minimum kickback, on the assumption that "work is actually done to specification".

In fact, of course, this is almost never the case; there is plenty of opportunity to achieve 'savings on the ground' through cheating on materials. Wade concludes that "such 'savings on the ground' are normally sufficient to bring the total rake-off to the officers (including the $8\frac{1}{2}$ per cent to at least 25 per cent of the value of what is meant to be put on the ground, and sometimes to as much as 50 per cent." Even taking his lower bound figure of 25 per cent, the extent of leakage from expenditures on maintenance work is clearly very substantial.

Wade estimates that in the late 1970s EEs were making an additional, illicit (black) income of *at least* Rs 260,000 per year, compared to average official salary (including allowances) of Rs 28,500 a year. As for the AE, Wade estimates that on average he probably made about Rs 80,000 in illicit income (with perhaps Rs 30,000 being his share of the works budget and Rs 50,000 being raised or extorted from the farmers for allocation of water) compared to an official average salary of about Rs 23,000 per year.

These large additional illicit revenues which can be extracted in these O&M jobs clearly make them attractive propositions within the State Irrigation Department, especially in comparison with posts in inspection and design. Aspirants for transfer to these posts are usually prepared to pay handsomely to the transferring authority or his agent(s). Wade estimates that EEs paid anywhere from Rs 50,000 to Rs 400,000 for transfer to O&M posts (the transferring authority being the Minister) with the price being correlated with possibilities for making illicit revenues, which differs across divisions. For AE posts the going price ranged from Rs 25,000 to Rs 50,000, with the remuneration being shared by senior Departmental officers, and one or two local MLAs.

Wade's account is replete with a great deal of detailed description of the complex links between the irrigation officers, the private contractors and the politicians. He also goes on to demonstrate the detrimental consequences of corruption for the canal irrigation system. For our purposes,

his most interesting conclusion remains the *estimated minimum rake-off of 25 per cent* from the annual works budget for canal maintenance.

Leakages of this order raise the obvious question: what about audit and other forms of scrutiny of government expenditures; why do these not work as effective checks on the generation of black incomes from public expenditures? There are several answers to this query. First, the audit conducted by the State Accountant General's Office is a *financial* audit, not a physical one. As Wade notes (p. 310) it is "sufficiently effective to make correct charging for bad structures, rather than over-charging for good structures, the most promising strategy, since neither this office nor any other independent body makes checks on physical quantities." Second, while there is an elaborate machinery for supervising, investigating and disciplining corrupt officers, it can be too easily neutralised. In principle, adverse comments in confidential reports (CRs) can trigger investigations by the Irrigation Department's Vigilance Cell, or the State's Anti-Corruption Bureau (ACB). In practice these deterrents are far from effective. To begin with, the safeguards against action against officers are strong (the original intent was to protect their independence). Where a case is allowed to be initiated under the Vigilance-ACB machinery, it can be easily derailed by intervention from the Departmental Secretary or the Minister. As Wade puts it (p. 310) "If the Minister sold the EE his tenure and subsequently put the screws on him for more money, he may be a bit ambivalent about allowing an ACB investigation to proceed". Indeed, the anti-corruption machinery is more likely to be mobilised "as a part of the struggle for power and spoils", whether between a senior officer and his Minister, or rival Ministers, or when the State government changes and the new party in power deploys the machinery of government to discredit its predecessor.

Is this case of corruption in canal irrigation in "a South Indian state" an aberrant, isolated example, or is it symptomatic of a more pervasive malaise? Wade cites the work by Pant (1979) to suggest that such practices are common in

other irrigation systems. In his study of the Kosi Canal system in Bihar, Pant reported that only 40 to 50 per cent of the recorded public expenditure was actually spent on works, with the remainder lining the pockets of the irrigation staff and bloating contractor's profits. Wade also draws attention to the Santhanam Committee's reports of pervasive corruption in government purchases and contracts.

Preliminary work by Talwar (1984) relating to public sector construction projects (mostly in Delhi) also confirms the existence of large discrepancies between the quanta of public expenditure and the value of the corresponding works actually built. Talwar distinguishes between "institutionalised" and "collusive" corruption. The former represents customary "cuts" to various levels of functionaries, while the latter reflects more audacious conspiracies to inflate project cost estimates in which only a handful of people are directly involved and which usually requires the explicit blessing of, if not initiation by, powerful politicians. Like Wade, Talwar is obliged to rely mainly on interview material gathered over many years of residence and public service in Delhi. Based on these interviews Talwar estimates that as much as 25 to 30 per cent of the recorded cost of public works in Delhi and neighbouring States may be siphoned off as black income in the hands of government functionaries, politicians and contractors. For one public sector agency his information suggests that the percentage of "leakage" may be about 40 per cent for houses and buildings, while it may climb as high as 80 per cent for "land development and acquisition" and "minor works, maintenance and beautification works".

Our own informal interviews confirm the view that leakages from public expenditures are a pervasive, not an isolated, phenomenon. Experienced civil servants indicated that leakages from anti-poverty programmes (such as IRDP) in the range of 10 to 30 per cent were quite common, while in some cases they may be even higher. A great deal depended on the quality and motivation of the district administration. According to a recent study by Jain *et. al.* (1984), the extent of corruption leakage in anti-poverty programmes

may be much higher, in the range of 50 to 80 per cent of programme funds.

Our interviews also indicate that kickbacks on government contracts and purchases are common. Nor are they limited to administrative departments such as the public works departments, but extend to include public enterprises. The impression we formed was that for most substantial public sector contracts, whether placed at home or abroad, significant cuts and kickbacks to key decision-makers has become the rule rather than the exception. This impression is also consistent with any number of press accounts.³ Furthermore, most of our informants agreed that the relative scale of this form of corruption—leakages from public expenditure—has grown substantially over the past two decades. In the latter part of this period it is believed to have become an important source of unaccounted funds for political finance of elections and inter-election political manipulations.

4. The Scale of Black Incomes from Public Expenditure: Some Speculations

The piecemeal evidence presented in the previous section provokes the question: how much does all this leakage from public expenditures add up to in any given year? It should be readily apparent that, at present, there is little prospect of any adequately grounded answer to this intriguing question. First, virtually all the piecemeal evidence summarised earlier is ultimately based on “off the record” interview information where the corroboration comes from other such interviews, not documentary evidence. Given the nature of the beast, this is hardly surprising—but it would be unwise to dismiss such interview data too lightly. Nevertheless, doubts can be legitimately raised. Second, as Wade’s study indicates, establishing the dimensions of institutionalised corruption in public expenditure in a given sector and geographical area with a reasonable degree of credibility requires close familiarity and prolonged effort. Until such time that comparable studies have been completed for other sectors

and areas of public expenditure, the basis for estimating any aggregate amount of leakage will remain very weak. After all, there can be no presumption that the rate of leakage found in one kind of public expenditure in one area is applicable across the board of all public expenditure. For some kinds of expenditure, such as Central and State government wage and salary payments to its permanent employees, the amount of leakage may be nil or negligible. Third, many instances of leakage may represent unique events (for example the kickbacks associated with a particular, massive weapons system contract), where question of customary or institutionalised rates of leakage simply does not arise.

For all these reasons, we are unable to offer any reasonable basis for estimating the aggregate amount of leakage (or illegal transfer) from public expenditures in any given year. Nevertheless, it may be instructive to obtain some idea about the dimensions which might be involved. We do this by simply taking a relevant subtotal of capital and current expenditure by the public sector and applying alternative percentages of 5, 10 and 20 per cent to this subtotal to see, for illustrative purposes, the scale of leakage which may be involved. Table 8.4.1 presents the results for 1975-76, 1980-81 and 1981-82.

For each year, Table 8.4.1 presents two columns. The first simply reflects the application of the specified percentages to the specified subtotal of expenditures, while the second column reports numbers which are 75 per cent of the first column. The second column is based on the assumption that three-quarters of the illegal transfers from these public expenditures accrue to beneficiaries who are in taxable brackets of income. Thus the latter set of columns contain speculative guestimates of amounts by which illegal transfers from public expenditures could augment the totals of tax-evaded income estimated in Chapter 5.

Table 8.4.1 suggests, that even if we make crude, but perhaps reasonable, assumptions regarding the average proportion of leakage from public expenditures, the amounts involved are quite substantial. Thus, if in 1975-76 the average leakage proportion was 10 per cent, it meant that black

TABLE 8.4.1
Leakages from Public Expenditures: Some Speculative Numbers
 (Current prices, Rs crore)

	1975-76			1980-81		1981-82	
	(1)	(2)	(3)	(4)	(5)	(6)	
1. Public sector gross domestic capital formation	7,677		13,922		17,444		
2. Net purchase of commodities and services by administrative departments	2,670		4,877		5,964		
3. Purchase of commodities and services by departmental enterprises	1,650		3,036		3,725		
4. <i>Relevant subtotal of public expenditure</i>	11,997		21,835		27,133		
5. Assuming 5% rate of leakage	600	450	1,092	819	1,357	1,018	
6. Assuming 10% rate of leakage	1,200	900	2,184	1,638	2,713	2,036	
7. Assuming 20% rate of leakage	2,399	1,800	4,367	3,276	5,427	4,071	

Note: For the last three rows, columns (2), (4) and (6) are computed as 75 per cent of columns (1), (3) and (5), respectively.

Source: Tables 24, 27 and 28 of Government of India, CSO (1984).

incomes (tax evaded) from public expenditures might have been in the order of Rs 900 crore, a sum which may be compared to the estimates of tax-evaded (legal) income in Chapter 5 ranging from Rs 2,467 crore to Rs 3,741 crore. The corresponding tax-evaded leakage in 1980-81 may have been Rs 1,638 crore, which compares with our earlier estimates of tax-evaded (legal) income ranging from Rs 4,813 crore.

We should reiterate that these numbers are purely speculative. They are presented only to drive home the point that even if the average proportion of leakage from public expenditures is quite modest, the amounts involved can be substantial.

Notes

1. While most of such income usually accrues to those who are in tax paying brackets, some goes to those below the effective income tax exemption limit. In such cases the incomes are 'black' in the sense of being illicit, but they are not black if a strict definition of tax-evaded income is used.
2. Strictly speaking, *taxable* income may increase since A's income (from all sources) is augmented by the bribe. While A cannot, legitimately, treat the bribe as a deductible expense.
3. As one example, see the article on the Delhi Development Authority in *India Today*, April 30, 1984. Another well-publicised example, of the "Kuo deal", is described in Shourie (1983).