

# WebMemo



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## Corruption in India: More Government Is Not the Solution

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Protesters took to the streets throughout India in the summer of 2011, demanding the establishment of a powerful new anti-corruption watchdog agency. In the aftermath of numerous high-profile corruption cases, the demonstrators' wrath and intensity are understandable. Their demands, however, are misdirected.

Adding yet another agency to the bloated Indian government is not the way to reduce corruption. In fact, it is the size and scope of the Indian state that is the major cause of corruption.

**Middle-Class Indians: Fed Up with Corruption.** The traditional power base of the ruling Congress Party is benefiting from the corruption. This includes 700 million people in rural India who are involved primarily in farming, many of whom benefit from generous government subsidies and are therefore tolerant of graft in these programs. But as more people move from farms to cities in search of middle-class jobs, that power base shrinks.

In contrast, the middle class faces daily demands for bribes to process government-mandated documents ranging from "\$45 for a driving license...\$110 to be admitted to hospital...\$130 for a marriage certificate" to \$100 to a customs officer at Mumbai Airport because a wife's name did not match her husband's in their passports.<sup>1</sup> In addition, beyond insult from petty bribery, there is injury from more sordid corruption:

In November 2010 Ashok Chavan, the chief minister of Maharashtra, one of India's most prosperous states, was forced to quit over his alleged role in a scam involving homes for

war widows. Retired senior army officers and relatives of senior politicians are accused of helping themselves to apartments meant for war widows in Mumbai.

[Indian government officials] were booed during the opening and closing ceremonies of the 2010 Commonwealth Games in Delhi due to...revelations of sleaze, incompetence, and missed construction deadlines. The games cost \$4.1 billion instead of the \$270 million first estimated, while revenue was only \$38 million.

BS Yeddyurappa of India's main opposition Bharatiya Janata Party quit as chief minister of the southern state of Karnataka in July after he was indicted in a mining scandal. An anti-corruption report alleges the scam cost the exchequer more than \$3 billion between 2006 and 2010.<sup>2</sup>

Tapping into rising middle-class anger, former Indian soldier-turned-activist Anna Hazare used hunger strikes and other Gandhian tactics to try to change politics as usual. Citizens are better educated and better informed (e.g., via Twitter), and they are demanding changes in business as usual. Hazare is pushing for the creation of an anti-corruption

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watchdog to be called “Lokpal,” from the Sanskrit lok (people) and pal (protector), which would have jurisdiction over all government officials. Indian Prime Minister Manmohan Singh initially rejected the proposal on grounds that it could undermine parliamentary democracy.

Versions of the Lokpal legislation have existed for decades but foundered on special-interest opposition and constitutional questions. Reflecting the expansion of the middle class, Hazare has had more success with his version of Lokpal, and some variant is likely to pass the legislature in the next few months. Indians remain divided on Hazare’s approach, with some viewing “it as an emotive and misguided attempt to promote a utopian one-step solution.”<sup>3</sup>

**The Twisted Relationship Between Government and the Economy.** No matter one’s view of Lokpal, it does not get at the most important issue. Lokpal targets corrupt entities within the state, but what if the very notion of state activity is the problem?

Perhaps the single biggest component of the corruption drama is an interesting case in which corruption has actually worked to the benefit of Indian consumers. It involves corrupt officials taking bribes from industry, causing the government to “lose” revenue it probably should not have sought in the first place.

In 2008, corrupt Indian government officials conducted an illegal sale of second-generation (2G) telecom bandwidth, depriving the government of a reported \$40 billion in tax revenue that might have been realized had a proper and transparent auction taken place. (Some critics argue that the \$40 billion figure is grossly exaggerated.) This 2G telecom

has been a crucial part of the Indian success story, bringing modern technology into the hands of hundreds of millions and spurring both growth and inclusivity. That would hardly have been possible if the government had drained off tens of billions of dollars before any investments were made.

This unusual case illustrates an important point: Private industries should not serve as cash cows for the state. They are supposed to improve people’s lives, both directly through the products they create and indirectly by strengthening the economy. The telecom industry has done that, transforming society from medicine to farming. In this case, the industry’s investments were made possible by defrauding the government. Rather than extracting wealth from society, the government did not get its take this time—and consumers benefited.

The overbearing state’s restrictions on economic growth are not limited to the telecom industry. India’s recent growth is not rooted in policies that support economic freedom; market-oriented reform has been almost nonexistent of late. The state maintains an extensive presence in many areas through public-sector enterprises, and a restrictive regulatory environment hampers realization of the economy’s full potential.

While India rates highly in a number of important categories in the *Wall Street Journal/Heritage Foundation 2011 Index of Economic Freedom*,<sup>4</sup> it receives very low scores in the connected areas of business freedom, investment freedom, and freedom from corruption. India ranks 87th of 182 countries in Transparency International’s Corruption Perceptions Index for 2010, which is used in the Index of Economic Freedom. Corruption is perceived as especially significant in government procurement

1. Paul de BERNIERI, “Insight: Anti-corruption Campaign Awakens India’s Middle Class,” Reuters, August 24, 2011, at <http://www.reuters.com/article/2011/08/24/us-india-corruption-middleclass-idUSTRE77N4JO20110824> (October 4, 2011).
2. “India’s Corruption Scandals,” BBC News, August 19, 2011, at <http://www.bbc.co.uk/news/world-south-asia-12769214> (October 4, 2011).
3. K. V. Prasad, “Lokpal Bill Probably by Winter Session: Singhvi,” *The Hindu*, August 30, 2011, at <http://www.thehindu.com/news/national/article2409783.ece> (October 4, 2011). See also Chandrabhas Choudhury, “Indians Divide Over Policing a Watchdog: World View,” Bloomberg, June 21, 2011, at <http://www.bloomberg.com/news/print/2011-06-21/indians-divide-over-policing-a-watchdog-world-view.html> (October 4, 2011).
4. Terry Miller and Kim R. Holmes, *2011 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2011), s.v., “India,” at <http://www.heritage.org/index>.

of defense, electricity generation, and telecommunications contracts.

**The Black Market.** Much criticism has been leveled in India at the “black” economy. This includes not only illegal activities, but also legal activities that are not declared because it is too difficult to acquire government permission to engage in them.

All economies have black markets. The Indian economy has reached such a size that estimates of the underground segment are in the neighborhood of \$500 billion annually. This spurs outrage at black marketeers who supposedly are robbing the Indian people. However, the black marketeers are the people—tens of millions of them. The only ones being “robbed” are federal and state governments, and that is usually the governments’ own fault.

India’s renowned entrepreneurs face severe challenges. India ranks 165th of 183 countries in the World Bank’s 2011 *Doing Business* measure of the difficulty of starting a business, and this is actually better than previous years.<sup>5</sup> The regulatory framework is burdensome, and the legal framework is weak. For example, it can take almost 200 days to obtain a construction permit.

Banned activity does not represent lost revenue for the government, since the government’s position is that it should not occur at all. Revenue is lost in legal activity that is hidden. But avoiding taxes is not the main reason for individuals to hide from the government; the main reason is the difficulty of setting up a business. Rather than face endless delays and high costs, many ordinary Indians decide to proceed without the necessary authorization and then must hide their businesses. Black market activity is due to a predatory state’s attempt to control entrepreneurship.

The black market is also directly connected to recent headlines claiming that India has lost more

than \$400 billion due to illegal capital flows.<sup>6</sup> Some of this is the result of ill-gotten gains from crime, which were illegally earned and ideally would never have existed. Other funds are “lost” either because they fled domestic restrictions or because India restricts capital movement.

Despite progress in the reform era, India retains tight capital controls even by the standards of emerging markets. What would count elsewhere merely as citizens and companies investing overseas—and bringing benefits back home in terms of financial returns, resources, corporate assets, and so on—is not permitted in India. As in all economies throughout history, people follow their self-interest and invest abroad anyway, but no benefits flow back to India, because the investments are deemed illegal by an interventionist state.

**Could a Good BIT Help?** In some incidents of corruption, the Indian government’s guilt is directly apparent. The Commonwealth Games, for example, were plagued by lack of competition in contract awards. In other cases, the harm comes to the state, not the people, which should not be defined as corruption or any sort of problem in the first place.

India is wrestling with how to deal a decisive blow against corruption. The answer is plain: Deal a decisive blow against state interference in the economy. To help, the U.S. should offer a proposal for a bilateral investment treaty (BIT) that liberalizes Indian investment. This would sharply reduce the incentives for corruption. It also might serve as political cover for future Indian governments that want to make the difficult choices needed to defeat corruption in its many forms.

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5. International Finance Corporation and The World Bank, “Ease of Doing Business in India,” *Doing Business 2011*, at <http://www.doingbusiness.org/data/exploreeconomies/india> (October 3, 2011).

6. BBC News, “India lost \$462bn in Illegal Capital Flows, Says Report,” November 18, 2010, at <http://www.bbc.co.uk/news/world-south-asia-11782795> (October 4, 2011).