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Regulation: A Constitutional Paradigm[**]

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"*The Supreme Court today heavily came down on the appointment of a bureaucrat to head a quasi-judicial body,* [The Competition Commission] *terming this as an attempt to usurp the powers of the judiciary*." Economic Times Nov 01 2003

"An independent central bank focused exclusively on price stability has become a central part of the mantra of "economic reform." Like so many other policy maxims, it has been repeated often enough that it has come to be believed. …But central banks make decisions that affect every aspect of society, including rates of economic growth and unemployment. Because there are tradeoffs, these decisions can only be made as part of a political process." J. Stiglitz http://www.project-syndicate.org/series/series_list.php4?id=11 june 2003

These two examples illustrate the dilemma that one faces in designing effective regulatory institutions. How do we confront these dilemmas? One-way of confronting such key issues is to seek an answer to the question – How and where should one locate regulation inside a constitutional schema? Traditional analysis of *regulation* often aims to evaluate the efficacy of the mechanisms or instruments used to achieve professed ends or it seeks to evaluate objectives and the functioning of regulatory agencies. While such analysis is widely practiced, and is undoubtedly important and essential, it is important to realise that the choice of instruments and their use takes place inside the wider construct of constitutional governance. In this paper we seek to analyse regulation in terms of the appropriate location of the institutions that comprise and effectuate regulation within the constitutional paradigm.

In attempting an institutional analysis of this kind, it obliges us to conceptually represent the State. This is an essential task because regulatory commands emanate either directly from the State or a body delegated by the State. Mainstream economics does not by and large engage significantly with the notion of State. This in itself is not problematic to the extent one is exploring social behaviour in the 'market place'. However, an analysis of the many instances of market failure inevitably solicits the presence of the State. Thus, when the *public interest theory of regulation* perceives *regulation* as the co-ordinated correction of varieties of market failure by simulating market outcomes that the market would have configured in the absence of market failure, it is implicitly believed that a selfless State acts to effect such correction. This *is* problematic because, among other things, this understanding of regulation treats the State as a black box. Since the State is viewed as a black box, there is no space for the isomorphic image of market failure – government failure. To quote a perceptive statement made by Coase while acting as a discussant for a series of papers on regulation – "Until we realize that we are choosing between social arrangements which are all more or less failures, we are not likely to make much headway." [Coase (1964)]

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In the first section of this paper, we construct an understanding of ' failure', which allows us to analyse the pattern of governance of regulation. At the outset of the section we enter into the social arrangement of the State byIn the first section of this paper we seek to schematically representing the State as a series of institutions that derive authority from a Constitutional structure – in particular developing the doctrine of separation of powers .as an analytical device. We follow this by placing In the second section of the paper we place regulation in thise scheme of constitutional governance. In the second section of the paper we use the analytical structure developed in the first section to comment on two or three recent instances regulatory failure in India. some current policy debates in India.

IMainstream economics does not by and large engage significantly with the notion of State. This in itself is not problematic to the extent one is exploring social behaviour in the 'market place'. However, an analysis of the many instances of market failure inevitably solicits the presence of the State. Thus, when the public interest theory of regulation perceives regulation as the co-ordinated correction of varieties of market failure by simulating market outcomes that the market would have configured in the absence of market failure, it is implicitly believed that a selfless State acts to effect such correction. This is problematic because, among other things, this understanding of regulation treats the State as a black box. Since the State is viewed as a black box, there is no space for the isomorphic image of market failure – government failure. As Coase has stated, while acting as a discussant for a series of papers on regulation – "Until we realize that we are choosing between social arrangements which are all more or less failures, we are not likely to make much headway." [Coase (1964)]

What is a Constitution?

The constitution is the highest source of law in a nation-state. The constitution creates the State as a social arrangement, which in turn could allow us to grapple with regulation as an activity embedded in such a social arrangement. While the understanding of the State as a social arrangement is the substance of the political philosophy, this is naturally hazardous territory for the economist. The hazard stems both from the methodology and the evaluative norm of efficiency (wealth maximisation) employed by economics. We do not directly engage with these hazards at this point; instead we move towards employing an instrumental perspective on the State by asking – What is it in practice that defines the modern liberal State? The answer probably lies in the act of forwarding the fundamental and primary value of Representative Democracy. Such 'Representative Democracy' can be constructed in a variety of forms – for instance it could either be a Presidential or Parliamentary Democracy, it could be based on proportional or majoritarian representation. Whatever the case may be (again, we do not engage with these important questions closely here in the interest of focussing on the problem at hand), it is almost invariably true that in a liberal democracy the constitution is the highest source of law in a nation-state. The constitution creates the State as a social arrangement by specifying offices and the powers and procedures of these offices.

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[1] This idealization changes in a globalised settings where at times reference is made to a higher code governing the conduct of nations.

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To phrase this in a different language – the constitution can be viewed as the document that specifies the rules of the game within which social arrangements are required to function. This characterisation extends both spatially and temporally. In the temporal sense constitutions play a particularly vital role of mitigating uncertainty – by restricting in period choices, which may be inimical for the long run social good.

In addition to specifying the grand rules, constitutions also typically seek to guarantee and promote a set of normative values in society. The answer would seem to be lie in the Constitution of such a state. Thus for instance the our Cconstitution of India sets out the tasks of

JUSTICE, social, economic and political;
LIBERTY of thought, expression, belief, faith and worship;
EQUALITY of status and of opportunity;
and to promote among them all FRATERNITY assuring the dignity of the individual and the _Unity and integrity of the Nation;

One way of interpreting such normative matters is It is possible to read them as a series number of functional concerns that are essentially incorporated into this the structure of the Constitution. Thus, Liberty, which provides the individual with the freedom to choose, thus seeks to expand the domain of individual action. The notion of Justice similarly has a number of attributes that these include both the concerns of equity and efficiency. Equality of status and opportunity similarly haves both process and consequentialist dimensions. However, it can be But it would be widely held that such functional concerns are appurtenant to the more overarching concerns of liberty – understood in its 'negative' attribute, and representative governance.

To balance these functional concerns and to find a way of solving the problem of aggregating and representing preferences of a society through the institution of some democratic mechanism, Tliberal he constitutions typically uses the doctrine of separation of powers. In this context, theThe elemental Montesquian argument was that since the State has three powers – the legislative, the executive and the judicial, concentrating these powers in any one or two bodies would diminish liberty. [Montesquieu (1949)] Economists have recently addressed this structural argument by showing that the doctrine of separation of powers improves social welfare by reducing the quantum of rent seeking activity in the political system. [Put in references] However one can also we invoke the doctrine in a more functional sense, after the manner of our earlier work analysing judicial activism [Anant and Singh (2002)].

In this work we developed on the functional aspect of separation of powers by drawing on the notion of transaction costs to explore the social implications of the doctrine being breached. More specifically it was argued that the endemic presence of transactions costs makes it impetrative that when the State exercises a choice, such choice be delegated to the institution best equipped to minimise transaction costs – a breach of this acts to raise transaction costs and therefore results in a misallocation of resources. Thus, one can view the broad divisions engendered by the separation of powers doctrine – the legislature, the executive and the judiciary, as being justified on the grounds that each branch is equipped to process different categories of information and therefore possess a different mechanism of decision-making (footnote). In this scheme, activism comes to be defined as a branch extending its mechanism of decision-making on the grounds of privilege onto problems that are the forte of some other branch. The consequences of such activism can

be ambiguous, in the sense that depending on the circumstances, activism can either enhance or diminish social welfare.

The structural and functional arguments make a peruasive case for a strong or strict separation of powers. But However, if one were to by and large summate the structural and functional arguments for upholding the doctrine of separation of powers together, there is overall, a fairly strong argument for upholding the doctrine. It is therefore important to seek an answer to the question as to why in practice the separation of powers is much too often weak. One response could be the presence of extensive political capture by a faction in society, however the problem can also be sourced elsewhere as well. The doctrine of separation of powers contains within itself a trade-off. Upholding the doctrine can be a costly in resources particularly if the problem on hand requires the input of all three branches of the State. The doctrine requires strong instutions and effective mechanisms for inter-institution negotiation. The strictness of separation promotes clarity and predictability but can be very expensive in terms of resources and bargaining. [ref: Cooter] If these branches are underdeveloped, and/or there are substantial bargaining costs across the branches, it could be expedient to work with weak separation of powers – of course with its attendant social costs. The problem here is that while weak separation promotes decisions making and it allows which ever institution is at a given moment decisively placed to act so as to resolve the problem, i.e. it economises on decision making resources it creates a potential for conflict between the concerned bodies . It is an important task for further research to analyse this trade-off; for our current purposes it will have to suffice to take cognisance of the trade-off in the context of analysing regulation within the constitutional scheme.

Regulation

The term regulation is widely taken to connote rules, both formal and informal – that have been put into place for social control. If this is accepted, then one needs to clarify the distinction between law and regulation. One approach to this question is to say that law and regulation are conterminous; the standard braches of law – property, contract, tort and crime act to regulate society. Yet law and regulation are often viewed as distinct categories. For instance, in a recent article Glaeser and Shleifer (2003) distinguish between private litigation and government regulation as alternate institutional frameworks to situate a social order. This work aims specifically to look at the choice between these alternate institutions. While we do not engage with this choice here, the point being made is that for the purpose of this paper we view regulation as being distinguished from law by identifying the presence of special regulatory agencies created by the State to effect a targeted category of social control – primarily associated with special categories of contracts.

It has been argued that standard contract law inadequately services certain contracts, such as those associated with public utility provision, because unlike discrete contracts, these contacts on the one hand involve substantial degree of asset specificity and on the other hand benefit a large number of users – sometimes as large as the voting population. In these instances, the regulator plays the role of administering the contract by achieving a balance between the producers's 'right to serve' against the consumer's 'right to be served'. [Goldberg (1976)] If we accept the act of regulation as the administration of contracts that cannot be adequately performed under the aegis of contract law, the question clearly arises as to how the 'administrator' is placed visa vie the constitutional

scheme.

In the first instance it needs to be noted that the act of regulation involves the interplay or engagement with functions of the three branches of the State, signifying that regulatory activity involves a hybrid conglomeration of the three functions. Now, it can be argued that a variety of hybrid institutions combining the functions of the three branches of the State can be created and there will be no real hassle with regulation as long as the problem on hand is slotted in the appropriate slot. This is what happens if there is strong separation of power overall. If there is weak separation of power then each time one has to device a new institution in which the separation of powers problem has to be worked out against a background in which there is weak separation of power. This ends up with over and under delegation, which is the analogue of activism.

2. Case Studies.

A. The reforms after 1991 as well as the debate on financial systems after the asian crisis emphasised the need to modernise the law on insolvency particularly as it relates to corporate insolvency. To deal with this class of issues the Govt in 1999 appointed a committee to examine the law relating to insolvency of companies. This committee (chairman: Justice B. Eradi) recommended :
"The whole issue of law relating to insolvency of companies should be viewed not only on basis of the existing provisions of Part-VII of the Companies Act, 1956 but also other relevant laws having a bearing on the subject, such as Sick Industrial Companies (Special Provisions) Act, 1985, (SICA), Recovery of Debts due to Banks and Financial Institutions Act, 1993, UNCITRAL Model Law on Cross Border Insolvency approved by United Nations (Annexure A) and International Monetary Fund report on "Orderly and effective Insolvency Procedures" (Annexed as B) The Committee, therefore, recommends that the provisions of Part VII of the Companies Act, 1956, be amended to include the provisions for setting up of a National Tribunal which will have,-
the jurisdiction and power presently exercised by Company Law Board under the Companies Act, 1956;
the power to consider rehabilitation and revival of companies – a mandate presently entrusted to BIFR/AAFIR under SICA ;
the jurisdiction and power relating to winding up of companies presently vested in the High Courts. In view of above recommendations Article 323B of the Constitution should be amended to set up National Tribunal. SICA should be repealed and the Companies Act, 1956 be amended accordingly.
7. 2 In continuation with the Committee's recommendation in para 7.1, the Committee recommends that the Tribunal should be headed by a sitting judge or a former judge of a High Court and each of its Benches should consist of a judicial member and a technical member. Tribunal shall have such number of members as may be prescribed by the Central Government.
The principal Bench of the Tribunal should be located at New Delhi and its Benches should be located at the principal seats of each High Court.
The Central Government may set up more such Benches if so required
(Emphasis added)

Independently of this exercise the Reserve Bank of India had constituted a set of advisory groups to examine the status of India's compliance with the international financial standards and codes . As part of this exercise a advisory group on bankruptcy law comprising of lawyers, financial market experts and academics was set up. This group examined the same question and chose to recommend a Special Bankruptcy Bench in each High Court. They reasoned

"In spite of the fact that tribunalisation of justice is now a settled fact especially after L. Chandrakumar [(1997)3SCC,261], there is a philosophical debate going on as to the nature, extent, structure and power. Even Justice Eradi Committee commented that in order to make National Tribunal able to quicken the dispute resolution, Article 323A & B of the Constitution is to be amended. This Group does not think that such a step, by-passing the judiciary, is necessary or possible;
A special bench of the High Court as a full time Bankruptcy Court shall serve all purposes as well as quickening the issue of the procedure recommended;
A special bench of the High Court will be able to bring multi-dimensional knowledge necessary for restructuring/reorganisation and bankruptcy proceedings; and
A special bench shall add validity of action in all renegotiated proposals and on the failure of restructuring process, quicken the insolvency proceeding."

It is important to note that both groups felt that excluding the jurisdiction of the high court would need a constitution amendment. This difference in approach is not new. 1989-1990 the Malimath committee had infact reached a similar conclusion . Examining this report the Supreme Court in Chandrakumar felt that while this was not practical tribunals need to reformed and "However, drastic measures may have to be resorted to in order to elevate their standards to ensure that they stand up to constitutional scrutiny in the discharge of the power of judicial review conferred upon them." They then identified the guidelines which form part of the Eradi committee recommendation. The RBI group recognised the possibility of constitutional change but felt that the political capital to implement would be limited so reverted back to a version of the Malimath recommendation.

The Supreme Court recently (Union of India and Anr vs. The Delhi High Court Bar Association and other, Appeal (civil) 4679 of 1995) following its reasoning in L Chandrakumar upheld the creation of debt recovery tribunals. But even this pointed out the importance of a structure that provided for the structure envisaged in that judgement and emphasised the "that the decision of the Appellate Tribunal is not final, in the sense that the same can be subjected to judicial review by the
High Court under Articles 226 and 227 of the Constitution"

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[3] Report of the Standing Committee…..
[4] One of the authors was a member of this group
[5] "The Malimath Committee specifically recommended that the theory of alternative institutional mechanisms be abandoned. Instead, it recommended that institutional changes be carried out within the High Courts, dividing them into separate divisions for different branches of law, as is being done in England. It stated that appointing more Judges to man the separate divisions while using the existing infrastructure would be a better way of remedying the problem of pendency in the High Courts." From L. Chandra Kumar (SCC 1997

Inspite of this backdrop and experience what was done leaves the door open for extensive litigation. In December 2002 parliament passed The Companies (Second Amendment) Act, 2002 providing for a national tribunal. But no constitution amendment was made. This act provides for benches but it is not clear if they will ensure a bench be located at the principal seats of each High Court. Thus on the one hand the act seeks to supplant the high courts but on the other makes no attempt to ensure that the coverage is compatible with the courts. Further the act provides for a Single Appellate tribunal. One of the earlier problems with the debt recovery tribunal was its inadequate appellate structure. Further the act provides for appeal only to the Supreme Court once again in conflict the pattern of the court. It is entirely possible that the courts may eventually rule this structure to be legitimate as was done with the debt recovery tribunals in 2002 (Union of India vs Delhi High Court Bar association) but what is almost certain is that it will lead to a extended period of litigation to establish legitimacy. Even after this is accomplished the writ jurisdiction of high courts will ensure that there are adequate grounds for disputes on an ongoing process as bankruptcy and insolvency will continue to raise issues of the hierarchy of rights and thus justifying pleas on constitutional grounds. Thus what seeks to be a measure to reduce litigation will in all likelihood increase it. The reluctance to pose either the constitutional question or the modified high court solution is not because the coalition govt cannot pass constitutional amendments. In this period three constitutional amendments 84th (electoral delimitation) 85th (Art 16 seniority) and 86th (21A right to education) were in fact passed. The limitation is linked to the inability to negotiate with constitutional entities.

Before leaving this example it is important to stress another facet of the recommendations of the RBI group. The Supreme court in L. Chandra Kumar had pointed out “The reasons for which the Tribunals were constituted still persist; indeed, those reasons have become even more pronounced in our times” they thus felt the importance to continue with the practise. There is however another solution, the reason why tribunals have become desirable is the need to incorporate specialist, what we have earlier termed executive, knowledge into their decision framework. This can be done through a quasi judicial body or by strengthening the executive capacity of the courts. The expert group outlined a framework in which that can be done through the concept of a “Trustee”. The point is that amalgamation of functional attributes can be done in more than one way

B. The competition commission poses a similar problem. The expert committee which had proposed the new constitution bill had suggested that the composition of the commission be done through a selection committee that includes the chief justice. However when the bill was finally placed before parliament the Govt moved a amendment to restrict this and said that “chairperson and other members shall be selected in the manner as may be prescribed.’’ Further the selection committee included the Law Minister instead of the Chief Justice contrary to the assurance given to parliament. The first chairperson selected was from the bureaucracy. As expected this led to a PIL with the court asking how can a bureaucrat be asked to “discharge a judicial function”. The controversy led to the cancellation of the appointment delaying the formation of what is a critical regulatory body.

Thus reacting to this statement by the court Mehta observed that “Competition

policy is not quite as simple a matter as it first appears: the complex web of relationships that exists between companies in modern capitalism can make detection of anti-competitive stakes in any merger difficult indeed." Or in terms of our functional descriptions assessing markets requires the skills associated with executive decision making. Mehta and others observing the process correctly pointed out that the stated concern has been with the identity of the person appointed as chairman (Retired Bureaucrat vs Retired Judge) but while that is important there is a more central concern on control and location of the regulator. The flavour of L. Chandra kumar emphasises the need to keep the judicial arm of the constitution involved in such amalgamated authorities. It has been argued in this case that competition authorities in other parts of the world have been headed by non-judicial personal. But what is not equally appreciated is that such structures must be consistent with the nature of separation of powers in that society. Thus, for instance, in the US, adjudication of competition cases is done by the courts. In England the body is headed by specialists and this is consistent with their unitary structure.

C. The final example is based on a current debate on the extent to which central banks must have autonomy. The debate in economics tends to be cast in terms of the objectives of Monetary policy and the need or importance to segregate them from Fiscal policy. In part the debate is over the real/financial impact of such policies. This debate has taken different forms over the years ranging from the pure monetarist positions to ones which now relate the importance of such policy in financial stability. In this case the issue does not concern the Judiciary but one between the legislature and the executive. The IMF with its concerns for financial market stability argues for independence for the authority with clearly defined financial objectives. On the other hand critics like Stiglitz recently have argued that there is need for greater democratic control. The resolution we would suggest is as much in the realm of theory as in the appreciation of importance of the doctrine of separation and the constitutional framework of governance. Once again we can refer to the recommendations of the RBI emphasising the link between fiscal responsibility and monetary transparency.

The point of these examples is to highlight the role played by separation of powers and the importance inter-institutional bargaining. This failure of dialogue and a incoherent appreciation of the doctrine of separation becoming on of the the key impediments to reform.

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[6] Pratap Bhanu Mehta "Judges Dominion" The Hindu Nov 4 2003

[7] Report of the standing Committee …. Also see TCA Anant "International Financial Standards and Codes: an Indian Perspective" paper presented at Banking and Financial Services Conference organized by the Commonwealth Business Council July 3-4 2002

Annexure
Constitution of India PART XIVA TRIBUNALS

323B. Tribunals for other matters.-

(1) The appropriate Legislature may, by law, provide for the adjudication or trial by tribunals of any disputes, complaints, or offences with respect to all or any of the matters specified in clause (2) with respect to which such Legislature has power to make laws.

(2) The matters referred to in clause (1) are the following, namely:-

(a) levy, assessment, collection and enforcement of any tax;

(b) foreign exchange, import and export across customs frontiers;

(c) industrial and labour disputes;

(d) land reforms by way of acquisition by the State of any estate as defined in article 31A or of any rights therein or the extinguishment or modification of any such rights or by way of ceiling on agricultural land or in any other way;

(e) ceiling on urban property;

(f) elections to either House of Parliament or the House or either House of the Legislature of a State, but excluding the matters referred to in article 329 and article 329A.

(g) production, procurement, supply and distribution of food-stuffs (including edible oilseeds and oils) and such other goods as the President may, by public notification, declare to be essential goods for the purpose of this article and control of prices of such goods;

_268[(h) rent, its regulation and contorl and tenancy issues including the right, title and interest of landlords and tenants;]

_269[(i)] offences against laws with respect of any of the matters specified in sub-clauses (a) to _270[(h)] and fees in respect of any of those matters;

_269[(j)] any matter incidental to any of the matters specified in sub-clauses (a) to _271[(i)].

(3) A law made under clause (1) may-

(a) provide for the establishment of a hierarchy of tribunals;

(b) specify the jurisdiction, powers (including the power to punish for contempt) and authority which may be exercised by each of the said tribunals;

(c) provide for the procedure (including provisions as to limitation and rules of evidence) to be followed by the said tribunals;

(d) exclude the jurisdiction of all courts, except the jurisdiction of the Supreme Court under article 136, with respect to all or any of the matters falling within the jurisdiction of the said tribunals;

(e) provide for the transfer to each such tribunal of any cases pending before any court or any other authority immediately before the establishment of such tribunal as would have been within the jurisdiction of such tribunal if the causes of action on which such suits or proceedings are based had arisen after such establishment;

(f) contain such supplemental, incidental and consequential provisions (including provisions as to fees) as the appropriate Legislature may deem necessary for the effective functioning of, and for the speedy disposal of cases by, and the enforcement of the orders of, such tribunals.

(4) The provisions of this article shall have effect notwithstanding anything in any other provision of this Constitution or in any other law for the time being in force.

Explanation.-In this article "appropriate Legislature", in relation to any matter, means Parliament or, as the case may be, a State Legislature competent to make laws with respect to such matter in accordance with the provisions of Part XI.]

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What is democratic? Compare parliament to the president direct election to indirect election?

Why is a threefold sop sacrosanct? Why not more constitutional entities (it is actually not threefold)

Centre vs states vs local govt, Judiciary, Independent authorities: CAG, election commission
Strict SOP versus overlap

Tradeoffs between constitutional vs statutory status

What does it mean for a regulator to be under parliament, under the executive and under the judiciary?

Tribunals, Fragmented law, ambiguity
Case study RBI, Competition Bill