

Law, Economics and the Control of Corruption

Dr. Kaushik Basu

*(Professor of Economics and C. Marks Professor,
Cornell University, Ithaca and New York, U.S.A.)*

**The Fifteenth Nani A. Palkhivala
Memorial Lecture**

December 2017



Published by
Nani A. Palkhivala Memorial Trust

NANI A. PALKHIVALA MEMORIAL TRUST

We hardly need to introduce you to the life and work of the late Nani A. Palkhivala. He was a legend in his lifetime. An outstanding jurist, an authority on Constitutional and Taxation laws, the late Nani Palkhivala's contribution to these fields and to several others such as economics, diplomacy and philosophy, are of lasting value for the country. He was a passionate democrat and patriot, and above all, he was a great human being.

Friends and admirers of Nani Palkhivala decided to perpetuate his memory through the creation of a public charitable trust to promote and foster the causes and concerns that were close to his heart. Therefore, the Nani A. Palkhivala Memorial Trust was set up in 2004.

The main objects of the Trust are the promotion, support and advancement of the causes that Nani Palkhivala ceaselessly espoused, such as democratic institutions, personal and civil liberties and rights enshrined in the Constitution, a society governed by just, fair and equitable laws and the institutions that oversee them, the primacy of liberal economic thinking for national development and preservation of India's priceless heritage in all its aspects.

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C/o. Forum of Free Enterprise

Peninsula House (2nd floor),

235, Dr. D. N. Road, Mumbai – 400 001.

Tele: 91-22-2270 3426 Telefax: 91-22-2261 4253

E-mail: ffe@vsnl.net

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INTRODUCTION

The Nani A. Palkhivala Memorial Trust was privileged to have Dr. Kaushik Basu deliver the 15th Nani A. Palkhivala Memorial lecture on 14th December 2017 on the subject “*Law, Economics and the Control of Corruption*”.

In a brilliant lecture, enlivened by real life anecdotal illustrations borne out of his vast experience as the former Chief Economist of the World Bank and the former Chief Economic Advisor to the Government of India, Dr. Basu examines the interface between law and economics and the manner in which these two disciplines can contribute to a country’s development in major ways.

As Dr. Basu notes, corruption is a scourge. It is bad for the economy and it is degrading as it cuts into the moral fibre of society. He has pointed out that in Transparency International’s chart of countries where 100 means “free of corruption”, India scores only 40 which indicates that by international standards, corruption in India is fairly high. However, he also points out that there are examples which show that countries in which corruption was endemic and pervasive in the past, have been able to conquer the bulk of corruption and there is no reason why India cannot do likewise.

The measures needed to control corruption have often been discussed but what distinguishes Dr. Basu’s analysis is that he argues that corruption is not a human response to economic incentives but in reality, a large part of corruption is a matter of mindset. He gives a timely warning that in battling corruption, you cannot use a ham-handed instrument like the stopping of all activities of a certain kind as that could bring the economy to a halt, and there is also a risk that if bureaucracy goes overboard,

control of corruption can easily become an instrument of political vendetta.

Dr. Basu believes that while passion and anger about corruption is important, an effective policy for the control of corruption also needs analysis, research and professional ideas. Dr. Basu's thought-provoking lecture is an exercise in that direction. His central theme is that traditional law and economics fail to explain why some laws are followed and some laws are collectively overlooked and he believes that the answer lies in the fact that laws can change our expectations of other people's behaviour and they can change their behaviour because they expect our behaviour to change. Understanding this can influence a new approach to laws which can control corruption.

Dr. Basu's lecture provides an innovative and exciting new approach to the question of the control of corruption and needs to be widely debated. It is with that purpose that the Nani A. Palkhivala Memorial Trust is publishing this lecture and giving it the widest distribution.

Y. H. Malegam

Chairman

11th September 2018 Nani A. Palkhivala Memorial Trust



NANI A. PALKHIVALA

16th January 1920 - 11th December 2002

Law, Economics and the Control of Corruption

Dr. Kaushik Basu*

Mr. Malegam, Justice Sujata Manohar, Ms. Bharucha, Mr. Mehta, distinguished members of the audience, it is an honour for me to be delivering the Nani A. Palkhivala Memorial Lecture. Palkhivala was a great citizen of India, a remarkable individual who contributed to our nation in many ways, in the of field economics and in the field of law. His views concerning the importance of secularism for markets to be able to function effectively, are today a matter of some urgency. I grew up in a family of lawyers, so for me Nani Palkhivala was a revered name during my early years in Calcutta. I remember the sports stadium that would fill up every year after the Union Budget when he would speak to analyze and dissect the Budget. To me also significant is what he emphasized as one of the most important lessons he got from his father. In his words, “My father taught me compassion and kindness for the less privileged as more important than anything else”. That sums up the essence of Nani Palkhivala.

* *The author is Professor of Economics and C Marks Professor of International Studies, Former Chief Economist of the World Bank and former Chief Economic Adviser to the Indian Government. The text is based on the Fifteenth Nani A. Palkhivala Memorial Lecture delivered under the auspices of Nani A. Palkhivala Memorial Trust on 14th December 2017 in Mumbai.*

I must also thank Mumbai. I love the city, its cosmopolitan nature and the vibrant culture. So, thank you very much for inviting me and giving me the opportunity to be here in Mumbai.

This is going to be a serious lecture. People in India usually get alarmed when you say this because a serious lecture is equated with a boring lecture. There's a bit of a risk of that I must warn you. I'm going to do two things, as Mr. Malegam already mentioned. I am going to talk about corruption and its control, based on some of my own experience in India and also on ideas that have come to us from the huge literature on the subject. Secondly, I want to take you into the discipline of law and economics, the interface between economics and the law. United States gets the credit for the start of the discipline, the serious interface between law and economics, with its enactment of the Sherman Antitrust Act in 1890. It has become a huge field of study now and I think, done right, the discipline of law and economics can contribute to a country's development in major ways.

Nevertheless, there are flaws in the discipline, the way it is practiced. I want to give you a glimpse of that using a little bit of modern game theory. When game theory is mentioned, people usually think of something very complicated, but that is not necessarily so. In its essence the ideas are simple and that is how I will use them. My aim is to show you the importance of bringing clarity of thought to bear on the discipline.

Corruption is a scourge. It is true that corruption can in some situations facilitate markets and their functioning. But on the whole, it is bad for the economy. It is degrading, cuts into the moral fabric of society, and you can see a correlation between countries that have managed to

get rid of the bulk of corruption and countries that have prospered economically.

We must strive to minimize, to put an end to corruption. People in India often argue that corruption is endemic and that is not surprising since it is such a pervasive problem. Indeed, this view goes back to ancient times. There are some beautiful passages in Kautilya's Arthashastra on corruption. He was one of the pioneering writers on this problem, delving into it as early as the 4th century BCE. Let me quote him: "Just as it is impossible not to taste honey or the poison on the tip of the tongue, so it is impossible for a government servant not to eat up at least a part of the King's revenue." It's a rather negative view of corruption and Kautilya goes on to say corruption is so hard to catch because just as fish moving under water cannot possibly be caught for drinking water, government servants who work on the government's budget cannot be found out while taking money for themselves.

Kautilya was a remarkable thinker and his writings must have contributed to the widespread belief in the inevitability of corruption. But I want to stress that corruption can be and has been curtailed in many countries. We do not have to live with endemic corruption. There are developed countries in the world, such as United Kingdom and Sweden, where, if you go back to the early 19th and late 18th centuries, corruption was widespread. In Sweden there was the practice of 'sportler'. Sportler (derived from the Latin 'sportula', meaning gift) is somewhere between a tip and a bribe—a convenient ambiguity. The sportler was widely used in Sweden in the 19th century, for what you wanted to get from the government. But over a period of a 100 years the practice vanished; indeed, overall corruption went down sharply and virtually disappeared. Today Sweden is ranked by Transparency International

as the third least corrupt country in the world. The story is similar for United Kingdom.

In recent times, there are examples of countries where corruption has gone down even faster, over a couple of decades. Singapore was a corrupt country. No longer. Singapore stands in Transparency International's chart of countries very high, with an index of 85. I should explain this index represents perceived freedom from corruption. So, 100 means completely free of corruption, and 0 means—well it's better not to think about it.

Needless to say, there is no country at 100 and there is no country at zero. Singapore is at 85 and Singapore is today ahead of United Kingdom in terms of this index. Hong Kong gets a score of 77, and Hong Kong, though behind United Kingdom, is ahead of United States. These were countries which just a few decades ago had pervasive corruption.

In case you are curious, the world's least corrupt countries are Denmark and New Zealand with a score of 90 each. India with a score of 40, is pretty corrupt, with China and Brazil in the vicinity.

Let me add a remark here on economic incentives. Economists treat corruption as human response to economic incentives. But in reality, a large part of corruption is a matter of mindset. In some societies people don't even think of doing certain things. Take for instance stealing other people's wallets. Most people, a huge majority, don't even think of pinching other people's wallets. It's not as if they do cost-benefit analysis and decide it is not worth stealing wallets. They just don't even consider it. This is what nurtures trust. Anonymous trust in India is low, but trust among close friends and relatives is very high. You know that your friend will not let you down. So, there are

a variety of ways where the human mindset matters and there is a lot of recent research on that. Though the bulk of my lecture will be on economics, this is worth keeping in mind.

Let me turn to some practical problems of corruption before I go into the analytics. In countries where corruption is pervasive, like India, China, Brazil, large parts of sub-Saharan Africa, and so on there are special problems. First, you have to appreciate that when corruption is endemic, you cannot use a ham-handed instrument to put an end to corruption because corruption resides amidst a lot of legitimate activity. So, if you try to put an end to corruption by stopping all activities of a certain kind you will probably put an end to corruption but you will bring the economy to a halt.

When I was in Government people would come and say about black money being parked abroad, that we should investigate everyone's bank account held abroad. What they missed is that India is today a modern society. Many Indians have bank accounts abroad, especially the ones who are doing business with different countries traveling back and forth, and a lot of it is legitimate banking. If you unleash bureaucracy on that, suspecting everybody, you are going to bring normal business to a halt. So, you have to be surgical in controlling corruption. That is the way you think in terms of medicine and that is the reason why surgery for malignancy is so difficult. You know that there are healthy tissues you can damage if you use a blunt instrument to remove a tumor. So you need research and targeting.

With bureaucracy there is very often a risk that you'll go overboard and use a ham-handed instrument to clear the problem. This is why India's demonetization was a totally unfortunate intervention. Declaring 86% of the value of

currency in circulation as illegal tender with four hours for notice, and then with only two months or a little bit more for people to change that money, was as blunt an instrument as can be used to cut corruption and allegedly catch black money. And indeed, the effect was very bad for the economy, which slowed down as a consequence of that.

My calculation is about three percentage points of growth was lost due to the demonetization. Let me explain this. There are a couple of trends in the international domain which have helped India in a big way, the most prominent being the decrease in oil price. Also, ease of doing business has improved in India. With all these changes growth would have been back up to where it used to be from 2005 to 2008, till the Lehman collapse occurred, at roughly 9.4% per annum. It is nowhere near that. In the latest quarter it was 6.3%, before that it was 5.7%. So, it is a slack of about 3 percentage points. The GST I should mention since I am speaking on contemporary policy, is good policy. I am glad it has been done even though its implementation was very poor.

The second problem with pervasive corruption arises from the fact that it is very easy to find some violation of the law anywhere you look, since virtually everybody ends up violating some law, big or small. When that happens, the control of corruption can become an instrument of political vendetta. In countries with pervasive corruption and you have a plethora of choice as to who you go after, even if the leader is serious about bringing corruption down, it is natural political instinct not to go after your friends. You won't survive politically if you start with that. So, you begin to go after your enemies, the voices of dissent, those who are critical of what is being done and gradually you silence those voices by bringing corruption charges against them.

This happened during the Indian Emergency and this is a risk that today's China faces in a big way, as does India. I like to believe that this risk is bigger for China than for India because India is after all a functioning democracy and so if there is a big silencing of the dissent that goes on, the electorate begins to take note of that, as happened during the Indian Emergency, and the next round of secret ballot can punish the government.

Let me turn now to some day-to-day matters where I had some hands-on experience as a policymaker. When I was Chief Economic Advisor to the Indian Government one form of corruption that showed up statistically as significant, concerned subsidized food distribution to the poor. The way India does it is the Indian Government, through the Food Corporation of India, buys up a certain amount of food grain from the market. It is actually quite a bit that the government buys up of rice and wheat. About one fourth of the production is bought up. This is done not by using force but the government announces a high "minimum support price" and farmers are given the option to sell their food grain to the government at that price. Then two things are done with this food: A part of it is kept in storage in case there is a shortage of food or a sudden inflation. It can then be released. The second is to give out a part of this food to poor households. There are roughly 500,000 stores all over India and the government hands out food below the market price to these stores and tells these store owners that poor people will come with their BPL cards and they should then be given out their rations at a pre-fixed price, well below the market level.

What many of these ration shops do is to sell off some of this food at the market price. When the poor come to collect their food grain ration, they tell them that the food has not arrived. We have estimates that roughly 45% of

the food meant for the poor leaks out. That is, it does not reach the poor. This is unfair to the poor and also a huge fiscal burden for India. What do you do about this? To me this is exactly where you have to bring economic analysis to bear on the problem. To try to do this entire operation by the government, from going to the farmer to collect the food, using government resource to transport the food and using government stores to hand over the food to the poor is not a good idea. A much better way to do the same thing is for government to hand over cash or food stamps to the poor and let them buy food from the regular market and private stores at the market price.

There will be no scope for the ration shop to divert food anymore. Another benefit of this is that when the poor go into the store, under this system they are going to go like anyone else because they are going to pay the market price with regular money. They have already received the cash; they will buy it at the market price. So, they will not face any discrimination or humiliation, waiting to receive subsidized food from the store-keeper.

Like any policy intervention this is not without its downsides. It is often pointed out that for many of poor people, once you give them cash they are not going to spend it on regular food. They will spend it on tobacco and alcohol. My response to this is: even if that were to happen I would rather have the poor households spend the money on other things than the ration shop owners spend the poor people's subsidy on other things.

Further, there are studies which show that you can actually cut down expenditure on alcohol and tobacco and improve the quality of spending by working on the *modality* of handing over the cash. There are some statistical studies from India, Bangladesh and very robust ones from Britain, which show that when you give a subsidy to a household,

if you hand it over to the adult woman rather than the man, the expenditure is much more responsible and enhances household well-being and in particular children's welfare.

So, the advice is don't try to do the whole operation through the government; use the private traders along with the government. Let the government give the subsidy directly to the poor and then let them buy the food from the market. You will cut out a huge amount of the corruption. This was a suggestion that I put on the table and I am hopeful that, though these things take time in India, something will eventually happen.

My other experience concerns the bigger law and economics debate and that is one reason I've come back to the subject now in a deeper academic way. Soon after joining Government an idea struck me about 'harassment bribes'. Harassment bribes are bribes that you're asked to pay for something that is legitimate. You've done your Income Tax Returns properly, and then you're asked to pay a bribe before you're given a final clearance. That is a harassment bribe—modern-day India's sportler. This is not a matter of big or small corruption. You've brought in a huge amount of imports from abroad, you've done your paperwork right but you're asked to give a bribe to release your cargo. This is also a harassment bribe.

As an aside, this is one reason there should be more people from outside government who should be brought in for short-term government work. When I lived in India as an ordinary citizen, I encountered demand for harassment bribes often enough--trying to get a driver's license, doing my tax papers, and so on. Once I went into government this was not happening at all. I mean I would go to these places, but as the Chief Economic Advisor I didn't face any demand for bribes. Hence, I believe bureaucrats, who have had their entire career in government may forget that

harassment bribery is common in India. Outsiders with short-term appointments will be more conscious of these failings of government than career bureaucrats.

What should be done about this? Since this is the Palkhivala Lecture let me get into some legal details. In India bribery of this kind is meant to be controlled by the Prevention of Corruption Act 1988. This Act says that if there is an incident of bribery and this is proved, then both the giver of the bribe and the taker of the bribe are equally liable to be punished. Section 12 of the law puts the responsibility of the crime on the shoulders of both parties. There are a few exceptions, I have to point out in case there are lawyers in the audience—Section 24 is meant to be an exception, but it's not followed in practice and there are judgments given which basically nullify the scope for exceptions. So according to the Indian Law, the giving and taking of a bribe are equally punishable.

When I first read this, an antenna went up as an economic theorist. Once you criminalize both the giving and taking of a bribe, after the bribe has been paid it is in the interest of both the bribe taker and the bribe giver to collude and hide the information, because, if caught, both of them will be punished. One way to rupture this collusion is to amend the law and say that, for harassment bribes, giving a bribe is not a crime. But taking a bribe is illegal. In fact, you can hike up the punishment for the taker. If you amend the law to allow for such asymmetry in punishment, the collusion between the giver and the taker will go down because after giving the bribe you will feel free to speak. And further, once you rupture the collusion between the taker and the giver, the bribe taker will be more hesitant to take the bribe in the first place because the bribe taker will be aware that in the second period the giver is not going to collude to hide the fact of bribery. This is actually

a verbal description of what is Nash equilibrium behavior, an idea that originated from John Nash the famous mathematician, game theorist.

I got excited by the idea, wrote it up as a short paper and posted it on the Ministry of Finance web site. It was my naivety that prompted me to do this. If I had been in government for some years I would have known not to do so. I am glad I was naïve.

Furor broke out after that. There were questions raised in the Parliament. There was a Member of Parliament, who wrote to the Prime Minister, Dr. Manmohan Singh, and said that I should be asked to leave government for putting forth such an immoral idea. There were articles that appeared, very critical ones in the Hindu and the Telegraph.

There was a memorable weekend when I got a call at home from a popular television channel asking me to come on TV and explain and defend my idea. I don't have to tell an Indian audience what television debates are like in India. It would be a wild shouting match on screen. I'm personally quite comfortable with that; and my first instinct was to go on television and explain that I was suggesting this not to be soft on corruption but in fact out of a moral compunction because I wanted corruption to end. But I thought I had given a lot of grief to the government because the Finance Minister, Pranab Mukherjee, and Prime Minister had got letters complaining about me. I thought I should phone them and ask if I should defend my idea or try not to stoke it.

I discovered the Finance Minister was away in Vietnam. So, I phoned Dr. Singh's residence. Someone came on the line and I said I have an important decision to take within the next half an hour and I would like to take the

Prime Minister's advice. She said she would check with the Prime Minister and hung up. Within 15 minutes my phone rang and the Prime Minister came on the line. I told him about the TV request on my corruption control idea and wanted his advice on whether I should risk fueling the debate further.

He listened and then said he had read about my idea and he did not agree with me at all. This was of course a bit disappointing to me. I tried to explain that he may have been misled by the popular reporting but on the phone, given how busy a Prime Minister is, you can't really argue. So, I let it pass. But then, he added--and this was memorable to me--that though he disagreed with me, as an advisor I am supposed to bring ideas to the table, and so I should feel free to talk about it and explain my idea to the people.

There are very few nations, beyond the rich and advanced economies, which give this kind of space to people to voice new ideas. I think it needs a lot of courage, which Dr. Singh had, and not too many politicians have, to be able to say I disagree with you but don't feel silenced by that. Bring your ideas to the table and let people hear them out.

I remember after that in a G20 Meeting with members of other countries talking about this experience. They all agreed that outside of advanced economies you don't have this kind of space for speech and the floating of ideas. This is something that we should cherish. I'm not saying you should accept this idea or accept that idea, but to have the space for discussion is where India stood out in the world. This is not something that we want to abandon.

I was lucky that after the incident a few prominent voices spoke up, urging that the idea be taken seriously. Mr.

Narayan Murthy was one of them, the international media picked it up, the Economist wrote a supportive article, Le Monde had an op-ed discussing the idea. There has been subsequent research, for instance, by Gianca Spagnolo and Maria Berlin, based on the fact that in China in 1997 a corruption law was made asymmetric in terms of punishment. The jury is still out but I am hopeful that we will eventually get the kind of amendment I was proposing, and that will greatly cut down the incidence of bribery.

All this shows the importance of ideas. Passion and anger about corruption is important but for effective policy we also need analysis, research and professional ideas. As one burrows deeper into ideas one also begins to see how traditional law and economics can be improved so as to enable policymakers to design and implement better and more effective policies.

In the remaining lecture I want to give you a glimpse of what research can give us. When I worked as the Chief Economist of the World Bank I used to give a five-lecture introduction to game theory each year in Washington. In my last year, I felt pleased that the auditorium had not just university students, but bureaucrats from the US government, Executive Directors of the IMF and the World Bank, and people from the US Treasury. I felt that some familiarity with these kinds of ideas is important for better policymaking and was pleased to see this level of interest. Emboldened by that experience, I am going to give you an even shorter course now--a 10-minute course on law and economics.

The discipline of law and economics began in the 1960s and there are three big names which got the discipline going. There was Guido Calabresi from Yale. He is still active and published a book earlier this year. There was Gary Becker from Chicago University, a great economist

and Nobel Prize winner, though I had my disagreements with many of his prescriptions. I invited him for a lecture at the World Bank and in introducing him I remarked on how lots of people identify themselves as anti-Beckerian. And I pointed out that it is a remarkable tribute to him that anti-him has become a school of thought. Finally, then there was Ronald Coase, the eponym for the Coase Theorem.

I got interested in law and economics through their work and through the American experience with antitrust legislation. Antitrust Legislation in the US, as I said earlier, began in 1890 with Sherman Act. Then there was the Clayton Act in 1914, Robinson-Patman Act 1936. With these antitrust legislations consumer rights got some protection. But after some time, Americans realized that if you stop firms from colluding it is good for the American consumers, but when firms are selling to consumers abroad you may not want to cramp their style, which is a dreadful form of nationalism, which led to the Webb-Pomerene Act 1918, which says if you are however producing the bulk of your goods for international buyers you can collude. And now virtually all countries, at least all rich countries have this provision. So, law and economics is something which is used, for good or for bad, in a variety of ways and it was the trigger for the research and literature that started in the 1960s.

But there is a fault-line beneath this discipline. Consider any law. Take a new speed limit law which says that if you drive at above say 80 kilometers per hour there's going to be a fine that you'll have to pay. According to traditional law in economics, which comes down to us from Gary Becker, the reason why this influences behavior is the following. Before this law was there, if you were thinking of going from Bombay to Pune and were wondering

how fast you would drive, you would make some mental calculations that if you go very fast there's a risk of a skid and an accident, and on the other hand you are likely to reach your destination earlier, and so on. You make these calculations and decide at what speed you will drive.

Now when a speed limit law comes into existence, your calculation will change because there's one more thing you'll have to take into account—if you drive fast there is a possibility that the police will stop and fine you. So, the probability of being caught multiplied by the fine that you will have to pay is another cost that will be a part of your calculation now. This was Gary Becker's theory and it shows that certain kinds of behavior can be curbed by either increasing the probability of catching the person violating the law or by increasing the amount of fine the person will be charged.

There is, however, a problem with this theory. In the end the law is nothing but some lines scribbled paper. How can that change human behavior? The way the Chicago school answered this was a mistake. They, inadvertently, I believe, treated the enforcers of the law--the police, the magistrate, the judge--as mechanical, robotic creatures, who, as soon as a new law comes in, go about enforcing it. But in reality, if you think of all individuals as part of the 'game of life', ordinary citizens, the police, the magistrate, the judge, the prime minister, the president, a new law cannot change the game of life for it is nothing but a few words on paper. I have elsewhere referred to this as the 'ink on paper' problem.

If everybody behaves exactly the way they were earlier, they should get the same returns as earlier. So, the law cannot change the game and at first sight it appears it cannot change behavior. Indeed, in emerging economies and even in rich countries there are lots of examples of

laws which collectively people look away from. No one follows that law and no one enforces them. But why are some laws collectively overlooked and why are some laws followed? Traditional law and economics fails to answer this and we need to understand this to improve the implementation of laws.

My view is that while a new law cannot change the game of life that we are playing, it can do something else. It can change your expectation of other people's behavior. And other people's behavior changes because they expect your behavior to change. This is the subject matter of my new book, **The Republic of Law: A New Approach to Law and Economics** that I am currently working on.

Words can trigger expectations and create new beliefs. When there is a new law saying you can't drive above 100 kilometers per hour, when I drive above 100 kilometers per hour, I may believe that the policeman is going to come chasing after me and stop me. And why will the policeman do that? Because the policeman believes that if people drive above 100 kilometers per hour and he does not stop them, then he won't get a promotion in his job. But why will the manager of the police department stop the promotion? Because she expects to be punished otherwise. In the end behavior change is predicated on nothing but our beliefs about one another's behavior. How these expectations can play a role, a very powerful role in determining human behavior, has been stressed from the time of the philosopher David Hume and can be found in the works of contemporary legal theorists and some economists.

The key element for understanding this more formally is the concept of focal point. The concept goes back to the work of the economist Thomas Schelling and has roots in

psychology. A focal point is simply an equilibrium that is salient.

I have distributed a sheet to all of you and you may want to just try this out. Take the colorful picture of a map with a river, a bridge, some trees, grass growing, some houses and a railway track. This is a game that Thomas Schelling had used in his famous book *The Strategy of Conflict*. Imagine the following thing – you and another paratrooper – has been dropped by the Indian Air Force in enemy territory. Each of you have in your pocket the map of the area where you've been dropped and this is the map that you now have in your hand. Now you have to do the following. You have to try to meet up. If you succeed, you will be able to destroy the enemy forces. If you do not manage to meet up, the enemy will kill you. And this is how you play the game. You look at the map, study the map and you know the other person has got a similar map. You choose some place in this terrain and you go and stand there. You can just choose one place. If both of you choose the same place, you will meet up and the enemy will be vanquished. If you choose different places to go and stand, you will not meet up, and you will be vanquished. Now, look at this map and choose a place where you will go and stand.

Where will you choose to go and stand? You want to go where the other person will go. There is no right answer as such. If everybody chooses the same spot that turns out to be the right spot. This is an exercise in human psychology. What is surprising is that six out of seven persons choose to stand at the bridge. Somehow the bridge is the focal point. I have tried this in my class several times. We don't quite know why. All we know is that people have the ability to coordinate psychologically.

Here is another game. There is a board with 16 blank squares, akin to a small chess board but with no black and white—all squares are blank. I call this the squares game. You and another player will have to choose a square each. If you choose the same square you will each get \$100 each. If you choose different squares, you get nothing. Which square will you choose? Again, there is no right answer. All you want to do is guess what the other person will do and the other person is trying to guess what you will do. Typically, in this game people make different choices and earn nothing.

Now I am going to make an inconsequential change to the board. I will color one square red but that is completely inconsequential for the game. Of course, you can see which one is red but the rules are the same as before. Both choose the same square, you both get 100 dollars. Otherwise you get nothing. But this innocuous change, has a dramatic effect on how the game is played. Almost everybody will choose the red square. It becomes the focal point. It facilitates coordination, when you know that all are keen to coordinate.

The central argument in my new book is that the law is, in the end, nothing but the creation of a focal point. It is supposed to influence our expectations of and beliefs about one another's behavior. And the purpose of law is to change our expectations of one another's behavior in ways that we get to a better outcome and create a better society.

In the remaining time, I want to give you one real-life example of the power of interpersonal beliefs. This pertains to totalitarianism in Czechoslovakia in the 1970s. How is totalitarian power manifested? David Hume writing in the mid-nineteenth century had pointed out that dictators and tyrants are so powerful not because they have greater

muscle power. In the end, what can an individual do? It is ordinary human beings' beliefs about one another that creates and props up the power of the tyrant or the dictator. Vaclav Havel, who was a dissident in the 70s and later became President of Czechoslovakia, developed this idea in a wonderful paper. There is no reference to Hume and I don't even know if Havel was familiar with Hume's work. But it is in essence the same argument. He wrote it as a dissident. In 1979 this document had been smuggled out of Czechoslovakia.

In the early 1980s, I was visiting Oxford and at a dinner, by quite a coincidence, I was seated next to the political philosopher, Steven Lukes. Lukes asked me what I was working on and when I told him of my interest in the sources of political power, he told me of Havel's paper that had been smuggled out of a Czechoslovakian jail and he was helping to publish it in English. And he gave me a translated but as yet unpublished copy of Havel's document. This was a very exciting moment for me.

The paper, 'The Power of the Powerless,' was a fascinating one, where Havel, without using the language of focal points makes use of the same argument I just presented to you. He talks about this country, never mentioning Czechoslovakia, with its post totalitarian system. The power of the state arises because ordinary people punish one another if they do not show loyalty to the state. It is this mutual monitoring that creates the huge power of the totalitarian state. In his system no one is actually loyal but all mimic loyalty, because it is individually rational to do so.

Havel's theory is in many ways a generous one, charitable to all, and I sympathize with this. There are situations in life where right from the tyrant at the top to ordinary people all

are caught in a trap. Each individual is powerless to break the trap. It is Nash equilibrium with a vengeance.

Totalitarian states are more prone to such traps but there have been traps like this that occurred in regular democratic nations. A striking example is the McCarthy period in the United States. There was general harassment of people on the ground that they were Communists or “un-American”. And what reinforced the trap, just like in Havel’s post-totalitarian state, was that if your friend was described as un-American and if you stood up to argue that that was not correct, that would be construed as evidence of your being “un-American”.

Fortunately, democracies have one advantage. There is an election, with anonymous voting, every four or five years, which in totalitarian Czechoslovakia was not the case. So organized uprising was the only route, with all its pitfalls. In the case of United States, the McCarthy period lasted for three years, and then it was gone. That is the natural check and balance of democracy.

In the case of United States there were also moral voices, like Vaclav Havel in Czechoslovakia, Gandhi in India, Mandela in South Africa who were willing to incur personal wrath to challenge the system. The power of the moral voice for society’s well-being can never be minimized. Everything in life is not just rationality and striving to do better for oneself. The number of things in life that we do simply because we want to be decent human beings, we want to be good to others, we want fairness, are numerous. And for the good society it is important to nurture and encourage these straits. As I said at the start and a recent World Development Report of the World Bank reminds us, though traditional economics tends to give short shrift to it, mindsets matter not just for individual behavior but in determining what kind of a society we end up creating.

There is much more to say to elaborate on these but time is running out on me. I want to conclude by saying that we are at a stage in India where there is a churning going on in our mindsets, in our ideas about what kind of a society we aspire to create, the values we uphold. For me, one of the most cherished values in society is tolerance and inclusion. India has had a history of welcoming minorities and immigrants. Since I am speaking here in memory of Nani Palkhivala, the example that easily comes to mind is the Parsees, who came here as a small group fleeing their home, but quickly found a home here, and made huge contributions to our nation.

Even while celebrating this we must not forget that we are also a society with a history of caste and discrimination, which persists even now. But hope lies in the fact that independent India was created with the explicit desire to put an end to these practices, to create a society where people of all races and religions feel at home. That was the hope enshrined in Rabindranath Tagore's *Gitanjali* and in our national anthem.

It is sad that there are small groups today who are trying to disrupt this hope by spreading the message of hate, by trying to push minorities in to corners. I would appeal to our leaders—intellectual, corporate and political—to strive and to speak up, and not give up on these cherished values.

Thank you once for giving me this opportunity to speak.

* *The booklet is issued for public education. The views expressed in the booklet are those of the author.*

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