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University of Maryland at College Park

Center Office: IRIS Center, 2105 Morrill Hall, College Park, MD 20742
Telephone (301) 405-3110 • Fax (301) 405-3020

LEGAL AND INSTITUTIONAL PREREQUISITES OF MARKET REFORM IN INDIA

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Kaushik Basu

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Author: Kaushik Basu, Cornell University

SOME LEGAL PREREQUISITES OF ECONOMIC REFORM IN INDIA

Kaushik Basu

Department of Economics
Cornell University
Ithaca, NY 14853, U.S.A.

Fax: 255-28 18
Email: kb40@cornell.edu

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ABSTRACT

The traditional attitude of international economic development research has treated the legal structure of a nation as superfluous. Institutional structures have either been thought of as unimportant or taken for granted when governments have tried to achieve equitable economic growth. Recent experiences in Eastern Europe, and advances in the discipline of law and economics, have demonstrated how the institutional and legal structures of developing countries can, in effect, legislate economic backwardness. This paper examines how the government can reverse this trend by providing, improving upon and reorganizing the nexus of legal and institutional structures in order to improve economic efficiency and development. Attention is focused on the circumstances of India.

The key mechanism, according to the author, for improving such structures is called the “principle of contract”. This principle allows for two or more individuals to freely enter into a Pareto optimal contract, while the government guarantees only that the contract’s terms are enforced in cases of a breach. It is argued that if this principle were followed, and the government reduces its involvement in the process of contract-making among its citizens, complicated legislation, acts and bills could be vastly simplified allowing for improvements in economic efficiency and development in many sectors of the Indian economy. Reforms, however, would entail the treading upon vested interests and thus implementation will require considerable political resolve.

Some Legal Prerequisites of Economic Reform in India

Kaushik Basu

1. Introduction

In 1991, around the time of the Gulf War, India found herself mired in a deep economic crisis. The crisis turned out to be the trigger for a massive reform effort that began in July 1991. The initial steps were emergency measures meant to stave off the immediate dangers that the nation faced. But by 1992 deeper reform measures, such as the move towards rupee convertibility, sharp cuts in import tariffs and the delicensing of several industrial sectors, were undertaken. While these are important measures, the present paper argues that we need deeper legal and institutional reforms if we want sustained economic progress in the long run.

But what do we mean by sustained economic progress? The ultimate objective of India's economic reform should be to raise the standard of living of the poorest people in the country. A higher growth rate of national income is important, but only as an instrument for helping the poorest sections.

It is now increasingly clear that such objectives cannot be achieved unless our economic reforms are founded on a suitable institutional and legal base. The enormous costs of grafting the market system in economies which do not satisfy the institutional prerequisites for such a system are evident from the recent experience of Eastern Europe (see Platteau, 1994, for discussion). While India has a much more robust institutional base, there is still a lot that needs to be done.

The present paper moves away from questions of detailed economic policy, which have occupied the center stage of policy debates in India ever since the reforms began in 1991 and

examines the need and scope for institutional reforms. Such reforms entail treading on vested interests and therefore their implementation requires considerable political resolve.

In this paper attention is restricted to one basic principle for reforming institutions and our legal systems. There are other principles of importance but for reasons of cogency this paper tries to keep the focus on what will be called the “principle of contract”¹. It will be argued that this principle often conflicts with the “bureaucratic instinct” and, therefore, has been repeatedly bypassed in the drafting of economic policy in India, to her detriment. If this principle were followed, the endless succession of complicated legislation, acts and bills² could be vastly simplified, to India’s advantage.

The “principle of contract” says that two or more adults should have the right to freely enter into any contract which does not hurt an uninvolved third party, and further that the contracting individuals should be able to get support from the state and its judiciary in getting retribution from someone who reneges on the contract.

Ignoring this principle in the drafting of law pertaining to economic functioning has hurt efficiency and progress in a variety of countries ranging from the socialist bloc, the Third World and all the way to the industrialized, capitalist nations.³ In the present paper, however, attention will be confined to India.

¹I call it the “basic principle” in Basu (1992).

²Complicated legislation is by no means exclusive to India. Here is what Mario Vargas Llosa has to say in his foreword to de Soto’s (1989) book: “It is said that the number of laws and executive orders [...] in Peru exceed half a million [...] We live in a legal labyrinth in which even a Daedalus would get lost.” (p. xviii)

³For a critique of the proliferation of irrational legislation in the U.S., see Howard (1995).

Even at the outset it is worth emphasizing that this is not a principle without exceptions. There are several domains in an economy where there is need for public and collective action. Public action is essential for the provision of health facilities, education, nutrition among the poor (see Sen, 1981, and Dreze and Sen, 1989) and for undertaking redistribution policies in favor of the poor. An instrument for effecting the latter is income taxation. Though, income taxation, effectively, places restrictions on free contracts among individuals, it should be there and be progressive in the interest of the ultimate objective discussed above. Some other exceptions to the principle are commented on later in the paper. While these exceptions are important, it is arguable that a variety of Indian legislation have paid no heed to the principle of contract, and that too for no 'higher' purpose but because of a failure to grasp the basic rules of economic life.

2. The Principle of Contract

Suppose persons A and B agree that they will both be better off if A supplies B 100 apples from his orchard now and B supplies A 200 oranges six months later; and so they sign a contract to that effect. If government adheres to the principle of contract, it will allow A and B to sign such a contract and, moreover if B refuses to give the 200 oranges six months later, A should be able to get the judiciary to enforce his claim or to seek retribution from B.

This principle can be the basis of welfare enhancement or, to use the economist's jargon, effect Pareto improvements and is the motivation behind legislation like 'The Indian Contract Act, 1872.⁴ If A and B voluntarily agree to a contract, it must be that they are better off by virtue

⁴“This act defines contracts, promises and other instruments of agreement between consenting adults or, as Chapter 2 of the Act makes more elaborate, between individuals of a certain age and “of sound mind”. This act is of special interest to economists because it tries

of the contract. And since this principle recognizes only those contracts where uninvolved third parties are not adversely affected, if this contract falls within the purview of this principle, its implementation must make some people better off (A and B) and no one worse off, which is the definition of a Pareto improvement. An example of a government that does not adhere to this principle is one which has a law which says, for instance, that no one is allowed to exchange apples for oranges or that the only exchanges that are permitted are 1 apple for 1 orange. It is easy to see that such a law may well thwart transaction between A and B. It is possible that A would not agree to such an exchange because, given his preference, it is not worthwhile giving up one apple for only one orange. Even if it were the case that they could secretly agree to exchanging 100 apples for 200 oranges, a different problem can arise. Note that, if B reneges at the end of six months (that is, when the time comes for him to deliver the oranges), A will not receive help from the government because he will not be able to reveal the original contract, which is in contravention of the law. Since B is aware of A's predicament it is very possible that B will in fact renege. Since A, in turn, knows this, A may refuse to get into this contract in the first place.

This example makes it clear that a government's non-adherence to the principle of contract can diminish social welfare by dampening trade and economic activity. Indeed a market economy cannot function unless people can get into contracts and expect these to be enforced. And for this we need the government to provide legal institutions which are supportive of this principle.

to give operational definition to important concepts like coercion, promise and even 'sound mind' !

This principle is not an unexceptionable one. There are some contracts which come under the purview of this principle but may have to be overruled -- I discuss some such exceptions later; but what is astonishing is the extent to which this principle or rule is disregarded in India. Legislation after legislation (many of which supercede the Indian Contract Act, 1872) tell us how we should behave, with scant respect for voluntary contract. This cannot but thwart economic progress and the result, to wit, the Indian economy, is fair testimony.

To illustrate an overt violation of the principle of contract, consider the Delhi Rent Control Act, 1958. It is replete with references to "standard rent", "fair rent" and "lawful increase" of rent. The following quotations are from Section 4.

"(1) Except where rent is liable to periodical increase by virtue of an agreement entered into before the the 1st day of January, 1939, no tenant shall, notwithstanding: any agreement to the contrary, be liable to pay to his landlord for the occupation of any premises any amount in excess of the standard rent of the premises, unless such amount is a lawful increase of the standard rent in accordance with the provisions of this Act.

(2) Subject to provisions of sub-section (1) any agreement for the payment of rent in excess of the standard rent shall be construed as if it were an agreement for the payment of the standard rent only." (my italics)

Observe that clause (2) above says that even if a landlord and a tenant voluntarily agree upon a rent above the standard rent, the state will not recognize the contract. For a large class of tenancies, the annual standard rent is calculated in a mechanical fashion. It is 10 percent of the actual cost of construction and the market price of the land on the date of the commencement of the construction. It is baffling why this should be treated as sacrosanct.

The rules for rent increase are as severe. Section 6 states:

“Notwithstanding anything contained in this Act, the standard rent, or where no standard rent is fixed under the provisions of this Act in respect of any premises, the rent agreed upon between the landlord and the tenant may be increased by 10 percent every three years”.

Every time government sets up a commission to examine the rental laws, the members of the commission invariably spend a lot of time on such matters. "Is 10% every three years fair?" they ask. Some say that in these days of inflation this is not enough. Some argue that, since tenants are generally poorer than the landlords, there should be no provision for a rent increase.

The rent control act and debates of the above kind reveal fundamental flaws in our thinking on policy. The question is not whether 3.3% per annum is sufficient increase but why the government should be fixing such things in the first place. These are matters which the tenant and the landlord should be free to fix at the time of entering into a tenancy agreement. Suppose a tenant and a landlord agree

- (A) on a high initial rent but no further increases after that, or,
- (B) on a low initial rent and an annual increase by the same percentage as the increase in wholesale price index.

The existing rent control law will not recognize (A) or (B). The rationale behind such wanton violation of the principle of contract is not evident. It stems from a failure to appreciate the principle of contract and the instinctive meddlesomeness of human beings or what may, alternatively, be called the 'bureaucratic instinct'.

The harm of ignoring the principle of contract and, equivalently, of exogenously fixing the terms of a contract can be great.⁵ In the above example, at times of inflation, given the terms of the rent control act, it may be better for landlords not to lease out their property but simply benefit from the appreciation of value. This is exactly what has happened in India and explains partly the shortage of housing in the country. It is likely that if the principle of contract were recognized, many more houses would be available to tenants and the increased supply would probably result in diminished averaged market rents.

Most Indian laws begin by saying “Notwithstanding any prior contract among the involved parties...” or something to this effect. What we need however are ‘contract-regarding laws’. Such a law would begin by saying, “In the event of the involved parties not having agreed to a prior contract. . .”.

Thus a contract-regarding rent-control law, that is, one which respects the principle of contract, would urge every landlord and tenant to sign a contract at the time of leasing. Then it would specify a slim set of rules for cases where no such initial contract is available.

Given that many Indian laws are designed with the sole aim of trampling over voluntarily agreed upon contracts, the code of law would shrink vastly if the law were made to respect the principle of contract. The main purpose of such a legal system would be to *enforce the contracts* people sign instead of telling people what should be the exact nature of their contracts.

Suppose an employer, A, and a workman, B, have decided on certain compensation to be paid to the workman in the event of a retrenchment. Again this will be considered null and void by the judiciary unless it happens to coincide exactly with the terms written down in Section 25F

⁵Basu (1989) shows how certain tenorial laws can contribute to technological stagnation.

of the Industrial Disputes Act, 1947, which requires that:

“the workman has been paid at the time of retrenchment, compensation which shall be equivalent to fifteen days’ average pay for every completed year of continuous service or any part thereof in excess of six months”.

The Industrial Disputes Act was amended in important ways in 1976 and 1982. It became obligatory for firms to obtain official permission for layoffs and retrenchment. In particular, establishments employing 100 or more employees now require prior permission from government for layoffs, retrenchment and closures; and, as Datta Chaudhuri (1994) observes, “government permission is seldom given”. Apart from the impact of this on industrial efficiency,⁶ these laws show a total disregard for ex ante agreements between workers and employers.

This is the reason why I find much of the debate on exit policy misplaced. The debate presumes that there must exist exogenous rules for the dissolution of firms and industries. A more efficient system would encourage workers and employers to enter into contingent contracts about how workers are to be compensated and how the assets are to be split in the event of the company’s closure. The main aim of the law should be to help the implementation of such contracts.

The defenders of status quo may argue that workers and tenants are generally in a weaker bargaining position; so to allow free contract would necessarily mean a worse deal for them. This argument is wrong. It can be shown that in many situations adherence to the principle of contract would not only enhance total welfare, but actually make the worker better off and the

⁶One major consequence of this has been to contribute to industrial sickness by creating hurdles to the closure of firms (Anant et al, 1993).

tenant better off (Basu, 1995; Fields, 1993).

One simple fallacy in this argument is easy to see. In Calcutta's Salt Lake City **plots of land** were sold by government below the market **price**. The idea was to enable the middle and lower-middle classes to acquire property which they would, otherwise, be unable to buy. This is indeed a desirable objective. Something similar is true of the land given to Delhi's ubiquitous cooperative housing societies. Having given this land, government was worried that soon the rich would buy up the land from the not-so-rich and would displace the latter from Salt Lake City. So what did it do? Through a variety of laws government has made it virtually illegal to sell land acquired from the government to other citizens.⁷

If we were really serious about helping the not-so-rich then, after selling them the land, far from putting restrictions on what they can do with the land, we would give them as much freedom as possible. After all, if a person wishes to sell his land it must be because he expects to be better off by doing so. Hence, his not being allowed to do so leaves him worse off. He may, for instance, want to sell it because he has a good permanent job offer from Bombay. The existing law hinders mobility and hurts him.

The right to sell, without government placing hurdles, is a minimal right which can generate a lot of welfare with no resource cost. There are countries, such as Sweden, which from complicated restrictions on property sales, have rapidly moved to a system of direct transactions. India should do the same.

⁷Of course, citizens get around it. Through various powers of attorney and false declarations they do buy land and sell houses, but this entails considerable transactions costs and enriches lawyers and government officials in charge of enforcing the law. Indeed, some laws such as the Monopolies and Restrictive Trade Practices Act, 1969, seem to exist only to be "got around" (Singh, 1993).

3. The Labor Market: An **Example**

Let me now try to explain how respecting the principle of contract in labour markets can help the labourers.⁸ Let us consider a model where an employer and a labourer can freely choose a daily wage (‘piece rates being ruled out by assumption). After that, once the worker begins to work, he can choose to be “lax” or “hard-working”. It seems reasonable to assume that, other things remaining the same, he prefers to be lax, though productivity is, of course, higher if he is hard-working. The law that we shall consider pertains to the employer’s right to dismiss the worker from employment. Consider two alternative legal scenarios.

Law 1 The employer cannot dismiss the worker even if he is lax.

Law 2 The employer and the worker have to agree on (a) or (b), below; and then they must adhere to what they have agreed upon.

(a) The employer cannot dismiss the worker even if he is lax.

(b) The employer has the right to dismiss the worker if he is lax.

Law 2 is closer to the principle of contract, since it gives the involved parties some freedom of contract, whereas law 1 gives no freedom. At first sight it looks as though this is a freedom to the advantage of the employer. Clearly, if law 2 is effective the employer will insist on (b). And this must hurt the worker.

⁸For a full-blown analysis the reader is referred to Basu (1995). For a discussion of the Indian law in the context of contracts in the labour market, see Chander (1993). I must emphasize here that it is not being claimed that labourers invariably benefit from the principle of contract. What I wish to demonstrate is that the converse claim, that workers invariably lose out if the law gives them the freedom to enter into contracts, is false.

Every sentence in the above paragraph is true, except the last one. To see this consider the data given below, where all numbers are rupee equivalents.

	<u>Worker</u>	
	Lax	Hard-working
Cost to worker	c_L	c_H
Output produced	x_L	x_H

From the meaning of 'lax' and 'hard-working' it is reasonable to assume -- and we shall assume -- the following.

$$c_H > c_L$$

$$x_H > x_L$$

In addition, it will be assumed that the use of labour, whether lax or hard-working, is always viable. That is,

$$x_L > c_L$$

$$x_H > c_H$$

I shall think of both costs and outputs as being measured in rupees.

Hence, it is being assumed that if the worker works all day in a lax manner the cost of sweat to him is c_L rupees. Hard work is more onerous than laziness; hence, a day spent on hard work costs the worker more, namely, c_H rupees. The chart also shows that a day of lax work produces x_L rupees worth of output and a day of hard work produces x_H rupees worth of output. Finally, I shall assume that a worker would prefer not to lose his job (as long as he gets positive benefit from the job).

What will be the outcomes under different legal regimes? If Law 1 is effective, the worker will certainly not work hard. Once his daily wage is fixed, given that he cannot be **dismissed**, he is best off being Lax. Hence, at the day's end there will be x_L rupees worth of output and c_L rupees worth of sweat lost by the worker. The net benefit of the enterprise is $x_L - c_L$. Let me, for simplicity, assume that if the employer cannot monitor worker effort the wage will settle down to $c_L + (x_L - c_L)d$, where d lies between 0 and 1. Let us denote the wage in a regime of Law 1 by w_1 . Hence, $w_1 = c_L + (x_L - c_L)d$. Note that this gives the worker a net benefit of $(x_L - c_L)d$ and the employer a net benefit of $(x_L - c_L)(1-d)$.⁹

Now suppose it is Law 2 that is effective. If the employer and the worker opt for (a) the **outcome will be** exactly as under Law 1. What happens if they opt for (b)? Since the worker knows that he will be dismissed if he does not work hard, he will choose to work hard. The cost of labour will be c_H and output x_H , thereby creating a net surplus of $x_H - c_H$. Hence, following the same reasoning as before, wage, w_2 , (that is, the wage that prevails under Law 2) will now be $c_H + (x_H - c_H)d$. This will give the worker a net benefit of $(x_H - c_H)d$ and the employer a net benefit of $(x_H - c_H)(1-d)$. Hence given a choice between (a) and (b), they will both voluntarily contract to abide by (b) if the following conditions are true.

$$(x_H - c_H)d > (x_L - c_L)d$$

$$(x_H - c_H)(1-d) > (x_L - c_L)(1-d)$$

Since it is entirely possible to think of a situation where $(x_H - c_H)$ exceeds $(x_L - c_L)$, we could have cases where, with Law 2, the worker and the employer opt for (b) and are better off than they would be under Law 1. What is surprising is that by relinquishing the right not to be

⁹If the underlying labour-market model is one of competition, d will be zero.

dismissed the worker can be actually better off.

A different way of viewing Law 2 is this. Law 2 is like Law 1 with the worker having the additional right to give up his right not to be dismissed. Hence to make my criticism in this light we could say that the Indian law gives individuals many rights but it typically does not give him the right to give up any of these rights.¹⁰

If we are hesitant to go all the way to contract-regarding laws, an intermediate step would be to make some provision for the right to give up rights.¹⁰ In Delhi in the late seventies, I needed to rent an apartment for a few years, but could not afford a large rent. If I could credibly assure the landlords I saw that I would leave their premises in three years, many would have happily leased their apartment to me at a low rent (the scope for taking in new tenants three years later, by when rents would have risen, being adequate compensation) but there was no way I could thus assure them. My right as a tenant -- generously conferred on me by the government -- not to quit became for me an albatross that I could not shake off. There is hardly any provision in the law which gave me the right to give up my right. The right to give up rights is not however an unheard of concept in world legal systems. A student who gets admission into an American university has the right to demand to see the recommendation his professor has written for him. However, U.S. law also gives him the right to "waive this right" if he so wishes.

It is worth emphasizing that the right to give up a right must not be confused with the right not to exercise a right, which we all, of course, always have. A tenant in India certainly

¹⁰In Basu (1984) I formalize in a social-choice-theoretic framework the concept of the right to give up rights.

has the right to quit when asked to do so by his landlord and therefore not exercise his right to stay on. What the Indian law does not confer upon a tenant is the right to give up, in advance, his right not to quit.

A possible objection to this suggestion is to argue that giving a worker the right to waive his right not to be retrenched is equivalent to revoking certain sections of the Industrial Disputes **Act**, in particular, the sections that grant him the right not to be retrenched; and so one should take the easier route of revoking the relevant sections. There are two counter-arguments to this. The revocation of a law - especially one which gives the impression of protecting a certain section of the population - is never politically easy. On the other hand, the addition of a clause which gives an 'additional' right - to wit, the right to waive a right - may be politically an easier task. Turning now to the question of equivalence, the two alternative amendments to the law are equivalent only in a certain idealized economic model. In reality, what is very important is the default option that the law specifies. In a country like India, large, over-populated and economically less developed, there will always be workers and employers who would not have written any contract about retrenchment. If an employer wants to retrench an employee with whom no contract **was** signed, **we will** have to fall back on the law as the default option. Here the two amendments would make a big difference. If we revoke the relevant sections of the Industrial Disputes Act, the employer **will** be able to retrench the worker costlessly. On the other hand if we **amend** the act by adding the 'right to waiver' **clause**, the worker can **claim that since** he did not waive his right not to be retrenched, he cannot be retrenched.

What is being argued in this paper is that we should encourage free contracting. In the absence of a contract we are in a second-best world and between the two options available in

such a world - namely giving the employer the exogenous right to retrench and giving the employee the exogenous right not to be retrenched -- I prefer the latter. Hence, my case for amending the existing law by adding on a 'right to waiver' clause.

4. Some Caveats

As mentioned earlier, there may indeed be cases where we would want to violate the principle of contract. One class of exceptions concerns very long-term contracts. Many societies consider it correct to prevent workers from making contracts for life. Such contracts can lead to serfdom and bondage. Since it is arguable that human beings are inherently short-sighted, they should be prevented from signing away all their rights for the rest of their lives. Thus we may agree that a voluntarily agreed upon contract which is the basis of life-long bondage should be disallowed by law. The Bonded Labour System (Abolition) Act, 1976, while notably poor in its drafting as a piece of legislation, is a law in the spirit of the above argument. Similarly, we may want to think of human beings as being endowed with certain fundamental rights which even they themselves cannot give up. Thus if two persons write a contract which entails one of them to die under certain contingencies, such a contract would be disallowed.

Secondly, there are indeed cases where the weaker side could benefit if the terms of some contract were exogenously specified by the government instead of being left to be determined through free bargain. For instance, if the labour market is oligopsonistic, a minimum wage law can not only raise wage but increase employment; and for this reason I believe that minimum wage laws can play a valuable role in some markets. There are other reasons as well (see, for instance, Drazen, 1986; Card and Krueger, 1994).

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Before moving on, it is worth emphasizing that, even for such an intermediate step towards the principle of contract, there will be exceptions. Government must have a special commitment to protect the poor and the weak, and there may indeed be situations where the principle would have to be violated in order to protect the interests of such people. It is worth pointing out though that, in the name of doing so, government has often worked against the interest of the poor.

What the principle of contract suggests is a way of thinking. Instead of beginning by having exogenous or imposed contracts, the present paper recommends that we go about this the other way around. That is, we should in general allow free contracting, and stop this only when there is good reason to believe that there may be large and adverse general equilibrium effects or third party effects. To sum up, the basis of economic progress is a contract-regarding legal system. There may be cases where we want contract-overriding laws but these should be the exception rather than the rule.

5. Legislating Development

This paper examines the government's role in providing legal and institutional structures for economic progress. It is worth stressing, however, that the government's role in the economy does not end here. Less involvement in the process of contract-making among citizens, must not mean less involvement in the economy. I do not talk about such interventions in the present paper in order to focus attention more narrowly on questions of contract-making and organizational inefficiency.

While this paper has been concerned with one principle for the reorganization of our institutions and legal framework, it is increasingly clear that there is a variety of ways in which a nation's laws influence economic efficiency and development. If the shepherds' guild in a country has the right to graze cattle on other people's land, clearly the farmers' enthusiasm to produce more can be seriously dampened. This is exactly what happened in Spain up to the last century (see North, 1985; Nugent and Sanchez, 1989). Likewise, if the person who invents a mechanical chanati-maker knows that if the machine is a success others will begin to manufacture such machines and not pay him anything for his idea, in all likelihood he will not invest, the time and money required to make the invention. Indeed this may explain why for such a simple, yet widespread, activity, to wit, the making of chapatis, no decent machine is available in India."

I have discussed elsewhere (Basu, 1992) how black money, quite apart from its negative effect on the morale of honest citizens, can actually thwart new entrants into business and therefore hamper industrial competition and expansion. Since the generation of black money is testimony of the poor implementation of taxation laws, this once again points to a link between law -- in this case its implementation -- and economic progress.

The subject of law and economic development deserves much greater attention from researchers than it has received thus far. The traditional attitude has been that of treating the legal structure as redundant in discussions of development. In researching on development we have focussed on savings, investments, stabilization and trade. The legal structure of a nation has either been thought of as unimportant or taken for granted. But recent experience in Eastern

"This is by no means the only explanation. There is an important gender issue involved here. Since, typically, women make chapatis and men make the purchase decisions, the demand for such a machine as revealed in the market place is low.

Europe and advances in the discipline of law and economics have alerted us to the need for much more direct investigation into the institutional and legal structures of developing economies. Even though we may not be able to legislate economic development, nations can have sufficiently retrograde legislative structures to be effectively legislating economic backwardness.

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