Regulation in India: Problems and solutions

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Abstract

Regulation is all over the Indian economic landscape, and it is often conducted by 'statutory regulatory authorities'. In this paper, we examine regulation in India through the lens of public economics, public administration, and the rule of law. Under conditions of market failure, there can be a case for state intervention through regulation. State failure in regulation can deliver various kinds of suboptimal outcomes including deficiencies on the rule of law, central planning and market failure. When regulatory organisations are constructed without adequate checks and balances, state personnel respond to incentives that yield arbitrary power, central planning, and organisational failure. Progress necessitates a departure from output-level engagements with regulatory staff. Root cause solutions require structural reforms to the laws governing regulators. The analysis delineates a framework for regulatory design grounded in the rule of law, separation of powers, and state capability. We need to go from the why of regulation (the economic ideas of market failures) to the how of regulation (which harnesses political science, law and public administration).

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1 The economics of regulation

From the foundations of public economics, we know a lot about the place of regulation in the overall problem of state intervention. Normally, the free market finds the efficient resource allocation. But there are market failures, where conditions of freedom generate inefficient outcomes. These are categorised as public goods, positive externalities, negative externalities, asymmetric information, and market power. These market failures take different forms in different sectors of the economy. Governments also have political and redistributive objectives, which are not motivated by efficiency considerations.

Regulation is the use of state power to coerce (mostly) firms to change their behaviour in various ways. The appropriate role for regulation is when faced with negative externalities, asymmetric information and market power. It is not an appropriate tool when used on the other motivations for state intervention (i.e. public goods, positive externalities and political/redistributive objectives). When faced with public goods problems, the right answer is state provision either through make or buy. When faced with positive externalities, the right answer is state funding.

By the late 1970s, the Indian state was largely organised as a central planning system, where officials controlled the resource allocation, the details of technology products and processes. In a central planning system, officials pick winners. They exert the coercive or spending power of the state to force economic outcomes. What technology is appropriate? Which industries shall flourish? How shall products and processes be designed? Which firms shall prosper? The efficient allocation of resources in society requires that the state be removed from these 'how to produce' questions. Central planning systems worldwide have generally induced stagnation.

The economic reforms process in India tried to roll back the central planning. But at the same time, the reformers and the intellectual community knew that the replacement was not pure *laissez faire*. What was required was a regulatory system where market failures were addressed, without it turning into a central planning system.

The leaders of the reforms of the 1980s and 1990s thought there was an opportunity to remove regulatory functions from government departments and construct new age regulators. This was the path to finding the 'goldilocks zone', of state intervention that addresses market failure while avoiding or reducing the central planning. As an example, Montek Ahluwalia championed a securities regulator through the 1980s, and the government ultimately created a non-statutory SEBI in 1988. This was led by a team from IDBI: Surendra Dave, Ravi Narain, Chitra Ramakrishna. By design, it was intended to not be like a normal government department. These persons represented a new level of knowledge when compared with conventional bureaucracies. It was hoped that regulators like SEBI would institutionalise a new kind of knowledge, based on reducing market failure, into the working of the organisation.

There is a 'goldilocks problem' in regulators. At one extreme is inaction, which leaves many important market failures unaddressed. At the other extreme is central planning systems, where (in effect) bureaucrats are in business, where the entire regulated industry looks and feels alike and it is (in effect) one big public sector organisation even though there is nominal private ownership. Nominal private ownership and isomorphic mimicry of a private economy, while operating under conditions of government control of products and processes, is increasingly visible in regulated areas in India such as electricity (Jaitly and Shah 2021) or finance (Shah 2026). The puzzle is to find the middle ground: where the regulator addresses market failure but steps back from central planning.

Many new regulators were established from the 1990s onwards. By and large, the hopes of the best reformers did not pan out. We did not get a secular retreat from central planning and today we have a new level of intensity of central planning control over large parts of the economy. The economists had the correct idea in terms of the objective. What was missing was the knowledge of law and public administration in constructing regulatory organisations. Regulatory design demands the translation of economic objectives into legal and administrative structures, based on knowledge, independence and accountability. When the legal foundation of a regulator permits excessive delegation and limited accountability, the economic objective remains unfulfilled, and the organisation defaults to the administrative habits of the past.

One of the most important measures of Indian growth is the year-on-year nominal growth of net fixed assets, aggregated across all private non-financial firms seen in the CMIE database. Figure 1 shows this time-series. After a period of growth 1991-2011, this series has fared poorly. The central question in Indian economic growth lies in diagnosing and solving the source of this weakness. Grand social and economic phenomena are always multi-causal. But it is hard to disconnect the difficulties of private investment in India, in the post 2011 period, from the emergence of large intrusive regulatory organisations as atleast one of the causes.

We are optimistic about the possibility of change. Over the decades, a new body of knowledge has emerged in India on these questions. In this paper, we show modern knowledge on how to achieve state capability in regulatory organisations. For India to regain economic dynamism, there

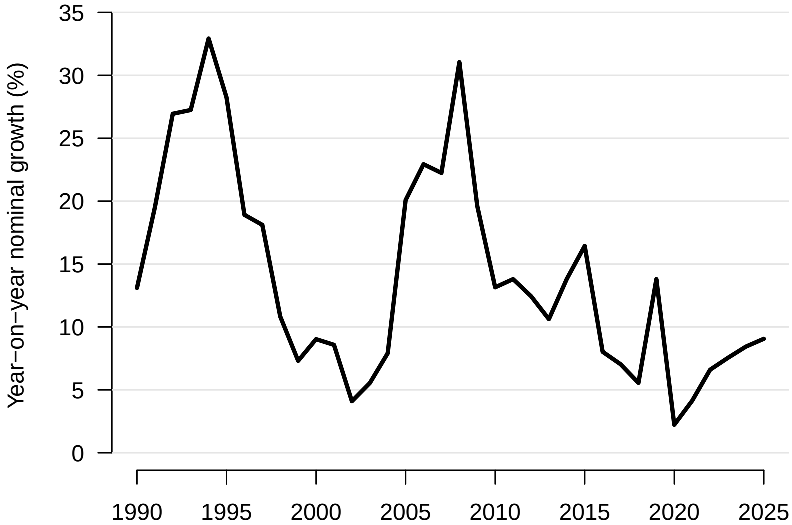

Figure 1: Annual growth of net fixed assets of non-financial firms

are few questions more important than this one: how to build high quality regulatory organisations.

2 Arbitrary power, state capability, regulatory theory

In public administration and political science, long-term organisational success or failure is shaped by the checks and balances. When coercive power is not wrapped in a protective cladding of checks and balances, incompetence and corruption tend to come to the fore. There is a temptation to personalise this, to associate behaviour of large complex organisations with the names of individuals at the leadership level. Instead, it is better to think in terms of public choice theory, where state personnel pursue their rational self interest and use arbitrary power for personal ends of laziness, incompetence and corruption (Buchanan and Tullock 1962). The central idea of the field of state capability is the creation of checks and balances against concentrated power. Organisations deliver well on their stated objectives when the individuals in the organisation face pressures of accountability and other restraints through legal constraints, norms and the political economy of discontent in the society.

This is the generic technology for how to think about state capability (Kelkar and Shah 2022). Its application into the field of regulation, applied into the Indian context, gives us the field of Indian regulatory theory (Roy, Shah, et al. 2019). In countries with mature administrative frameworks, there is general legislation that governs the operations of state agencies. In India, the absence of such general frameworks place the burden of establishing checks and balances on the primary legislation creating each distinct regulator.

The term 'regulatory theory' pertains to this general toolkit: of establishing checks and balances for an Indian state agency that wields regulatory power. It is domain neutral. When we come to one specific area of regulation or another (e.g. food safety), there is detailed domain knowledge on what regulators should actually do by way of addressing the market failure in (say) rules about milk pasteurisation. Regulatory theory is domain agnostic; it is the general technology about how to write laws that define regulatory organisations, and how to design regulatory organisations when it comes to organisation design and processes, so as to achieve high state capability.

At present in India, there are persons who view themselves as having specialised experience in banking regulation or electricity regulation. This self-identification tends to be shaped primarily by domain knowledge e.g. in banking or electricity. The structure of their organisations and the nature of their administrative actions reflect domain-specific preoccupations, isolated from this broader discourse on state capability. A new kind of human capital is now required in India, that thinks about state capability in a deeper way. A greater appreciation of regulatory theory, as a general toolkit, will help shift the discourse into the domain-neutral technology (i.e. regulatory theory, located in public administration and law) coupled with deep insights into market failure for the specific domain (located in public economics). Every regulatory organisation requires these two streams of thought to come together.

The convergence of domain knowledge and regulatory theory produces outcomes that neither discipline can achieve independently. Specialised economics knowledge, within a domain, identifies the specific intervention required which addresses the market failure while imposing the lowest cost upon society. This is primarily a technical quest located in economics. Regulatory theory determines the legal and procedural mechanisms which shape government organisations that wield coercive power. It is about addressing the gap between the peak domain *knowledge* available within a regulator and the Indian intellectual community, vs. the regulatory outputs (regulations, licenses, orders) that come out of a regulator.

3 Inputs, outputs, outcomes and root cause solutions

The field of regulation fits into a clean inputs-outputs-outcomes classification scheme (Krishnan and Shah 2026).

- **Inputs: The working of the regulator.** The floorplan of the regulator is laid in legislation that defines the objectives, coercive instruments, processes and governance of the regulator. Vague objectives and sweeping powers that set the stage for abuses of power are to be avoided. The next stage of work lies in organisation design. Given a law, how would the organisation be designed as organogram, processes, information and incentives. The best example of Indian work on organisation design was done for IBBI in Narain (2016). These two elements – the law and the organisation design – constitute the *inputs*.

- **Outputs: The actions of the regulator.** The regulator impinges upon the world through its legislative function (i.e. through the laws that it writes) and through its executive function (i.e. the stream of licensing and enforcement actions that it takes). When the inputs are faulty, these outputs are faulty. Substandard inputs manifest as regulations lacking cost-benefit analysis, licensing decisions untethered from objective criteria, and enforcement and other regulatory orders devoid of legal reasoning. Substandard inputs generate arbitrary power, not sufficiently enveloped in checks and balances, which generates low state capability.

- **Outcomes: A dynamic competitive private industry.** The desired outcome is a vibrant private competitive industry, featuring domestic and foreign players. Under conditions of sound inputs and outputs, the regulated industry achieves efficiency, capital formation, and technological advancement (Kelkar and Shah 2022). Conversely, faulty outputs generate the outcome of central planning, where the industry stagnates under the weight of regulatory compliance, policy uncertainty, or industrial policy (where the state picks winners).

Domain experts look at a regulator (e.g. SEBI), they deeply understand the securities markets, and they see faulty actions in the form of regulations, licensing decisions and orders. There is a natural feeling in a well-meaning external expert impulse to try to show the regulatory staff the errors of their ways, to help them fare better. There are research and reform organisations in India who try to engage with regulators in this fashion. This faces four limitations:

1. Few research and reform organisations in India have deep domain knowledge. The pressures of the funding environment and government engagement tend to emphasise consulting or staffing services. In this case, the external organisation is not actually equipped to think deeply about market failure and the lowest-cost intervention, about avoiding the central planning or industrial policy.

2. Officials working in a regulator often have a lot of domain knowledge. Regulatory agencies employ individuals with substantial sectoral exposure. The limitations tend to be more on the knowledge of public economics. External research and reform organisations can add value when they are able to match the domain knowledge within the organisation (e.g. the knowledge inside SEBI on securities markets) and add value with better knowledge of public economics (Sahoo 2012).

3. Officials are not unthinking. They create the stream of outputs in response to their incentives. If external experts propose different behaviour, this is unlikely to cut much ice. Within the framework of public choice theory, bureaucrats optimise for utility within the bounds of their statutory and institutional environments (Buchanan and Tullock 1962). In the absence of procedural checks requiring economic analysis or fair hearings, the rational response of the official is to prefer the exercise of arbitrary power.

4. The sheer volume of actions by modern Indian regulators is very large. SEBI evaluates thousands of matters, issues continuous streams of circulars, and processes extensive enforcement orders (Damle and Zaveri-Shah 2022). As an example, TRAI has about 300 employees and spends about Rs.2 billion per year; it is an advanced persistent force engaged in state intervention in one industry. The research and reform organisations are generally outgunned: it is hard for them to achieve the depth of knowledge and persistence. The state apparatus possesses scale and persistence that renders consulting engagements on specific outputs ineffective.

A high impact path for knowledge to make a better economy lies in research and reform organisations that go to the root cause: to understand the incentives that shape regulators in India, and help reshape those incentives so that regulators are better able to find the goldilocks zone of addressing market failure but not engaging in central planning. This requires a shift in analytical focus from the individual output (e.g., a specific tariff order or surveillance measure) to the statutory inputs that govern the production of all outputs. As an example, when we examine electricity regulation in Tamil Nadu, there is a role for a substantive economic critique (Jaitly, Sane, and Shah 2025), and it is important to engage in root cause analysis about how the regulator can work better (Jaitly, Mehta, et al. 2025).

4 The centrality of the rule of law

What is the rule of law? This is a world where everyone knows the law, the law is applied without fear or favour by state officials, where everyone is treated equally in front of the law, where sanctions are only imposed by the state through due process with a show cause notice, a fair hearing and penalties grounded in a reasoned order that can be appealed. Under the rule of law, state action is predictable.

As an example, consider licensing. State personnel command coercive power when they deny a person the license to operate a business. Suppose a firm applies for a license. Ideally, it should be reasonably feasible for a knowledgeable observer to predict which firms will get a license based on objective criteria (Roy and Shah 2015). In a world without rule of law, civil servants have arbitrary power to accept or deny licensing applications. In a rule of law world, the rejection of a licensing application requires a reasoned order and the possibility of appeal.

When the rule of law is absent, there is arbitrary power. Civil servants inside a regulatory organisation, that is not enveloped in the rule of law, are able to make oral threats to private persons about their future actions by way of regulation-making, licensing, investigations, and orders. When a regulator has faulty processes that lead up to penalties such as suspension of regulated activities, that is tantamount to a death sentence for a firm (Aggarwal, Patel, and Sane 2024). A greater consciousness about these issues helps avoid a wide variety of policy mistakes e.g. Shah (2014) on the subject of 'wilful defaulters'.

The presence of arbitrary power has a corrosive effect, and leads to a breakdown of capabilities of the organisation. An organisation operating outside the rule of law substitutes jurisprudence with administrative fiat. The internal mechanisms of such an organisation atrophy, as officials rely on coercion rather than investigation, evidence gathering, and logical reasoning.

The rule of law is sometimes thought about as a pious phrase, an idealistic view of how government ought to work. Also, the rule of law is evoked when thinking of criminal sanctions but not often when considering civil sanctions. Economic reasoning about the incentives of private persons to build firms are useful. Economic growth is made out of the emergence of high productivity firms, but high productivity firms do not emerge out of thin air. Certain individuals make decisions to commit energy, time and money in the attempt to build a firm. The risk premium required for these investment goes up when state power operates in an unpredictable way, that is, not in accordance with the rule of law.

Economic dynamism depends upon capital formation and long-term strategic decisions by private and foreign individuals. These decisions require a calculation of policy risk. Where regulatory institutions contain the ever-present risk of arbitrary power, the risk premium demanded by investors increases. This diminishes the aggregate volume of investment and hampers Indian economic growth.

When an organisation's procedures are in line with rule of law procedures, this yields predictability and creates confidence in the minds of investors. But this alone does not solve the problem of central planning. It is, in theory, possible to have a rule of law arrangement where a state organisation controls details of products and processes, and picks winners. In practice, the presence of arbitrary power corrodes, so socialistic arrangements tend to stray away from the rule of law. When the state dictates commercial outcomes, the stakes for private participants become existential. This can lead to large scale private resources being devoted to the capture of the regulatory apparatus. Consequently, in practice, the rule of law is inconsistent with a socialist system. The maintenance of the rule of law requires a restricted perimeter of state intervention, confining the regulator to the mitigation of identified market failures.

5 Elements of modern Indian thinking on how to build regulators

Over recent decades, many elements of the checks and balances for a regulatory organisation have come to be more deeply understood in India (Roy, Shah, et al. 2019). The intellectual evolution of this field progressed through a stream of research products and the proceedings of various government committees, culminating in the Financial Sector Legislative Reforms Commission (Financial Sector Legislative Reforms Commission 2013). All these features need to be encoded in the primary law which creates the regulator.

We now summarise the knowledge from this literature of the key design components for the law that creates a regulatory organisation, and for the organisation design of such organisations.

Clarity of purpose: Regulators must have clearly defined objectives, grounded in addressing market failure, as opposed to sweeping objectives and powers drawn from the age of central planning. Narrow quantifiable objectives are required to generate accountability; broad and vague objectives are a license to exercise coercive power without restraint. A standard example that economists will appreciate is requiring a central bank to the narrow pursuit of an inflation target.

This problem, of designing the purpose for each government agency, falls under the subject of 'agency architecture'. It is drawn from new public management, and applies for all government agencies, not just regulators. When statutes confer broad mandates, such as the general development of an industry, regulators expand their jurisdictions into commercial domains unrelated to market failure. Statutes must confine the regulator to explicit purposes.

The composition of the board: As with private corporations, it is a healthy arrangement to have a majority of independent directors, who are private citizens and not government officials (past or present). This helps address the shortfall of democratic legitimacy that is an ever-present risk with regulators. Independent private individuals represent the people, and help create checks and balances against the administrative state (Krishnan 2023).

While this is a general technology from the field of new public management, it is particularly important as regulators contain the power to write law. Ordinarily, in liberal democracy, only elected politicians have the power to write law. When the power to write law is placed in the hands of officials, methods have to be designed to check this and shift power to the people. The board structure is a critical part of this.

The role of the board: By default, many boards in India are polite lunches with eminent people. Better governance is not achieve through board composition alone.

The law needs to embed a prominent role for the board in the working of regulators: (a) Initiating and approving all drafting of regulations; (b) Holding the management accountable; (c) Establishing the budget of the regulator; (d) Overseeing the processes and organisation design of the regulator.

Separation of powers: From the 17th century, we have known that state organisations work better when there is greater separation of powers. The fusion of legislative, executive, and judicial powers within many Indian regulatory agencies — often termed Type 2 regulators as opposed to the Type 1 regulators seen in advanced economies where no judicial function is present — presents acute challenges to constitutional norms (Nair and Sahoo 2006; Sahoo 2012). Structural firewalls must be erected within the agency to separate the investigative staff from the adjudicatory officers, ensuring that the prosecutor and the judge are not comfortable colleagues. A board dominated by independent directors, which controls the legislative process, also helps address the problem of separation of powers.

The legislative process: Special care is required in law and organisation design when mere officials write law (Pattanaik and Sharma 2015). A formal process is required through which the regulator issues regulations (i.e. law). The primary law must not engage in excessive delegation: Each power to draft regulations must be carefully drafted with precise problems being delegated by lawmakers to the officials of the regulator. The legislative process must start and end at the board.

Every new regulation must be backed by a packet of documentation. This must articulate a problem in the world that needs to be solved, it must demonstrate that this state intervention is within the narrow powers conferred upon the regulator in the law, it must show that the problem in the world that is sought to be addressed is indeed a market failure, it must analyse multiple rival interventions that could be imagined and use cost-benefit analysis (also termed regulatory impact assessment) to choose the lowest cost intervention. It must run a process of consultation through which this documentation packet and the draft legal instrument are examined by the public (Burman and Zaveri 2018), and finally come back to the board for a thorough discussion and release of the final modified regulation.

The executive process: Formal processes must be in place for licensing, investigations and prosecutions. The main accent here must be upon predictable and rule of law behaviour of officials and the removal of their arbitrary power. Decisions regarding market entry, such as the issuance of licenses, must rely upon objective, codified criteria rather than the subjective discretion of the regulator. Surveillance and investigative actions must follow predetermined procedural manuals to prevent discriminatory targeting.

The judicial process: A rule of law mechanism should be utilised through which hearings take place at a neutral forum. The adjudication of enforcement matters requires strict adherence to the principles of natural justice. This includes the provision of comprehensive evidence to the defendant and the drafting of high-quality, reasoned regulatory orders. The often poor performance of regulators at appellate tribunals, such as the Securities Appellate Tribunal (SAT) or the Appellate Tribunal for Electricity (APTEL), serves as a direct indicator of their adjudicatory capability. Research demonstrates that regulatory orders frequently fail appellate scrutiny due to deficiencies in reasoning and procedural fairness (Aggarwal, Patel, and Singh 2025; Aggarwal, Kulkarni, et al. 2025; Asthana, Sane, and Vivek 2021; Patel and Sane 2024).

Principles for penalties: The penalties imposed by the regulator must be consistent with Article 14 of the Constitution, they must be proportionate, and they must use the smallest possible pain that creates the required deterrence (Sane and Vivek 2022). The application of discretionary sanctions, such as debarment from markets or the calculation of disgorgement, must be linked systematically to the magnitude of the violation and the unlawful gains acquired.

Transparency and accountability: The working of the organisation must be fully transparent, with ample reporting, which supports accountability to the board and to the public at large. This necessitates the mandatory publication of all regulatory instruments, adjudication orders, and financial statements. Certain regulators exhibit opacity by withholding detailed legal instruments and relying on press releases to communicate sanctions (Kulkarni and Sane 2025), a practice that hinders public understanding and legal certainty. Independent performance evaluations of the regulatory agency, by teams of domestic and international experts, are required to establish credibility and gain legitimacy (IEPF Chair Unit on Regulation 2021).

Interface to the government: There are many complexities about the interface between government departments and vigilance organisations, to the regulator, which require sophisticated design. Finding the correct level of autonomy and regulatory independence — where the regulator is accountable to its board and is also immune to political pressures on executive or judicial functions — is also a tight rope walk (Shah 2016). Statutory directions from government ministries must not override the independent adjudicatory or legislative functions of the regulator.

Organisation design: Once the above elements are in place, sophisticated work is required on organisation design through which a team can come together and achieve competence in discharging the required functions (Narain 2016). This includes the issues of budgets, finance, HR, the organogram, and accountability mechanisms for each workgroup. Regulatory agencies require financial autonomy, supported by codified, reasonable fee structures that prevent unjust enrichment. Furthermore, the agency must possess human resources flexibility outside the constraints of traditional government rules to attract requisite technical expertise.

6 Conclusion

Economists understand the public economics of market failure and the case for regulation. Freedom works well, but there are market failures, and when faced with three situations (asymmetric information, negative externalities, market power) there may be a case for regulation.

Economists have been less sure footed when it comes to the task of setting up successful, high performance regulatory organisations, which find the goldilocks zone between the extremes of central planning systems or rampant market failure. The ingredients required to correctly build regulatory organisations need to be drawn from the fields of political science, law and public administration. The translation of economic principles into effective state action is contingent upon the structural integrity of the implementing agency.

Over the last 20 years, considerable knowledge has arisen on this field in India (Roy, Shah, et al. 2019). We now know a lot about how this can be done. FSLRC was the key milestone (Financial Sector Legislative Reforms Commission 2013). It provided the foundational template for the Indian Financial Code and established the blueprint for embedding checks and balances into primary legislation. In 2026 there will be a book, edited by K. P. Krishnan and Ajay Shah, which brings this field together (Krishnan and Shah 2026).

Modern Indian regulators flood the zone with a large number of actions (regulations, licensing decisions, enforcement orders). Research and reform organisations do not have the resourcing to engage with this hose pipe. Episodic deregulation is ineffective when the organisations engaged in the central planning are purring away producing more constrictions (Shah 2025). It is better to go to the root cause, and solve problems at their foundations. This requires using modern Indian knowledge of regulatory theory to reshape regulatory organisations. The solutions require political science, law and public administration.

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