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THE ECONOMICS AND POLITICS OF TRANSITION TO AN OPEN MARKET ECONOMY: INDIA

by

Ashok V. Desai

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TABLE OF CONTENTS

ACKNOWLEDGEMENTS 5
RÉSUMÉ 6
SUMMARY 6
PREFACE 7
I. INTRODUCTION 8
II. FORMATION OF THE PATRIMONIAL STATE 9
III. THE ORIGINS OF THE REFORMS 19
IV. THE REFORMS 27
V. REACTIONS AND CONSEQUENCES 54
VI. THE OUTCOME 62
BIBLIOGRAPHY 71

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RÉSUMÉ

Ce document analyse les causes économiques et sociales ainsi que les conséquences du retournement soudain des politiques économiques de l'Inde en 1991–93, après quatre décennies d'autarcie et d'interventionnisme. Le changement de l'environnement politique et l'émergence de nouveaux groupes d'intérêt, conjointement à une grave crise de la balance des paiements, n'ont laissé d'autre choix au parti au pouvoir que de rompre avec l'héritage d'un État patrimonial. Davantage de concurrence, aux niveaux tant politique qu'économique, a contraint les hommes politiques à supprimer les contrôles quantitatifs directs sur la production industrielle, les importations et l'accès au capital. Toutefois, ces réformes sont restées partielles et n'ont pas fondamentalement modifié l'équation politico–économique. L'opposition systématique à la réforme est restée suffisamment vivace pour accaparer ou neutraliser certains des gains de la libéralisation. C'est ainsi que le mouvement de réforme a chancelé avant de cesser tout à fait.

SUMMARY

The paper analyses economic and political causes as well as outcomes of the sudden reversal of Indian economic policies in 1991–93, after four decades of autarky and interventionism. It argues that a changing political landscape and the emergence of new interest groups, coupled with a severe balance–of–payments crisis, left little choice to the governing party but to break with the legacy of a patrimonial state. More competition, at political and economic levels, forced the hand of politicians to remove direct quantitative controls on industrial production, imports and access to capital. These reforms remained, however, partial and did not fundamentally change the politico–economic equation. Systemic opposition to reform remained strong enough to capture or neutralise some of the gains of liberalisation. Thus, the reform movement faltered and eventually ceased.

PREFACE

During the 1990s, the number of countries which have embarked on fundamental economic policy reforms leading to open, competitive market economies has grown dramatically. Centrally planned economies in Eastern Europe and East Asia, as well as countries with highly interventionist policy regimes such as India or Brazil, have been eager to reduce government involvement in economic decision making, to ensure macroeconomic stabilisation, and to open up to international trade and capital flows. Based on these experiences, a considerable amount of knowledge about critical reform ingredients and the timing of their implementation have been accumulated.

Experience has also shown, however, that reforms are not always carried through, or are stalled during the reform process, due to opposing political interests. Economic reform always creates winners and losers, and frequently the losers include politically powerful groups. In 1996, the OECD Development Centre launched a research project to analyse the political preconditions for the success of economic policy reform in transitional and developing countries. The objective is to study the interplay between economic necessities and political challenges during the implementation of policy reform, thereby generating recommendations for dealing with political opposition to reform.

The project focuses on the experience of six countries: three large economies, China, India and Russia, and the smaller Colombia, Egypt and Viet Nam. The distinction between large and small countries was made because the regional dimension adds to the problems of reform in large countries, while outside influences may play an important role in small economies. The case studies, each of which is being published separately, will be complemented by a synthesis volume identifying common experiences and summarising the major policy conclusions for countries, which are latecomers in implementing reform.

India was chosen as an example of a large country in which central governments have to interact with regional governments and where political focus emerges both at national and regional levels. The study shows that economic favours handed out by politicians to secure power had only a short–term effect and did not prevent increased competition between old and newly emerging political parties. Greater political choice paved the way to economic reform, but reforms remained partial as special interest groups were able to slow down and ultimately to stop the reform process. One of the lessons from this experience concerns the need to forge reform coalitions which can sustain economic liberalisation.

Ulrich Hiemenz
Director
OECD Development Centre
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I. INTRODUCTION

After four decades of autarky and interventionism, the government of India reversed some of its cherished policies, and partially dismantled its controls on industry, trade and finance in 1991–93. Why did it do so? How was the shape of its liberalisation determined? Why did the reforms lose momentum? What general lessons does the experience hold? These are the questions the present paper aims to address.

The immediate cause of this change of direction was a balance of payments crisis. Yet there were alternatives available to the government: it could have intensified import restrictions, or restrained growth. These options were in fact tried out; but having failed to stabilise the balance of payments, they were abandoned and a different course adopted. The reversal was preceded by a general election and a change of ruling party. Thus, a change in power equations preceded the liberalisation.

However, the party that came to power — the Indian National Congress — was itself the party which had earlier created the interventionist state. The reversal of its earlier policies reflected a change in its perception of self–interest. The painful measures introduced to contain the payments crisis wrought a change in the attitudes of the big industrialists; their conversion to liberalisation made it difficult for the Congress to stay moored to its ideological anchor. Their change of heart had greater influence on economic policy because political competition had intensified in the previous 15 years: other parties had emerged which could wrest power from the Congress — and had done so for short periods. The broadening of political choice lent new influence to interest groups. The exercise of that choice is the basic cause of the Indian reforms, and their limited scope is explained by the limits of the activation of interest groups, and of their perception of self–interest.

That is the core of the story that is developed in the next four sections. The next section outlines the formation of the patrimonial state: the conversion of the government into an instrument of redistribution orchestrated by the politicians, and the corruption that vitiated the instrument with the passage of time. The third section turns to the crises of the patrimonial structure — emergence of competition in the political system, a rise in the demands upon the state, and its culmination in the external debt crisis. The fourth section describes the reform process — the regrouping of the political forces and the temporary formation of the majority required to push through the reforms, the actual shape of the reforms, and their impact upon the system. The concluding section makes a balance sheet of the gains and losses, and draws lessons on when reforms work and when they do not.

II. FORMATION OF THE PATRIMONIAL STATE

India's political system before 1947 resembled a king's court. The viceroy, or the representative of the sovereign of the United Kingdom, was appointed by the British Government, and was assisted by a Council whose members were either also nominated from Britain, or promoted from the Indian Civil Service. The civil service was predominantly British, recruited by means of examinations, and administered the country with the help of locally recruited lower bureaucrats.

Limited political activity was permitted. Those who supported the regime petitioned or lobbied the rulers; they submitted memorials and representations, and sat on various councils that advised the rulers, whose members were either nominated or elected by limited, loyal electorates. The levers of political action were pressures brought to bear on or conveyed through the administration. Those who opposed the government were associated with the Indian National Congress (Congress for short). They agitated; their main form of agitation was breaking a law and inviting a penalty, usually a term in prison. Their numbers fluctuated. When an agitation was launched, the number of those who were arrested gave an idea of the active opponents of the government; between agitations they were less well defined, as students amongst them went back to their studies or on to careers, lawyers went back to practice, and all except the small number that the Congress could financially support found some way of supporting themselves.

The first step in an end to the confrontation between the government and the Congress came with the introduction of dyarchy in 1936: continued rule by viceroy at the centre, and governments elected by limited electorates in the provinces. This change was governed by a Government of India Act passed by the British parliament in 1935. The Act embodied safeguards for the civil and judicial services, which the British government did not want to see interfered with by the elected governments.

The transfer of power in 1947 introduced legislatures elected on universal adult suffrage in Delhi as well as the provinces (later renamed States), and replaced the appointed viceroy's council at the centre by a council of ministers (the cabinet) belonging to the party with a majority in the legislatures, presided over by a prime minister at the centre and a chief minister in the provinces. The viceroy was replaced by a president, who was elected by all members of the central and provincial legislatures, and who had no executive authority; he carried out constitutional functions on the advice of the cabinet. The provincial governors continued to be appointed by the central government, but their councils were replaced by cabinets belonging to the majority party in the state legislature and headed by a chief minister.

This was the sum total of the changes; in particular, the bureaucracy, the judiciary and the armed forces were left untouched. The Congress agreed to keep the administration as it was because of the crisis the party faced immediately on assuming power. The country became independent amidst a serious breakdown of law and order in the north. As British India was divided into independent India and Pakistan, some 30 million people were uprooted and moved across the new borders; 1–2 million of them were killed in the process. Hence keeping the administration intact was an obvious priority. Besides, some members of the senior civil service had begun to cultivate the Congress and conveyed their support before independence. The Congress was not sympathetic to the continuation of British civil servants; this was clearly conveyed, and almost all of them took early retirement within a year after transfer of power. Their departure led to handsome promotions for and a considerable increase in the influence of the remaining Indian civil servants, army officers and judges; this largesse cemented their loyalty to the new governments. Equally, the new rulers were keen to retain their loyalty. Hence they agreed to stronger safeguards in the Constitution, adopted in 1948, for the bureaucracy than had prevailed in colonial times, especially the following:

a) appointment: members of the civil service can only be appointed by a commission consisting of civil servants on the basis of examination results (Articles 315–323);

b) dismissal or demotion: it is possible only after an enquiry in which the civil servant is charged and given a chance to defend himself (Article 311);

c) conditions of service: they must be approved and can be amended only by Parliament or state legislature (Article 309).

Thus all that happened with independence in 1947 was that a few thousand politicians were elected to legislatures, and a few hundred amongst them became ministers. Most of those who were elected belonged to the Congress; but even then, only a fraction of its members who had taken part in agitations against the government got a place in the power structure. Independence gave the politicians as a class no place in the power structure.

This was impracticable, because with the advent of democracy, dissent became legitimate, and could, if backed by popular mandate, lead to power. Unless accommodated in the power structure, politicians might leave the Congress; and unless they were accommodated or controlled, interest groups might support opposition parties. Independence had brought the Congress to power; but it needed to stay in power — to get elected repeatedly. The Congress got a majority of votes in only one general election — the 1984 one. In the initial years, it was helped by disunity of its opponents, but from the first it faced the problem of gaining the support of large enough interest groups.

It strove to gain that support by resources raised from industry: it made the government an instrument for transferring resources from industry to important vote banks. This redistribution was clothed in the garb of socialist ideology; but its core was a patrimonial state (a term applied by Brass [1995]), in which the politicians acted as the mediators of redistribution. This was the role they evolved for themselves, but in order effectively to play that role they had to address four problems:

i) Industrial differentiation: there were too many industrial firms ranging from large mass manufacturers to small rural craftsmen. A strategy had to be evolved on whom to exploit and how. Differences in exploitation could themselves be used as favours to the more privileged victims.

ii) Instruments of control: an array of instruments had to be developed to target industrial firms accurately, and to prevent evasion of controls.

iii) Distribution of benefits: the resources obtained had to be redistributed to vote banks. Since demand for benefits exceeded supply, distinctions had to be made amongst beneficiaries, and methods of rationing benefits had to be worked out.

iv) Interception of benefits: the benefits had to be used to the advantage of the ruling party, and to keep it together.

We shall describe in the rest of the section how these problems were solved.

Differentiation Within Industry

The first step was to discriminate between firms that were to be brought under control, and smaller firms that were to be left alone. This was done in the Industries (Development and Regulation) Act 1951; it brought firms using power and employing more than 50 workers or firms not using power and employing more than 100 workers under control. The controlled firms had to seek registration with the government if they existed, and to obtain a prior licence if they were newly set up. They also needed a licence to diversify or expand. Industrial licensing became the most important instrument for rewarding and punishing industrialists.

In the 1950s, however, India was receiving considerable foreign, predominantly US aid. It was considered a promising, growing market by American and European firms. Antagonising them would have been economically self–defeating, and politically unwise. Yet there was political pressure from Indian industrialists. Some of them had supported the Congress before independence, and more after independence. They expected an independence dividend; and the Congress was not sympathetic towards British firms.

The British businesses in India were distinguished from the newer foreign companies by their form of management: they were managed by companies in Calcutta which acted as their managing agents. This form of management was invented by British business in the late 19th century. Managing agents in Calcutta floated companies in London to set up a tea garden, a jute mill, a railway or a coal mine, and promised to manage the company for a commission. Capital was raised on the basis of the managing agents' reputation from investors who had little knowledge of India. In this way, a handful of managing agents came to manage hundreds of British–owned companies in Eastern India. Newly emerging Indian business houses imitated the British practice; businessmen's families set themselves up as managing agents of textile mills, sugar mills, trading companies etc.

By the early 1950s the managing agency system had come into disrepute because managing agents obtained a return from the companies irrespective of whether the companies made a profit or not; shareholders had no control over the companies. Following the post–war notion of companies as being run on behalf of shareholders, the government of India passed a Companies Act in 1956 which placed restrictions on the extent of managing agents' remuneration and the forms it could take, and which embodied an intention eventually to abolish the managing agency system. The system was finally abolished in 1969.

The Indian managing agents smoothly adapted themselves to approaching abolition by extracting their remuneration in the form of expenses or as unaccounted commissions. The British companies, however, found it difficult to do so because they needed to repatriate their profits, which was prevented by exchange controls. Hence most were sold off at low prices to Indian industrialists in the late 1950s and the 1960s. This was the first windfall Indian industrialists obtained after independence.

The inhibition against using industrial licensing to discriminate against foreign firms slowly disappeared in the mid–1960s. In 1966 there was an industrial recession. It became common for firms to lobby against granting licences to competitors; in this lobbying, Indian firms had an advantage. By this time, relations with the United States had deteriorated, foreign investment inflows had dwindled, and discrimination could be practised against foreign firms without serious consequences, but the unsystematic and covert discrimination against foreign firms, exercised through the licensing system, evoked protests from foreign governments. Hence in 1973, a Foreign Exchange Regulation Act was enacted. Under this Act, all foreign companies were required to bring down their shareholding in Indian subsidiaries and affiliates to 40 per cent or less, or to obtain the government's permission to retain more. A case could be made for a higher share by arguing that the company was export–intensive or technology–intensive, or served some other public purpose; but the argument was accepted in the case of very few companies. Most were forced to divest equity; some such as IBM and Coca Cola left. Some sold equity to their Indian partners, others made public issues at low prices. This was the second tranche of the political largesse to industry under Indian ownership.

Meanwhile there were portents of a rebellion with possible industry backing in the 1960s. C. Rajagopalachari, a senior Congress leader, left the party in 1959 and started a rightist Swatantra party. In the general election of 1967, it won 44 seats and became the largest opposition party (Brass, 1995). More seriously, rightist opposition surfaced within the Congress. In 1966, Indira Gandhi took over the reins of the Congress. She soon faced opposition from the older leaders; big industrialists, especially from western India, supported the latter. To subdue the industrialists, the government introduced a new layer of control. It defined a number of conglomerates as big business houses. When they wanted to set up production, to expand or to diversify in any firm designated as belonging to them, they had to get permission from a new Monopolies and Restrictive Trade Practices Commission (MRTPC). The Commission, set up in 1969, was extremely dilatory and non–transparent; it was more effective than industrial licensing in bringing large firms under political control.

Meanwhile, the government itself had entered a number of industries from the mid–1950s onwards. They were more directly useful to politicians than private companies in a number of ways. First, they had large, unionised labour forces. Politicians or parties that controlled these trade unions wielded considerable latent power. Second, they offered considerable opportunities for patronage and corruption which could be exploited by ministers; conversely, the public enterprises could use patronage given to politicians to marshal their support when necessary — for instance in getting licences or thwarting competition from private firms. In addition, appointments to key positions such as bank chairmanships which offered opportunities for patronage and corruption could be manipulated by politicians with advantage. Third, rules that governed expenditure were more generous for public enterprises; thus ministers and bureaucrats could get privileges through them to which they would not be otherwise entitled — for instance, cheap, luxurious accommodation in guest houses, free cars, entertainment, etc. Finally, they were a source of senior managerial positions for bureaucrats and politicians.

Once public enterprises had grown up and their above uses were realised, they came to be favoured in industrial licensing. Companies under the ownership of the central and State governments began to proliferate from the late 1960s onwards. Industrial controls prevented many private companies from expanding or modernising; as a result, hundreds of them went bankrupt in the 1970s and 1980s. They were taken over by the governments, and added to the number of enterprises under their control.

Thus by the 1980s, an entire caste system within industry had been set up under the industrial licensing mechanism. The highest caste was that of public enterprises, which were most useful to politicians. Then came small enterprises, which were not subject to industrial licensing, and which also received state patronage in the form of tax concessions, cheap credit, access to scarce inputs, access to industrial land, market reservation in hundreds of products, and in some cases, direct subsidies. Third came Indian large firms which were not attached to a business house and which did not harbour foreign investment exceeding 40 per cent of equity. These were subject to industrial licensing, but were not subjected to any special disability. Then came companies belonging to business houses, which had to jump the hoop set up by the Monopolies and Restrictive Practices Commission. The last were subsidiaries of foreign companies, which were subjected to all the discipline suffered by business houses and in addition were discriminated against. The industrial licensing mechanism was used to match supply and demand, and it slowed down the emergence of competition. Because of it, large firms ceased to fear competition, and adopted cost–plus pricing. Inflation was built in, and productivity improvement was slowed down. Capital–output ratios were high, and total capital productivity was generally negative in the 1960s, 1970s and 1980s.

Instruments of Control

Industrial licensing was the principal instrument of control; but it was reinforced by import licensing and by canalisation of savings flows through government–owned financial institutions.

Import licensing was first introduced in 1939, primarily to ration scarce dollars and shipping space during the war. It was never dismantled; the machinery continues to exist till today. Initially, the Chief Controller of Imports and Exports simply allocated the available import capacity amongst the registered importers, irrespective of whether they were traders or industrialists. Once industrial licensing was introduced, however, traders' licences were curtailed and finally abolished in 1963. Industrial companies' import licences for machinery came to be linked to their industrial licences, and their import licences for inputs came to be tailored to their licensed capacity. In this way, import licensing became an instrument for policing industrial capacity. When a company got a new industrial licence, it had to negotiate a phased manufacturing programme, under which it undertook to reduce the import content of its product on a predetermined scale over the first few years of production. Import licences were reduced every year in accordance with the programme.

Import licences permitted targeting of particular enterprises, and were the primary instrument of import control; tariffs were relatively modest till the 1970s. By that time, the volume of import licences issued, running into thousands, was too large for effective manipulation by politicians, the manipulation had passed into the hands of lower bureaucrats, and returns to politicians were limited. At that point, a degree of automaticity began to be introduced into import licensing, and tariffs began to be raised. Tariffs had the advantage that the centre could retain the entire revenue from them, in contrast to income tax and excise duties, revenue from which had to be shared with the States. Hence in the 1980s, tariffs came to be added to the armoury of import controls. As tariffs rose, numerous exemptions and rebates were granted to favour particular industries and enterprises.

Finally, the government took steps to pre–empt savings. With the outbreak of the war in 1939, controls were introduced on the public issue of corporate shares and bonds to prevent them from competing with government borrowings. After the war, this machinery was made permanent. More important than the control on public issues was the control on their pricing. Share issues were priced on the basis of a formula applied to a company's past profits. This led to underpricing; the brighter the prospects of a company, the greater the underpricing. Thus companies were induced to borrow rather than issue equity. Between 1958 and 1962, the government set up three financial institutions — Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), and Industrial Credit and Investment Corporation of India (ICICI). Initially they were funded from the central budget, and gave long–term loans to industry. In the absence of a broad capital market, companies came increasingly to rely on these financial institutions for capital. In time the institutions also came to buy shares. Most of the companies were run by ex–managing agents, now termed promoters, who had little capital of their own to fund industrial investment. Hence over time, the financial institutions came to own a substantial proportion of issued shares and debentures — in many companies, more than the promoters. In companies where they had substantial holdings, they placed their nominees of the boards. In this way, companies came to be controlled by financial institutions, and through them, by the Ministry of Finance.

Finally in 1969, banks were nationalised. From that point onwards, a rising proportion of their funds was pre–empted by the government by raising the statutory liquidity ratio, or the ratio of funds that had to be invested in government securities. Government securities were defined to include securities issued by the financial institutions. Thus companies became dependent on government banks for short–term capital and on financial institutions, funded by the banks, for long–term capital. In this way the government monopolised the access of private — and government — companies to private savings.

Thus by the early 1970s, the central government controlled corporate business in three ways — it controlled production, expansion and diversification through industrial licensing, it controlled industrial imports through import licences (and later, tariffs), and it controlled industry's access to savings through banks and financial savings. Although the balance between discretion and automaticity in the operation of these controls changed over time, this fully developed system of industrial controls lasted until 1991.

State governments did not share in this system of central controls; but they had their own instruments. They controlled land transfers and conversions of land use. In 1976 they were given additional powers by the Urban Land Ceiling (Regulation) Act, which prohibited the holding of transactions in urban plots over 500 square metres. This Act made large tracts of land unsaleable and put their owners at the mercy of State governments; the discretionary power was used by politicians and bureaucrats to collect money. The land belonging to closed businesses constituted an important part of land brought under government discretion, and was subject of tortuous and murky dealings between their owners and government functionaries. The State governments also administered the Industrial Disputes Act of 1948. Under it they were given the power to approve closure of businesses. The permission was not given as a rule. This blocked up much property and assets and created scope for corruption. Electric power stations were nationalised under the Electricity Act of 1948 and placed in the State governments' hands. State governments routinely used electricity tariffs to overcharge industry and favour politically more valuable consumers such as farmers and urban consumers. Thus although it was not so comprehensive or extensive, State governments also had an apparatus of control over industry.

Distribution of Benefits

The largesse obtained from industry was distributed to four major classes: to the poor, consumers, farmers, and the populous castes which had votes.

The first strategy of reducing poverty involved an increase in government employment. The government employed half a million people in 1947. Nationalisation of the railways in 1952 added a million workers, and tripled the numbers. From 1.7 million in 1957, the number of posts in the central government rose to 3 million in 1971 and 4.1 million in 1994 (Pay Commission, 1997). (Actual employment was 2.8 million in 1971 and 3.8 million in 1994 because of unfilled vacancies.) The increase for all the levels of government — central, State and local, as well as public enterprises — was much greater. More recent figures are not available but, whilst the central government's work force rose from 2 million to 3.3 million between 1961 and 1985, total public sector employment rose from 7 million to 17.3 million (Table 2.1). Between 1961 and 1981, the governments accounted for 19 per cent of the increase in total employment and 44 per cent of the rise in non–agricultural employment (Desai and Desai, 1988).

However, expansion of employment in government did not directly benefit the rural poor; and it had catastrophic effects on efficiency. Recruitment was weighted towards white–collar workers; the proportion of new graduates absorbed by the governments in 1961–85 exceeded 75 per cent. The management of millions of employees, far in excess of the requirements for the work to be done, eroded the authority of higher civil servants. Those who still functioned did so through a small proportion of willing workers, and left the rest to their own devices. Those who did not, tried to get a transfer to less arduous posts or posts where it was easier to get recognition from powerful politicians and bureaucrats. Work became a voluntary contribution in lower echelons of the governments; this facilitated the taking of money for action. Not all parts of governments were equally affected. The vast majority of bureaucrats had no favours to bestow and hence made little money beyond their salaries and perquisites; and at the centre and in the richer States, it is rare for the senior civil servants to be corrupt, but an honest civil servant would normally be one who does favours or winks at favours being done without charging for it, not one that prevented them.

Table 2.1. **Increase in Public Sector Employment, 1961–85**

	1961	1966	1971	1976	1981	1985	Rise 1961–85	Composition 1961	Composition 1985
	Million							Per cent	
Centre	2.1	2.6	2.8	3.0	3.2	3.3	59	30	19
States	3.0	3.7	4.2	5.0	5.7	6.3	108	43	36
Local authorities	1.2	1.7	1.9	2.0	2.0	2.2	84	17	13
Governments	6.3	8.0	8.8	10.0	10.9	11.8	88	89	68
Parastatals	0.8	1.3	1.9	3.4	4.6	5.5	611	11	32
Central					(2.7)	(3.3)			19
States					(1.8)	(2.2)			13
	7.1	9.4	10.7	13.4	15.5	17.3	145	100	100

Source: Desai and Desai (1988).

So from the 1970s onwards the anti–poverty strategy shifted its stress from providing direct employment in government to public works. The central government funded a number of schemes under which State governments were encouraged to start road–building and other public works programmes at times other than in the agricultural crop season. These programmes generated significant employment only in a handful of States. Elsewhere they occasioned corruption and leakages, and were scaled down. Instead the banks, which were nationalised in 1969, were directed to give loans to the poor and unemployed to start remunerative activities, such as buying milk animals. Forced credit not directed towards the poor alone; it also went to farmers and small industrialists. Loans to the poor and farmers led to a high level of bad debts.

A machinery to supply foodgrains to urban consumers was created during World War II; the intention was that their demand should not compete with government purchases made for supplying the troops. After 1947, foodgrains supplied in this way came to be subsidised; but the subsidy came partly from the farmers, who were forced to sell grains to the government by means of movement controls. After the green revolution in 1967, however, the marketed surplus from the areas which experienced it grew; the machinery to procure foodgrains was allowed to run down, and purchases were concentrated in the new surplus areas. Soon thereafter, the government began to use the procurement machinery to assure farmers of minimum prices by means of a price support programme. Thus, beginning by subsidising the urban consumer, the government adapted the machinery to subsidise the farmer as well. In the 1990s, the public food distribution machinery was greatly expanded; the volume of foodgrains distributed more than doubled, and ration shops came to be set up in rural areas.

The farmers were not the target of subsidies till the green revolution. It created a class of prosperous farmers in a geographically concentrated area (principally in the irrigated zones of the western Gangetic valley and the lower valleys of the southern rivers — Krishna, Godavari and Kaveri). It also gave them bargaining power as a large proportion of the marketed surplus began to come from them. Apart from price support, they obtained increasing subsidies on irrigation water, fertiliser, electricity, diesel oil for irrigation pumps, and credit. Subsidies on fertiliser, diesel oil and credit were given by the centre, the rest by the States. Competition amongst the States led to a progressive rise in the subsidies under their control; electricity, for instance, is provided free to farmers in some States and is subject to a fixed charge in others. The subsidy on electricity was financed by high prices charged to industry; and it led to a level of excess demand which resulted in chronic shortages. The high prices and shortages forced industrial consumers to set up their own captive diesel generators; the diversion of their demand away from the state power generating companies hastened the bankruptcy of the latter.

Indian politicians early recognised the need to redress the disabilities suffered by members of the lower — "untouchable" — castes and by tribal people. When dyarchy was introduced in 1936, a list or schedule of such castes and tribes was prepared. The constitution of 1948 prohibited untouchability and discrimination and guaranteed equal opportunity of employment, but provided for discrimination in favour of scheduled castes and tribes (Bakshi, 1996). Under this provision, 15 per cent of the seats in parliament and legislatures were reserved for them, and in the 1950s, a similar reservation of government jobs was made, raised later to 22 per cent. In the 1970s as political competition intensified, politicians sought to use reservations as a means of attracting support of not–so–backward castes. Finally in 1989, the central government introduced a further reservation of 27 per cent of government jobs for backward castes not included in the original schedule, thus raising total reservations to 49 per cent, just short of the 50 per cent allowed by the Supreme Court. Similar laws providing for reservations of politically strategic castes were enacted by the States at their own pace, generally much ahead of the centre.

Interception of Benefits

Political parties in democratic systems commonly distribute state–controlled resources to uses for which they have won popular mandate; that is how they win and retain legislative majorities and attain political power. However, this process has been vitiated in a number of ways in India: the benefits are intercepted by politicians, bureaucrats, or networks of the two. Some bureaucracies work out ways of sharing bribes; barring those, however, the intercepted benefits are unevenly shared, and lead to disaffection. Disaffected politicians switch loyalties or bring down governments; disaffected bureaucrats shirk work, and clutter up the courts with litigation alleging unfairness.

The only politicians originally accommodated and paid by the state were legislators. To this day, they are poorly paid. Even now, the salary of a member of parliament is Rs 1 500 a month (the current exchange rate (mid–1999) is Rs 38 to a dollar). In addition he gets a constituency allowance of Rs 3 000 and an office expenses allowance of Rs 1 000. When the parliament is in session he gets an attendance allowance of Rs 200 a day. Thus an MP's maximum cash pay is Rs 9 500 a month, at a time when an apartment with a good address in Delhi costs at least Rs 25 000 a month, the cheapest car costs Rs 250 000, and its running costs come to at least Rs 3 000 a month. A member of parliament could not lead an average middle–class existence in Delhi at even three times his legitimate income. Most MPs as a consequence are socially invisible in Delhi: they form a separate caste.

On the other hand, their income in kind is substantial. They get 50 000 free telephone calls, 7200 kWh of electricity, 1000 kilolitres of water. They get a house or apartment in Delhi, unlimited free travel on the railways, free air travel on business and 28 air trips a year for themselves and a companion. Some of these entitlements could be illegally transferred; for instance, the houses of many MPs are used as lodging houses by friends, party workers and constituents. Besides these, there are other perquisites meant to be used as favours. MPs can buy three second–hand vehicles a year from the army. They get 100 gas connections and 25 telephone connections a year. There were other entitlements — for instance, to two watches of government–owned Hindustan Machine Tools a year, or a Maruti car — which have become devalued with the disappearance of shortages. There are other, unauthorised entitlements; for instance in 1987–89, 38 MPs were found to have been sold confiscated guns by the customs department. MPs would normally expect to go through customs at airports unsearched; in 1994, an MP was arrested for assisting a ring of smugglers.

Thus, the political system pays even legislators poorly, and a large part of the income is in kind. The income of State–level legislators is even lower. Hence the temptation to cash in the privileges is strong. The most commonly used privilege is that of *sifarish*, i.e. of recommending persons for government jobs. The core central services are recruited by examinations, and the only way of manipulating recruitment to them is by means of representation in selection committees, but there are many more jobs in departments and public enterprises where recruitment is not subject to such rigorous rules. That is where politicians' recommendations lead to biased and corrupt appointments, and to overmanning. Politicians cannot themselves occupy government positions; but State governments have got around this limitation by creating parastatal organisations which politicians can head — co–operative societies, co–operative banks, and government corporations. Apart from rewarding politicians better than a legislative position, these posts also give them control over resources and patronage. Most States have gone further and made open–ended arrangements for funding or subsidising institutions headed or run by politicians. The commonest such institutions are schools and colleges.

Appointments in the government and in public enterprises are generally made by committees of bureaucrats. Hence they are essential intermediaries in the exercise of political patronage; and instead of being intermediaries, they themselves appropriate and exercise patronage. In the 1960s, when political patronage first emerged in a significant way, there was much friction between politicians and bureaucrats. Politicians regarded bureaucrats as obstacles to development and social progress. To bring them to heel, Indira Gandhi increasingly politicised senior bureaucratic appointments. Under her rule, the quinquennial pay commissions raised the salaries of senior bureaucrats much less than the price increases, and thus reduced their real incomes. The politicisation and impoverishment rapidly converted bureaucrats to the exercise and encashment of patronage. From the 1970s onwards, patronage networks emerged consisting of politicians and their client bureaucrats. The politicians appointed their favourite bureaucrats to key positions, for which the bureaucrats shared their rewards with the politicians. These networks corner key positions; so they cause considerable dissatisfaction within the bureaucracy. This dissatisfaction finds an expression in the numerous suits filed by aggrieved bureaucrats. These suits multiplied so much that the government set up a special court called the Central Administrative Tribunal in the early 1980s to try them.

A network requires that a politician should be able to place his favoured bureaucrat in a strategic position, but the appointments are made by ministers on the advice of bureaucrats' committees; politicians can only make recommendations. The recommendations are not always successful; the greater the opportunities for enrichment or for obliging people, the more sought–after the job, and the greater the competition amongst patrons of different candidates. Competition is particularly severe for senior positions which offer particularly good opportunities for enrichment or for obliging people, for instance, headships of revenue departments, of banks or of profitable public enterprises. such posts are so intense that they are generally made by the prime minister in the centre and the chief minister in the States. Thus, patronage is concentrated in central and State cabinets of ministers; every legislator wants to get into them. The unequal distribution of patronage leads to tensions; every once in a while, legislators who are left out either withdraw support from the ministry or threaten to do so. The way the Congress dealt with this problem was by means of a form of musical chairs: the central leader would every once in a while change the chief minister of a state; the new chief minister would bring in his own cronies, and the largesse would thus be more evenly spread, but the frequent undermining of local leaders led to erosion of the Congress organisation, and was an important reason for its defeat by local parties. Those parties usually were and are led by a supremo who, as chief minister, acts as the hub of all party patronage networks. This arrangement curbs competition for patronage and works well in the hands of a skilled leader, but there is instability when the leader dies or otherwise stumbles. Also, since a high proportion of the resources are intercepted, popular dissatisfaction often brings down the ruling party and votes in a competitor. This type of alternation is behind the virtual two–party systems that have emerged in many States. In the multi–party coalitions that have followed in recent years, chief ministers have sought to achieve the same objective by appointing extremely large cabinets, but that dilutes politicians' access to patronage just as do musical chairs, and has not reduced dissidence. Thus, patronage has been an important cause of instability in parties.

III. THE ORIGIN OF THE REFORMS

The economic reforms of the 1990s can be traced back to the emergence of political competition in 1966. Till then, the Congress was a united, monolithic party, which ruled at the centre and in almost all the States. In that year, Indira Gandhi took over as Prime Minister. She faced opposition from the older leaders in the Congress. She broke with them and split the party. To break their nexus with industrialists, she banned corporate contributions to parties. She nationalised banks to make industry more dependent on the government, and introduced a new control on industrial houses in the form of monopoly control. In an attempt to secure major vote banks, she introduced subsidies for farmers as well as new public works schemes. Thus the split in the Congress and the emergence of political competition led to a rise in the exploitation of industry, and extension of patronage to new interest groups.

This strategy succeeded only for a time. As the oil crisis struck in 1973 and inflation scaled new heights, political opposition gathered strength again. Railwaymen struck in 1974 and could be subdued only with highly repressive measures. A new political agitation led by Jayaprakash Narayan spread to the streets and attracted thousands. Finally Indira Gandhi imposed an emergency in 1975 and arrested thousands of opposition politicians. This raised the penalty of being in opposition, and gave the opposition politicians a powerful reason to capture power. In 1977 Indira Gandhi revoked the emergency and called a general election. In this election, a coalition of opposition parties, brought together by their common bitter experience in the emergency, formed a front called Janata Party and won a landslide victory.

They inherited an economy with high exchange reserves, a strong balance of payments and low inflation. However, three events occurred which rapidly turned this comfortable situation into an economic crisis; the coalition was too weak to tackle them, and fell in a sequence that presaged a similar sequence ten years later.

The first event was the report of the seventh Finance Commission. Under the Constitution, Finance Commissions have to be appointed every five years to reallocate the States' share of the central government's tax revenue. The 1977 finance commission recommended a drastic increase in the States' share. This transfer, unaccompanied by any transfer of the centre's responsibilities, brought about a sudden deterioration of the centre's fiscal balance. The ratio of central government savings to GDP came down from 4.9 per cent in 1978–79 to 1 per cent in 1979–80, and its budgetary deficit (i.e., deficit not covered by borrowings) rose from 0.7 to 2.7 per cent of GDP (Ministry of Finance, 1982).

Second, this loosening of fiscal discipline coincided with a serious drought in 1979–80; agricultural output fell by 12.5 per cent over the previous year, and inflation (as indicated by the national income deflator) accelerated to 16 per cent from 3 per cent; the annual point–to–point rise in wholesale prices peaked at 23 per cent in February 1980.

The third event was a rise in world oil prices. The central government controls domestic prices of oil products. It owns refineries as well as two corporations which are the only domestic producers of crude — Oil and Natural Gas Corporation and Indian Oil. Government–owned companies get controlled prices for crude and refined products; the difference between the controlled prices and the international prices at which crude and refined products are imported is paid from an oil price equalisation fund, which also pays out the controlled prices to domestic producers. It is also used to cross–subsidise imported crude, which is more expensive than domestic crude, and some refined products such as paraffin, bottled cooking gas and diesel oil. When international oil prices rise, the oil price equalisation fund begins to make losses. It may run through its accumulated profits, and then stop paying producers and refiners; since they normally make good profits, they can bear losses up to a point. Beyond that point they have to be subsidised or the sale prices of refined products have to be raised.

After rising sharply in 1973–74, international oil prices stabilised till 1978. In early 1979, however, they began to rise again. The coalition government hesitated to raise domestic prices, and the oil price equalisation fund rapidly went into deficit. Since the government was unable to restore fiscal discipline, the International Monetary Fund was not prepared to support it with credit.

In the meanwhile, there was continuous disunity in this front consisting of parties which had diverse histories and ideologies. It split in March 1980 under the instigation of the Congress, and a breakaway faction formed a minority government with outside support from the Congress. The support was withdrawn after seven months, and in the ensuing general elections, the Congress won a majority.

The Long Boom of the 1980s

Faced with rapidly falling exchange reserves, the Congress government raised controlled prices of foodgrains, fertilisers and oil products, and obtained IMF support. It was helped by a sharp rise in domestic oil production. Oil output, which was 10.5 million tons in 1978–79, doubled in two years, and reached 30 million tons in 1985–86.

Once the run on reserves was stopped with the help of IMF credit, the government continued to finance a high current account deficit by recourse to World Bank loans. It allowed its own enterprises to raise bank loans abroad, and made foreign loans advantageous to them by keeping domestic interest rates above international levels. High domestic interest rates were also used to attract deposits into Indian banks from Indians resident abroad (Table 3.1). The flood of petro–dollars to developing countries in the 1970s had made many of them bankrupt. By the 1980s few of them were good credit risks; India benefited from the fact that international banks faced a shortage of solvent borrowers. Hence through the 1980s India could attract debt inflows to finance a high external deficit.

In December 1984 Indira Gandhi was assassinated and her son, Rajiv Gandhi, took over as Prime Minister. He had watched her efforts at gaining and keeping power, and after the death in 1981 of Sanjay, his younger brother, he had helped his mother as political manager. During this stewardship he had come to the conclusion that the comprehensive control Indira Gandhi had sought to exercise over the economy made political management difficult without bringing commensurate gains. In particular, industrial licensing was seen to be of little political use. It made industrialists come to the government only when they needed to expand or diversify; the control on the capacity that licensing sought to exercise was easily evaded, and those who evaded it were also induced to evade taxes. There were other more effective instruments of industrial control in the government's hands, namely import licensing, and loans from government financial institutions. Above all, dependence on industrialists for contributions to party funds required their active pursuit by party officials, and it was not possible to prevent officials from intercepting the proceeds or other party members from unauthorised intermediation. It was better to rely on a few government powers — for instance, on allocation of contracts to carry oil imports, or defence purchases — to raise political funds through a handful of trusted ministers.

Table 3.1. **Financing of the Current Account Deficit, 1976–77 to 1995–96**

	($ billion)							
	Current a/c balance	Fall in reserves	IMF drawings	Official loans	Private debt flows	Banking flows	Equity capital	Other
1976	1.6	–1.6	–0.3	0.5		0.1		–0.4
1977	2.0	–1.8	–0.3	0.0		0.2		0.0
1978	0.1	–1.2	–0.1	0.5		–0.1		0.7
1979	–0.4	–0.5	0.1	0.9		–0.1		0.0
1980	–2.2	0.7	1.2	0.4		0.1		–0.2
1981	–2.6	1.8	0.7	0.5		0.1		–0.4
1982	–2.4	–0.6	2.0	0.6		0.3		0.2
1983	–2.2	–0.7	1.3	1.3		0.9		–0.5
1984	–2.5	–0.8	0.1	2.1		0.9		0.3
1985	–4.9	0.6	–0.2	1.9		2.1		0.5
1986	–4.6	0.6	–0.5	2.6		2.0		–0.1
1987	–4.9	0.7	–0.9	3.5		2.3		–0.7
1988	–7.2	1.0	–1.1	4.7		2.4		0.1
1989	–5.9	0.7	–0.9	4.3		2.2		–0.4
1990	–10.9	1.3	1.2	2.2	5.3	0.7	0.1	0.1

1. Years beginning 1 April.
2. Debt service on Rupee debt to Russia is treated as a domestic transaction.
3. Transactions with IMF include credit, repurchases of Rupees and issue of SDRs.
4. Private debt includes commercial loans from foreign financial institutions.
5. Banking flows include deposits from nonresident Indians.

Sources: Ministry of Finance (1982, 1987, 1992, 1997).

So 1985 saw the first steps in the liberalisation of industrial controls. There were three sets of restrictions in existence: industrial licensing, which applied only to firms with fixed capital over a certain limit (Rs 3.5 million in 1985), additional approval by the Monopolies Commission for companies with assets over Rs 1 billion, and reservation of over 800 products for small firms (i.e., firms with fixed assets under Rs 3.5 million). The reservations were left untouched (and remained so till February 1997, when a modest de–reservation of 14 products was announced), but the limit of assets of companies requiring approval of the Monopolies Commission was raised from Rs 1 billion to Rs 10 billion; few companies had assets over Rs 10 billion at that time. More importantly, 25 product groups were de–licensed in March 1985; firms concerned no longer needed licences, but only had to “register” with the Secretariat for Industrial Approvals. Another 22 were de–licensed in December 1985 provided the plants were located in designated backward areas. In January 1986, 28 industry groups were broad–banded: in other words, they were redefined more broadly so that firms in them could diversify into related products without seeking government approval. In 1986, the government allowed firms which achieved 80 per cent capacity utilisation to ask for a fast–track increase in licensed capacity to 133 per cent of the maximum production in any of the previous three years (Ministry of Finance, 1987). The changes were complex and arbitrary, but they led to an acceleration of industrial growth from 4.5 per cent in 1985–86 to a peak of 10.5 per cent in 1989–90. The experience of their working was an important backdrop to the more radical steps of 1991.

The Crisis at the End of the 1980s

As described in the previous section, Rajiv Gandhi, after coming to power in 1984, made a major change in party funding strategy: instead of relying on Indian industrialists for funds, he relied upon chosen ministers to collect commissions on big contracts under government control — contracts for oil exploration and drilling equipment, for ships to bring in imported oil, for military equipment, and for power generation equipment. The shift was not complete; it is reported that he went back to collecting money from Indian industrialists later in his term of office. It is also known from the diaries of the Jain brothers (two businessmen who were close to senior Congressmen) that some of his ministers collected bribes on their own initiative. Bribes taken at that time from foreign companies that sold power generation equipment to government–owned generating companies are documented in the recent investigations in the Hawala case (Kapoor, 1996).

One of these contracts, for Bofors guns, landed Rajiv Gandhi into trouble. His finance minister, V.P. Singh, suspected bribes and started an investigation. He was moved to the defence ministry, from which he resigned, as well as finally from the Congress in 1986. Allegations of the kickbacks, paid through intermediaries with accounts in Geneva, surfaced in the press. Rajiv Gandhi could not shake off suspicions that he was amongst the beneficiaries. The Congress party delayed and obstructed investigations as long as it could. Finally in January 1996, documents from Swiss banks were handed over to the Central Bureau of Investigation. It has released the names of two intermediaries — Ottavio Quatrocchi, the agent of Snam Progetti in India, and Win Chadha, a commission agent. The Hinduja brothers, industrialists and traders operating from London, Hong Kong and Bombay, opposed the release of the documents relating to their accounts, and are also reported to have received commissions from Bofors. These were intermediaries; the names of the politicians and bureaucrats who received money from them are yet to be released.

After he left the Congress in 1986, V.P. Singh took away many dissidents from the Congress, and constructed a coalition of opposition parties similar to the one that took power in 1977. This coalition was helped by the growing unpopularity of the Congress. The Congress was hurt most by suspicions of corruption, but there were other issues as well. One of the most important was a case in which the Supreme Court awarded alimony to a Muslim woman divorced by her husband; the Congress, in an effort to win Muslim votes, pushed through Parliament a law which deprived Muslim divorcee women of compensation from their husbands. This political move did much to alienate Hindu support for the Congress.

The Janata Party, which had come to power on a wave of mass support in 1977, was decimated in the elections of 1980 and 1984. It had won 295 seats (out of 544) in the 1977 elections; its seats shrank to 31 in 1980 and 10 in 1984. Taking a lesson from this, V.P. Singh tried to create a loyal support base for his new coalition, Janata Dal, amongst middle castes which were not so high–born as brahmins and not so low in the hierarchy as the untouchables. The proportion of these castes (officially called other backward castes) in the population slightly exceeded 50 per cent. They owned much more than half of agricultural land, and constituted the new agricultural elite. V.P. Singh sought to gave them a share in the administration, and thus to turn them into a political power base. Janata Dal won 143 seats in the 1989 elections; Congress won 197, and BJP 85 seats. None had a majority; but JD formed government, and BJP supported it from outside (Table 3.2).

Table 3.2. **Results of the Last Four Elections to Lok Sabha**[1]

	INC	JD	BJP	DLP	INC	JD	BJP	DLP	INC	JD	BJP	DLP	INC	JD	BJP	DLP	TOTAL
	1989				1991				1996				1998				
India	197	143	86	48	231	59	119	54	150	45	196	123	140	6	177	104	543
UP	15	**54**	8		5	22	**51**		5		**54**				**57**		85
Bihar	4	**31**	9		1	**31**	5		2	25	24	**25**	5		**18**	17	54
Maharashtra	**28**	5	10		**38**		5		15		**33**		**33**		4	6	48
West Bengal	4			**27**	5			**27**	9			**33**	1		1	**24**	42
Andhra Pradesh	**39**				**25**		1	13	**22**			19	**22**		4	12	42
Madhya Pradesh	8	4	**27**		**27**		12		10		**27**		10		**30**		40
Tamil Nadu[1]	**27**				**28**			11				28			3	**18**	39
Karnataka[2]	**27**	1			**23**		4		5	**16**	6		9	3	**13**		28
Gujarat	3	11	12		5		**20**		10		**16**		7		**19**		26
Rajasthan		11	**13**		**13**		12		12		**12**		**18**		5		25
Orissa	3	**16**			**13**	6			**16**	4	1		5		7	**9**	21
Kerala	**14**				**13**				**10**			10	**9**			6	20
Haryana	4	**6**			**9**				2		**7**		3		1	**4**	10
Other states	21	4	7	21	26		9	3	32		16	8	19	3	15	8	53

1. INC stands for the Congress, BJP for the Bharatiya Janata Party, JD for the Janata Dal and DLP for the dominant local party. The figures for 1998 are provisional. Bold figures represent the party with the most Parliament seats from the state.
2. The dominant local party was DMK in 1996 and AIADMK in 1998. DMK continued to rule the state in 1998, but AIADMK took a majority of parliament seats.
3. In 1998, the BJP entered an alliance with Lok Shakti, a splinter group of Janata Dal which won 16 seats; the BJP fielded no candidates.

Source: Butler, Lahiri and Roy (1995); The Asian Age, 4 March 1998.

V.P. Singh unearthed the 1980 report of a commission appointed by the earlier Janata Party government that had advocated reservations in government jobs for the middle castes and implemented it. In this he ran into opposition from urban university students, who saw in it a considerable narrowing of their employment opportunities. The agitation was particularly strong in Delhi, which saw repeated blocking of roads, bloody confrontations with the police, and a number of self–immolations on the streets by students in the summer of 1990. The press gave considerable publicity to the agitation.

As V.P. Singh was seeking to build a power base amongst the middle castes, his deputy Prime Minister, Devi Lal, was trying to build one amongst farmers. As agriculture minister, he declared that farmers did not have to repay loans, thus instantly turning bank loans to them into bad debts. The government's purchase price for wheat was raised by 17 per cent, and that of common rice by 16 per cent in 1989–90. As a result, the government, which had released 8.3 million tons of foodgrains (out of imports and its own stocks) into the economy in 1988, withdrew 1.3 million tons in 1989 and 6.7 million tons in 1990.

While V.P. Singh was battling with social unrest, the balance of payments rapidly worsened (Table 3.1). In October 1989 Iraq occupied Kuwait; consequently the United Nations declared an embargo on Iraq. The 300 000 Indian workers working in Kuwait and Iraq returned to India, and their remittances ceased. Under a tripartite agreement, India used to import 5 million tons of oil a year from Iraq and pay for it with commodity exports to the Soviet Union; this source of supply dried up, and India had to scrounge around in a rapidly hardening international oil market. Imports of oil products rose from $3.8 billion (18 per cent of exports) in 1989–90 to $6 billion (33 per cent of exports) next year. Just when the winter wheat crop of 1990 was being planted, there were shortages of diesel oil on which tractors, irrigation pumps and road transport moved. The late 1980s were also a period of large and worsening fiscal deficits (Table 3.3). These deficits, combined with rising government inventories of foodgrains and stringent import controls, led annual average inflation to rise from 7 per cent in 1989–90 to 10 per cent and 13 per cent in the next two years.

Table 3.3. **Combined Fiscal Balance of Central and State Governments, 1980–81 to 1995–96**

(Per cent of GNP)

	Expenditure			Revenue			Fiscal deficit		
	Centre	States	Total	Centre	States	Total	Centre	States	Total
1980	16.3	13.7	30.0	10.1	9.4	19.5	6.2	3.8	10.0
1981	15.9	14.6	30.5	10.5	10.7	21.2	5.4	3.9	9.3
1982	17.0	16.2	33.2	11.0	11.5	22.5	6.0	4.7	10.7
1983	15.7	17.0	32.7	9.4	12.7	22.1	6.3	4.4	10.7
1984	17.4	17.8	35.2	9.9	12.8	22.7	7.5	4.9	12.4
1985	18.8	17.3	36.1	10.5	13.9	24.4	8.3	3.4	11.7
1986	20.2	18.8	39.0	11.2	13.9	25.1	9.0	4.9	13.9
1987	19.8	18.6	38.4	11.7	13.5	25.2	8.1	5.1	13.2
1988	19.3	18.0	37.3	11.5	13.1	24.6	7.8	4.9	12.7
1989	20.3	18.9	39.2	12.4	14.1	25.6	7.9	5.8	13.7
1990	19.7	17.8	37.5	11.4	13.3	23.5	8.3	5.7	14.0
1991	18.1	18.6	36.7	12.2	14.0	24.7	5.9	6.2	12.1
1992	17.4	18.9	36.3	11.7	14.2	24.7	5.7	5.9	11.6
1993	17.5	18.4	35.9	10.1	14.3	23.6	7.4	4.9	12.3
1994	16.9	19.2	36.1	10.8	14.1	23.7	6.1	6.3	12.4
1995	16.7	18.4	35.1	10.9	13.9	23.9	5.8	5.4	11.2

1. Years beginning 1 April.
2. From 1989–90 onwards, the centre has added "non–debt capital receipts" consisting of loans recovered and sales proceeds of shares in public enterprises to revenue in calculating fiscal deficit.

Sources: As for Table 4.1.

The attempts of V.P. Singh and Devi Lal to carve out new political support bases alarmed the BJP. The BJP drew support from upper castes and the urban middle class; these were upset with the government's discrimination in favour of farmers and backward castes. Finally in October 1989, the BJP withdrew support from the government. A faction of the Janata Dal split, and its leader, Chandra Shekhar, formed a government with the support of the Congress.

In the meanwhile, the balance of payments worsened, and reserves began to decline. In July 1990, the government drew the reserve tranche of $660 million from the International Monetary Fund. The worsening balance of payments and political instability alarmed foreign lenders. Foreign bank loans and purchases of public enterprise bonds came down from Rs 54 billion in 1989–90 to Rs 34 billion in 1990–91. By October 1990, non–resident Indians began to withdraw deposits. The reversal of capital inflows led to rapid erosion of exchange reserves. By December, when the Gulf War began, they had fallen to $1 billion, equal to the cost of a fortnight's imports. On 23 January 1991 the government withdrew the first credit tranche from the IMF, negotiated drawals under the contingency compensatory finance facility (CCFF), and began preparations for drawing the upper credit tranche, which would take the government's borrowings to over 40 per cent of its quota. To draw it the government would have had to take action in the February budget to meet qualification criteria — disinflate the economy, bring down the fiscal deficit, and improve the balance of payments (Ministry of Finance, 1992*a*).

Before it could do so, a dispute broke out between the ruling party and the Congress. During the Gulf War, the government had allowed US planes on the way from the Pacific to the Gulf to refuel in India. It is very unlikely that it did so without the concurrence of

Rajiv Gandhi, the leader of the Congress party, but when the news broke in January, the Congress joined in the attacks on the government. Chandra Shekhar, the Prime Minister, decided that it was impossible to work with the Congress. He resigned, and recommended the dissolution of Parliament. Elections were called for May. Rajiv Gandhi was assassinated during the election campaign. Riding a sympathy wave, the Congress won 231 seats — 41 short of majority. The Congress government had a raging economic crisis on its hands — exchange reserves of less than the cost of a fortnight's imports, stringent import restrictions which were strangling industry and transport, flight of capital, and inflation at 12 per cent. The next tranche of CCFF drawals was due in July, but before it could be drawn, the International Monetary Fund would expect corrective policy measures. These were taken at the time of the budget in June 1991. They were as follows (International Monetary Fund, 1991):

Fiscal policies

i) an increase in prices of petroleum products;

ii) net tax increases equal to 0.5 per cent of GDP;

iii) steps to improve tax compliance, including wider deduction of tax at source;

iv) a decision to sell up to 20 per cent of equity in some public enterprises, with a yield of 0.4 per cent of GDP;

v) sharp cuts in subsidies: abolition of export subsidies and sugar subsidy, and a rise of 30 per cent in fertiliser prices;

vi) a reduction in defence expenditure from 3.1 to 2.8 per cent of GDP; and

vii) cuts of 0.3 per cent of GDP in transfers to public enterprises and restraint on other expenditure;

Structural reforms

i) deregulation of industry: relaxation of industrial licensing, and automatic approval to 51 per cent foreign direct investment in a wide range of industries;

ii) trade reform: abolition of export subsidies, introduction of tradable import entitlements linked to export earnings, and a limited reduction in the peak tariff rate from over 300 per cent to 150 per cent;

iii) financial sector reform: removal of interest rate ceilings on private debentures and on loans from term–lending institutions;

iv) public enterprise reform: narrowing of public sector reservations, strengthening of performance monitoring, and proposed sale of up to 20 per cent of equity to mutual funds.

In addition, the Fund laid down structural benchmarks outlined in Box 3.1 to be satisfied by the time of the first review, which was to be not later than 31 March 1992; and the World Bank laid down further conditions in a structural adjustment loan. These were the origins of India's reform programme.

Box 3.1. India: Structural Benchmarks for the First Review of the Proposed Stand–By Arrangement

1. Industrial Policy

a) Submit amendments to the MRTP Act to Parliament so as to eliminate the restrictions on large firms' activities because of their size alone.

b) Announce a timetable for relaxing the prior approval requirements for capital goods imports.

c) Formulation of specific policy proposals concerning the rationalisation/exit of chronically loss–making firms.

2. Foreign Direct Investment

a) Introduce regulations implementing the measures announced in the July 1991 Industrial Policy Statement.

3. Trade Liberalisation

a) Introduce greater transparency in the trade regime by moving to a harmonised system of customs classification.

b) Review the progress in the elimination of those exchange restrictions, including cash margins, imposed since November 1990 and establish timetables for those that have not already been removed; restrictions affecting capital goods imports to be completed by the time of the first review.

c) Eliminate quantitative restrictions on imported inputs and capital goods for export production.

d) Eliminate the public sector monopoly on imports of all items except petroleum, edible oils and fertiliser, and certain items canalised for health and security reasons.

4. Pricing Policies

a) Introduce a system of formula–based quarterly adjustments in petroleum product prices to ensure adequate oil–related fiscal receipts.

b) Announce detailed plans to give public enterprises greater freedom in setting prices according to market forces.

5. Public Enterprise Reform

a) Announce a concrete plan to strengthen the Board for Industrial and Financial Reconstruction (BIFR) and formulate a list of unviable public sector companies that will be referred to the BIFR during 1992/93.

b) Formulate a programme for disinvestment during 1992/93, including proposals to broaden the menu of disinvestment options.

6. Tax Reform and Expenditure Controls

a) Formulate a programme for tax reform, including concrete measures proposed for 1992/93 and a timetable for action in the medium term[1].

b) Introduce a detailed tracking system for all categories of expenditures and a system of quarterly expenditure reviews[1].

c) Implementation of the additional revenue and expenditure measures amounting to Rs 20 billion referred to in the first sentence of paragraph 10 of the Memorandum on Economic Policies (performance criterion for December 1991).

7. Financial Sector Reform

a) Formulate detailed recommendations, with a clear timetable, for reducing directed lending, enhancing the soundness of the banking system, and implementing policies to further the development of capital markets.

1. The reaching of understandings on these issues will be a condition for the completion of the first review.

IV. THE REFORMS

The new Congress government took charge in June 1991. It won 231 seats out of 543 in the lower house of Parliament — 41 short of a majority. It could seek support from one of three other parties — the BJP, which had 119 seats, the Janata Dal, which had 59 seats, or the two communist parties, which together had 66 seats. The communists were against policies which would have won the Fund's and the Bank's support. In particular, the West Bengal government, run by Communist Party (Marxist), at that time felt it could not attract private investment (although it has since proved itself wrong), and relied upon industrial licensing and public sector reservations to get any industrial investment. Hence it was entirely against industrial liberalisation. For the same reason it was against foreign competition and hence against trade liberalisation. The Janata Dal had just gone through a traumatic period in which it had been split and thrown out of power by the Congress; there was still much bitterness on both sides. That left the Bharatiya Janata Party as the only possible supporter. The support was not formalised; the Congress did not want to be seen as an ally of a Hindu fundamentalist party, but both parties shared an interest in avoiding fresh elections.

The government inherited a payments crisis which could be tackled only with the help of the International Monetary Fund. The conditionalities finally imposed by the Fund were described in the last section. Of them, two were paramount: a reduction in the monetised deficit, and a trade policy that relied less on bureaucratic restrictions and more on a realistic exchange rate (Ministry of Finance, 1993). In similar circumstances in 1980, the government had accepted conditionalities to get IMF support; when the balance of payments improved, however, the government prematurely repaid the loans it had taken from the Fund and reneged on the its promises. Hence if the Fund were to extend support again, it would want a finance minister with credibility. None of the Congress politicians was credible. Finally, Narasimha Rao, the Prime Minister, chose Manmohan Singh. He had held every major post in the economic bureaucracy: he had been Economic Affairs Secretary, Finance Secretary, Deputy Chairman of the Planning Commission, and Governor of the Reserve Bank. He had recently returned after steering the South Commission as Secretary General. During his stint with it he had travelled extensively, observed how export–oriented, open trade policies had transformed the East Asian economies and how dirigisme had left India behind. He was therefore a recent convert to market–driven growth. With him in the Ministry of Finance, the Fund and the Bank felt reassured enough to extend emergency support.

However, the reforms that were actually achieved were not those in the Fund–Bank blueprints; they were shaped as much by political forces and by the state of preparation in the bureaucracy as by the requirements of the Fund. What the bureaucracy felt it could achieve was packaged into conditionalities and formed part of structural adjustment loans from the World Bank.

The reforms that took off first were in industrial policy; here there was the experience of the liberalisation of 1985/86 which was hugely successful: industrial deregulation was behind the impressive industrial boom of 1985–88. Its success created a constituency amongst industrialists for industrial de–licensing.

The next area was trade, where too, proposals for import de–licensing were ready. By the 1980s, import licensing of industrial inputs had become quite mechanical. It was based on consumption, and had little to do with industrial licensing except when a new production facility was built. Corruption in import licensing mainly benefited bureaucrats; its political significance was small. Its abolition would remove the need for firms to get licences twice a year, the delays, and the bribes. Hence there was considerable support for its abolition, and no good political reasons for its retention. Along with it, import licensing of capital goods was also abolished. That required more courage, which was supplied by the International Monetary Fund and the World Bank, who underpinned the abolition with financial assistance.

Reforms in the areas under the control of the Ministry of Finance — the budget, the capital market, the banks and exchange control — were slower off the ground because of the deliberate and cautious style of Manmohan Singh; but after 1993, when other ministers lost appetite for reforms, the Ministry of Finance was the only one that continued them. All the reforms were hedged with exceptions to skirt around powerful vested interests; reforms were not attempted at all in areas such as agriculture where interest groups were too powerful.

Industry

Of the five classes described in Section I above, public enterprises were the most important to ruling politicians and the parent ministries they managed as a source of employment, patronage and commissions. By 1991, however, their utility had been eroded by years of poor profits, lack of funds for expansion and militant labour forces. The International Monetary Fund was in favour of privatisation, and offered to allow proceeds of privatisation sales as a credit towards reduction of the fiscal deficit. The parent ministries, on the other hand, were entirely against loss of control over the enterprises. A compromise was finally reached between them and the Ministry of Finance involving three elements. First, since the government did not have the money to invest in public enterprises and since they had monopoly of some of the most basic industries, these industries should be opened up to private firms. Second, government equity in public enterprises would be sold up to a point where it did not involve giving up government's management control. Finally, it was decided to end the unconditional guarantee against closure, which implied that workers in a public enterprise could get their wages throughout their working life whether they produced anything or not. Loss–making enterprises were to be referred, as were private firms, to the Bureau of Industrial Finance and Reconstruction for rehabilitation or closure.

Small firms were left untouched. Although many small firms had become "sick" — i.e., had stopped servicing bank loans — local politicians, their relatives and friends were too often involved in small industry, so it was regarded as too sensitive to touch. Policies in other areas did change even when they impinged on small firms. For instance, the Ministry of Finance induced the Reserve Bank of India to deregulate banks' lending rates. A subsidised rate for small advances (that is, advances under Rs 200 000) was retained, but the spread between it and unsubsidised rates was much reduced. Similarly, the Ministry of Finance weakened excise duty concessions for small firms, but the reservation of 836 products for small industry remained intact till February 1997.

Compared to public enterprises and small firms, the policy on large firms was relatively easy to reform. The de–licensing of 1985 was seen not to have been politically costly. The number of firms involved and the volume of work had turned industrial licensing into administrative drudgery. The corruption had been pushed down to lower bureaucracy; there was little in it for politicians. They had lost little out of the liberalisation of 1985, and had retained other levers of control e g, on the oil industry — which served them well enough. So there was no serious resistance to further de–licensing. However, industries where politicians were heavily involved or where there were potential conflicts of interest between lobbies were retained under licensing. Amongst them were automobiles, where Maruti, owned by the government, was the dominant firm, and sugar, where nominally co–operative factories in some States were run by politicians and where there was rampant political interference in pricing. Automobiles were de–controlled in 1994; Maruti was then protected by import controls and local content restrictions on new entrants. Sugar continues to be under control.

With the raising of the limit to Rs 10 billion in 1985, the control on "monopoly" houses had virtually disappeared. Very few cases came up before the MRTPC; and the ministry of industry had the power not to refer even eligible cases. The industrial houses were strongly against MRTPC control; so under their pressure, MRTPC's role in licensing was entirely removed. The law was changed in 1993, and the commission was changed into a Restrictive Trade Practices Commission.

In the middle of the payments crisis of 1991, the Fund's argument for allowing inflows of non–debt–creating foreign equity investment was strong, but discrimination against foreign investment was part of the post–independence credo, and had provided Indian industrialists with lucrative take–over opportunities. Those opportunities were exhausted by 1991; there were few foreign subsidiaries left, but their reintroduction could meet considerable political resistance. There was a Secretariat for Industrial Approvals (SIA) in the ministry of industry dating back to the 1970s which had the discretion to allow controlling foreign investment, but it was consistently negative.

In the event, the government set up a higher discretionary mechanism which could override the SIA, consisting of two committees. The Foreign Investment Promotion Board, consisting of secretaries of economic ministries, first vetted foreign investment proposals; it then sent them to the Foreign Investment Co–ordination Committee, a committee of ministers. This duo turned out to be very accommodative till 1994: it even allowed investment in such "non–essential" businesses as fast food chains, cosmetics and fashion firms. From 1994, as nationalist backlash gathered strength, the duo slowed down; finally in 1995 the FIPB was transferred to the ministry of industry, which simply filed applications without replying. The new industries minister who came in after the general election in May 1996 approved 350 waiting cases within days; the United Front government continued this positive attitude towards foreign investment while it lasted.

This discretionary policy did not address the bitterness of those foreign firms which had been forced to sell off part of their equity cheaply to meet the disinvestment requirements of the Foreign Exchange Regulation Act. For them the government resuscitated a list of "priority industries" from the early 1970s: before the enactment of FERA, at a time when restrictions on investment by business houses and foreign firms were savage and arbitrary, the government had made up a list of mainly capital goods industries in which these restrictions were relaxed. In those industries, foreign investors were allowed in 1991 to invest up to 51 per cent of equity with "automatic approval" — that is, by simply reporting their intention to the Reserve Bank of India. They were also allowed to raise their holdings in equity at a preferential price if approved by three–quarters of the shareholders.

Table 4.1. **Foreign Investment Inflows, 1991–95**
($ billion)

	1991–92	1992–93	1993–94	1994–95	1995–96	1996
Direct investment	150	341	620	1 314	2 133	1 710
With RBI registration		42	89	171	169	83
With SIA or FIPB approval	87	238	314	701	1181	
Nonresident Indians	63	61	217	442	715	446
Portfolio investment	8	92	3 490	3 581	2 214	2 343
In Indian stock exchanges		1	1 665	1 503	2 009	1 511
In foreign stock exchanges		86	1 460	1 839	149	812
Offshore funds etc	8	5	365	239	56	20
Total	158	433	4 110	4 895	4 247	4 053

1. 1996 figures are up to December.
Source: Ministry of Finance (1997).

As a compromise between the Fund's argument for foreign equity investment and Indian businessmen's allergy to competition from foreign companies, foreign institutional investors (FIIs) were allowed in 1992 to make portfolio investments in Indian companies. None could take more than 5 per cent (raised in December 1996 to 10 per cent) of the equity of a company, and all foreign investors together could not take more than 24 per cent (raised in February 1997 to 30 per cent if the board of the Indian company approved). The red tape was minimal: the FIIs had to obtain registration with the Securities and Exchange Board of India. Simultaneously, Indian companies were allowed to float equity and bonds in the Luxembourg market with the approval of the Ministry of Finance.

Initially, portfolio investment proved more popular; twice as much portfolio investment flowed in up to 1995 than direct investment (Table 4.1). Indian companies preferred this unthreatening form of investment. Both Indian companies and foreign investors preferred GDRs which, being non–voting shares, were even less threatening to Indian managements, but access to foreign markets was possible only for the larger and more reputable companies. Most of foreign direct investment came with the FIPB's approval; apparently both Indian and foreign companies preferred the flexibility of negotiating terms face–to–face with the FIPB to the rigid conditions regarding equity and industry involved in going to the Reserve Bank.

Trade

Trade liberalisation was high amongst the priorities of International Monetary Fund. Intent on reducing the fiscal deficit, it was not pressing tariff reduction; nor could it press for exchange decontrol in the middle of a payments crisis. So it concentrated on import licensing.

The opposition came from the importing ministries, mainly ministries of petroleum and of fertilisers. They saw it as their job to ensure steady supplies of both, and expected to have foreign exchange pre–empted for their use. Its pre–emption required a physical restriction on other imports in the form of import licensing.

There were two types of import licences: capital goods licences for imports of machinery, and replenishment licences to meet running input requirements. A study of exports completed in 1990 (Desai *et al*. 1990) proposed an instrument called the super–REP (for replenishment licence), which would be issued to exporters for a certain proportion of their exports, and which could be used to import any goods which required licences. The super–REP would be tradable and be traded at a premium which would give a uniform level of protection to all importable products; the premium would go to exporters and would therefore give them a uniform subsidy. Thus the super–REP was free of anti–export bias. The government would be able to regulate the premium by buying or selling super–REPs in the market. The super–REP was intended to be a trade–neutral device that would enable the government to influence the terms of trade between foreign and domestic goods quickly and flexibly. A copy had informally been sent to Montek Singh Ahluwalia, the commerce secretary, and to Manmohan Singh who six months later became finance minister. They saw an advantage in the super–REP which was not foremost in the mind of the author: it would enable the government to pre–empt foreign exchange for its own use, releasing only the remainder to exporters. Hence the super–REP was renamed the eximscrip and introduced in the trade policy of July 1991. Exporters were issued eximscrips to the extent of 30 per cent of their export earnings[1].

Eximscrips worked well. They simplified import licensing, though they did not eliminate it. They needed to be issued against each export transaction, they required physical handling, and before long it was noticed that they were being forged. So the budget of 1992 abolished them, and introduced a dual exchange rate. Exporters were required to surrender 40 per cent of their exchange earnings at the official exchange rate, and the remaining 60 per cent at a market–determined exchange rate. Importers could buy foreign exchange from banks at the market rate; import licensing was abolished except for a negative list consisting mainly of agricultural goods and consumer goods. With this step, exchange control on trade transactions was decentralised to the banks. The eximscrips were replaced by special import licences, also given for a proportion of export earnings (20 per cent of exports earning hard currency, and another 5 per cent for exporters with ISO9000 or BIS14000), which could be used to import some goods on the negative list. In addition to traditional advance licences based on physical input coefficients, new advance licences were introduced which were a certain proportion of export earnings and could be used to import any input listed against the product in the trade policy handbook (Ministry of Finance, 1993, 1995).

The rupee was devalued from Rs 17.50 to Rs 25.89 to a dollar in June 1991. When the dual exchange rate was introduced in March 1992, the market rate fluctuated between Rs 30 and 32 to the dollar; that gave an estimate of the maximum cost to the exchequer if the exchange rate was unified and the government began to import at market–related rates. Aided by CCFF loans from the Fund, structural adjustment loans from the bank, revived exports and sluggish imports, reserves had climbed from $1.1 billion in June 1991 to $5.6 billion by the following March, and $6.4 billion a year later; these reserves constituted a buffer that could be used if the rupee depreciated excessively. So, finally, the budget of February 1993 unified the exchange rates; the dollar exchange rate settled at Rs 31–32. Exchange control on invisible transactions was also decentralised in March 1993; with that, much of the way to convertibility on current account was traversed.

Tariff reduction was more gradual and less radical than changes in exchange control and in import licensing. In June 1991, the maximum tariff was brought down from 350 per cent to 150 per cent. In the next four budgets it was reduced to 110, 80, 65 and 50 per cent; after a pause of a year it was reduced to 40 per cent in 1997. Rates below the maximum were also brought down; but most of the fall in collection rates occurred between 1992 and 1994 (Table 4.2).

Table 4.2. **Maximum Tariff and Average Collection Rates, 1990–91 to 1995–96**
(Per cent)

	1990–91	1991–92	1992–93	1993–94	1994–95	1995–96
Rate on personal baggage[1]	350	255	255	150	100	80
Maximum tariff[2]	350	150	110	80	65	50
Average collection rate	47	44	37	30	29	29
Oil and products	34	31	31	36	31	30
Non–oil products	51	49	39	28	29	28
Food products	47	27	12	19	22	23
Chemicals	92	82	71	52	44	44
Natural fibres	20	21	20	14	9	12
Synthetic fibres	83	63	45	18	18	36
Paper	24	23	18	13	11	8
Metals	95	110	97	69	53	52
Machinery	60	64	53	31	38	33
Other	20	14	13	10	11	13

1. The rate on personal baggage applies above the exemption limit, which was Rs 6000 in 1995–96.
2. From June 1993, domestic excise duties have been applied to imports as well.

Sources: Ministry of Finance (1993, 1995, 1997).

The liberalisation of trade and payments in 1991–93 faced no resistance from domestic industry and trade because the initial devaluation had given it added protection, and because the controls that had just preceded it had been draconian. In addition to tariffs and import licensing, the Reserve Bank had imposed a cash margin of 50 per cent on imports other than those of capital goods in October 1990; in other words, importers had to make an advance deposit of half the value of imports before they could even apply to get an import licence. This margin was raised to 133 per cent in March 1991 and 200 per cent in April.

These cash margins had been so disruptive that non–oil imports were running 20 to 30 per cent below the previous year's level by the middle of 1991, and industrial production was falling. This bitter experience made subsequent liberalisation all the more welcome; and the 33 per cent devaluation gave ample shelter to domestic industry. In 1993, the Ministry of Finance conceded the demand of industry that imports should bear the same excise duties as domestic products, and thereby raised protection.

Resistance came from the bureaucracy. The Directorate General of Technical Development had ensured that import licences were consistent with licensed capacity or output. Its abolition encountered strong opposition, and no further departments were abolished. The Directorate General of Foreign Trade, which issued import licences, lost much work with the abolition of import licensing of inputs and capital goods, but it developed another side of its work — that of issuing of duty–free advance import licences to exporters, and licences for equipment imported at concessional rates of duty and subject to export obligations. Advance licences had two advantages over replenishment licences: they were in theory to be issued before the exports were manufactured and hence speed money could be obtained by delaying them, and the import duty they saved was value that could be shared with exporters. So advance licences came often to be issued months after the exports were shipped.

While the author was in the Ministry of Finance, he proposed a way of getting around this obstruction and corruption: the amount of import duty credit earned would be calculated as a percentage of exports and published in advance. When exports were made, the value of duty credit would be entered in a passbook. The passbook would be debited with the duty saved when duty–free imports were made. This idea was finally implemented in the 1995 April trade policy, but the customs introduced their own hurdles. They would question the unit value of exports and of related imports. Often they insisted on using notional values of imports based on unit values of similar imports in the previous three months. They would refuse to accept the value placed by the exporter to fix their own value, and thus put off giving the export duty credit. They allowed customs duty to be debited in the passbook, but not the countervailing (excise) duty. If an exporter asked for import duty credit, they would deny him excise duty credit on domestic inputs. In these ways they sabotaged duty–free exports.

They could do this in the name of safeguarding revenue. In other words, they held out an implicit threat to the finance minister that if he insisted on effectively duty–free imports for exporters, they would bring down revenue; a finance minister who was committed to the reduction of the fiscal deficit could not afford to challenge them.

Public Finance

As Table 4.3 shows, the centre was running a larger fiscal deficit than the States in the late 1980s. It was possible for the centre to do so because it had the exclusive right to borrow abroad and to issue money. The States shared in the monetised deficit insofar as their overdraft limits with the Reserve Bank of India were periodically raised; but their share was small. Their rise in overdraft limits came to 0.3–0.4 per cent of GDP in the late 1980s, and has been 0.1–0.3 per cent in the 1990s.

The States were ruled by diverse parties, some of which were virulently opposed to taking recourse to the IMF, and the minority Congress government at the centre did not feel strong enough to impose any conditionalities on them. When the central government negotiated a CCFF loan from the International Monetary Fund in 1991, the central government accepted conditionalities related only to monetary variables under its own control. Hence the burden of fiscal adjustment fell entirely on the centre.

The 1991–92 budget was delayed because elections were held in May. The normal budget, due on 28 February every year, was not presented because the minority Janata Dal government had lost the support of the Congress and resigned. The budget was presented on 24 July, almost two months after the new Congress government took office. It was hurriedly put together to meet IMF conditionalities (Table 4.3); it aimed to reduce the fiscal deficit from 8.4 per cent of GDP to 6.5 per cent. To this end it abolished the export subsidy and the sugar subsidy, and reduced the fertiliser subsidy. It raised oil product prices. It raised corporation tax by 5 percentage points, and some excise duties. There was no reform strategy behind it; it was meant to reduce the inflationary impact of fiscal transactions, and to avoid a major effect on any interest group it spread the new burdens thinly. A cosmetic programme of disinvestment of government stakes in public enterprises was worked out as a compromise with the Fund, involving sale of government's shares to government–owned financial institutions. By 1997, disinvestment had covered 40 of the 241 enterprises of the central government. The most popular shares were those of refineries; the government's share in the equity of some went down to almost 50 per cent, but in 16 enterprises, it remained over 90 per cent. Without a change in management, the market value of most enterprises remained low, and the government became unwilling to unload shares further.

Table 4.3. **IMF Programme Targets for 1992–93**

	Actual			Ceilings			
	Outstanding at the end of						
	June 1992	Sep. 1992	Dec. 1992	June 1992	Sep. 1992	Dec. 1992	March 1993
Performance criteria (Rs billion)							
RBI's net domestic assets	885	870	915	897	900	943	969
Net RBI credit to centre	990	986	994	997	999	993	977
Macroeconomic objectives (% growth)							
Money supply	5.9	7.5	11.5	3	3.7	8	10.4
Reserve money	7.4	6.7	7.8	7.1	5.9	11	13.8
Indicative target (Rs billion)							
Net bank credit to centre	1 677	1 662	1 689	1 701	1 697	1 729	1 687

1. The ceiling for net domestic assets of Reserve Bank of India would be adjusted for a) unexpected effects arising from changes in the exchange rate and in the price of gold, b) changes in reserve requirements, and c) changes in the net international reserve floor.
2. The December 1992 target for net Reserve Bank credit to the central government includes Rs 7.5 billion for Reserve Account Subscription to the International Monetary Fund.

Source: Ministry of Finance (1993).

In the political debate on the budget, the need for disinflation hardly figured; the main issue was one of the Fund's pressure, and allegations that the finance minister was its stooge. This made him keen to give any reforms he might undertake a national "brand image". So he appointed a tax reforms committee; the reports of this committee formed the basis of a number of reforms in the next four budgets.

The 1992 budget concentrated on personal taxes. It abolished wealth tax on financial assets, and raised the exemption limit from Rs 0.5 million to Rs 1.5 million; later, one residence was added to the tax–exempt assets. Thus in effect, this low–yielding and vexatious tax was abolished for most people. The budget removed the highest tax bracket of 57.5 per cent and reduced income tax bands from four to three, and abolished or reduced some deductions related to particular savings instruments. For the first time in over 50 years, it allowed gold imports: returning passengers could bring in up to 5 kilograms of gold on payment of a modest duty. Although this measure left scope for harassment of passengers by customs officials and collusion between officials and professional smugglers, it was popular.

By February 1993, the political atmosphere had changed. The previous year's budget had proved popular, and critics of the Ministry of Finance and the International Monetary Fund had lost support. The budget therefore offered more freedom for manoeuvre; the question was, how to use it. The fiscal deficit had been brought down in two years from 8.3 to 5.7 per cent. The Fund was pressing for a further deep cut to 3.8 per cent. The CCFF arrangement was to end during 1993; if further balance of payments support was required, following the Fund's advice was imperative.

There was a difference of opinion amongst the economists in the budget strategy group. One view was that the balance of payments was still fragile. Thanks to foreign loans, the foreign exchange reserves had recovered, but the figure for December 1992

— the last one available when the budget was being made — was $5.5 billion, only slightly higher than a year before; the reserves were not rising. Thanks to the collapse of the Soviet Union, exports in 1992–93 were actually lower than two years earlier. If industrial recovery gathered strength, the trade balance might quickly worsen, and fresh IMF support may become unavoidable.

Against this, industrial growth was sluggish; the index of industrial production rose only 0.6 per cent in 1991–92 and 2.3 per cent in 1992–93 (although national income figures, which are published much later, placed industrial growth in those two years at –1.7 and 4.4 per cent respectively). There was considerable surplus capacity. The situation was appropriate for relaxing the disinflationary policy — if the IMF and the balance of payments would permit.

After analysing the trend of imports and exports the author of this paper came to the conclusion that the balance of trade would show a substantial surplus in 1993–94. So he circulated a note to the budget group saying that in his view:

a) another loan from the Fund would not be needed since the reserves were likely to rise significantly in the following winter;

b) the macroeconomic situation required reflation, and the fiscal deficit should be forgotten for that year; and

c) the freedom of manoeuvre should be used to make deep cuts in tariffs, for which the time was passing rapidly as inflation cut into the real devaluation achieved in 1991.

After thinking about it for some days, the minister, Manmohan Singh, agreed. He budgeted for a reduction in the fiscal deficit from 5.7 to 5.2 per cent; actually, expenditure sanctioned in the middle of the fiscal year raised it to 7.4 per cent. However, the collection rate was brought down from 37 per cent in 1992–93 to 30 per cent in 1993–94, industrial growth rose from 4.4 to 7.1 per cent a year, exchange reserves went up from $6.4 billion to $15.1 billion — and there was no need for IMF support.

This economic improvement destroyed the finance minister's bargaining power; he was no longer indispensable. His ability to push reforms disappeared; at best he could act in his own areas of responsibility, namely revenue, banking and the capital market. In his next three years, he concentrated on reduction of maximum tax rates and of dispersion in tax rates, and in concurrent removal of exemptions and rebates. In 1993–94 he had lost control of the fiscal deficit. In the next two years he brought it down again gently; in 1995–96, it was 5.8 per cent, about the same as three years before.

Manmohan Singh had entered politics for patriotic reasons: as secretary of the South Commission in the late 1980s, he had seen how East Asian countries had overtaken India, and how much of the difference in performance was due to economic policy. He responded to an urge to do his bit for the country, but the same patriotism made him continue as finance minister even after political opponents placed him under siege. The politically rational strategy at that point would have been to counterattack, but an ingrained sense of responsibility prevented him from doing so. He thereby avoided the risks inevitably attached to aggression; but his party lost the 1996 election, and he his finance ministership.

The Banking System

Senior appointments in banks are processed in a Banking Department within the Ministry of Finance and made by the Prime Minister on the finance minister's recommendation. They were made at the highest level because of the powerful patronage involved: whoever made the appointments came under strong pressure from politicians who ran rackets in league with bank officials. Manmohan Singh left these patronage networks untouched, and thus avoided politically sensitive decisions. Instead he concentrated on reducing the load of nonperforming assets on government banks, introducing competition, and deregulating interest rates.

In 1992, the banks were set a programme to achieve BIS levels of capital adequacy — faster for foreign banks and more viable government banks, more slowly for the worse banks. Interest–free loans were given out of the budget to government banks to achieve capital adequacy. The schedule for achieving capital adequacy was relaxed repeatedly, but there was gradual improvement. Tribunals were set up in which banks could sue defaulting borrowers, in the belief that they would speed up recovery. They worked slowly; till 1996 they had settled cases involving loans of Rs 2 billion, out of total bad debts of over Rs 300 billion. They faced legal challenges to their constitution in superior courts. Instead of reducing bad debts substantially, they only added a level in the hierarchy of courts, since the losing party could still appeal to the High Courts and the Supreme Court. The main effect of this focus on bad debts was that banks cut down credit to the "priority" sectors where the incidence of bad debts is high — agriculture, small industry, unemployed youth etc. These sectors are supposed to get 40 per cent of the credit; their actual share of increases in credit after 1990 was much lower (Table 4.4).

What is remarkable is the instability in the allocation of bank assets. The reasons are multiple. In 1991–92, credit to industry and trade was reduced by the anti–inflationary controls of the Reserve Bank. In 1993–94, industry raised substantial funds from equity issues and consequently borrowed less from the banks. In 1994–95 and 1995–96, bank credit shot up as industrial growth recovered. Banks coped with these fluctuations in trade credit by buying government securities when they could; otherwise they accumulated cash balances. In April 1992, the statutory liquidity ratio was reduced from 38.5 per cent to 25 per cent on the increase in deposits, and the central government and its long–term financial institutions ceased to take access to the banks, Table 4.4 shows no impact of this change; investment in approved securities was above the statutory requirement in all years except one. The statutory requirement was replaced by telephone calls from the Reserve Bank to "persuade" banks to take up central government loans when they were issued. In effect, therefore, the banks operated in such a mix of controls, instructions and economic fluctuations that it was impossible for them to follow any consistent policy of asset allocation.

The instability in asset allocation was compounded by instability in the growth of resources. The Reserve Bank targeted growth in M3; but it had little control over M3. In theory it could control bank deposits by open market operations, but there was virtually no market for government securities outside banks, and the centre's and States' borrowing requirements were so large that the Reserve Bank could not afford to push up interest rates owing to their effect on government budgets. Hence the Reserve Bank did not use open market operations to control money supply; as Table 4.4 shows, there was no negative correlation between the rise in reserve money and banks' investment in securities. The Reserve Bank could try indirectly to regulate M3 through reserve money, but almost a quarter of the money supply is in the form of currency; the share of currency in M3 fluctuates enormously, and with it, the money multiplier. Hence control of reserve money cannot control the money supply. The Reserve Bank used monetary rhetoric in its public statements, but had no levers to implement control of money supply.

Table 4.4. **Annual Allocation of the Increase in Assets of Scheduled Commercial Banks, 1990–91 to 1995–96**

	1990	1991	1992	1993	1994	1995
Credit against foodgrains	*9.6*	*0.4*	*4.8*	*7.4*	*1.8*	*–5.0*
Priority sectors	*9.6*	*6.4*	*10.3*	*7.2*	*13.7*	*18.5*
Agriculture	0.9	3.6	4.2	2.2	3.7	6.2
Small–scale industry	6.2	2.5	4.4	4.6	6.7	8.5
Other	2.5	0.3	1.7	0.4	3.3	3.8
Exporters	*3.5*	*2.8*	*11.8*	*3.1*	*11.1*	*9.3*
Total preferential credit	**22.8**	**9.7**	**27.0**	**17.6**	**26.7**	**22.8**
Total non–priority credit	**38.8**	**13.6**	**34.2**	**2.7**	**39.0**	**56.1**
Non–priority industry	23.8	6.6	27.0	–1.4	23.4	37.0
Non–priority trade	1.6	0.6	1.9	0.6	3.2	4.5
Other	13.4	6.3	5.4	3.4	12.3	14.6
Securities	**41.3**	**38.6**	**36.1**	**47.6**	**22.4**	**31.1**
Government	29.7	32.5	30.9	44.8	22.1	29.2
Other	11.5	6.1	5.2	2.9	0.3	2.0
Balances	**–2.8**	**38.1**	**2.7**	**32.1**	**12.0**	**–10.0**
Cash	0.6	0.5	0.7	0.0	0.9	0.3
Balances with RBI	–2.6	33.7	–13.2	33.7	8.9	–13.6
Call money	–1.9	2.3	15.6	–1.0	0.3	3.7
Inter–bank	1.1	1.6	–0.4	–0.6	1.8	–0.4
Increase in assets (%)	**100**	**100**	**100**	**100**	**100**	**100**
Increase in bank assets (Rs billion)	259	392	428	564	747	499
Increase in bank deposits (Rs billion)	280	408	371	516	770	529
Increase in currency (Rs billion)	67	82	74	139	185	175
Increase in M3 (Rs billion)	349	493	452	667	964	704
Increase in reserve money	102	117	114	278	306	250
Money multiplier	3.4	4.2	4.0	2.4	3.2	2.8
Ratio of deposits to currency	4.2	5.0	5.0	3.7	4.2	3.0

1. Variations in bank assets are financial years ending with the second Friday of the last fortnight of March. Variations in other assets are for years ending on 31 March.
2. Variations in M3 include small changes in balances with Reserve Bank of India.

Sources: Ministry of Finance (1993–1997).

The instability in the growth of bank deposits, combined with sudden and drastic changes in the Reserve Bank controls on lending, meant that the banks lurched from massive surpluses to shortages of loanable funds. Whenever there was a shortage, there was a concurrent liquidity shortage amongst borrowers, and they stopped servicing their loans. Despite the new tribunals, legal means of recovering loans were virtually non–existent. In this way there were cyclical accretions to non–performing assets. The recapitalisation of banks did nothing to resolve this problem, which will continue to recur.

To encourage competition, Manmohan Singh asked the Reserve Bank to license new banks and to allow foreign banks to open new branches. The Reserve Bank placed a minimum limit of Rs 1 billion on the capital of new banks. Still it received a large number of applications, but it licensed only nine new banks, most of them owned by government financial institutions. These banks as well as foreign banks concentrated on urban, corporate, wholesale and non–fund business; so there was little change in the level of competition in most of the country.

There have always been a large number of finance companies other than banks. Some are of a traditional type. For instance, *chit* funds are co–operatives whose members contribute a constant sum every month; the sums collected are auctioned amongst members, and the interest received on the loans is shared out amongst members. More common are firms which collect deposits and lend them out; to escape being called banks they take deposits for a minimum of one year, and some firms act as agents of non–financial companies by collecting deposits for them. To prevent them from taking away deposits from the banks, the Reserve Bank prescribed maximum interest rates both financial and non–financial companies could pay at a level slightly higher than banks' rates. These maxima were routinely ignored; the financial companies paid cash margins above the permitted interest rates. Depositors also preferred the cash payments on which they could avoid paying income tax, but there was virtually no protection against default and fraud by such financial companies. Their business grew rapidly in the 1990s, mainly on the strength of two types of loans: loans against cars and trucks, and lease finance against industrial equipment. The standardised nature of these businesses and the availability of firm collateral led to the emergence of large finance companies.

Table 4.5. **Financial Performance of Scheduled Commercial Banks, 1990–91 to 1995–96**

	Interest received	Interest paid	Margin	Other income	Expenses	Gross profits	Provi–sions	Net profits
				(per cent of working funds)				
State Bank and subsidiaries								
1990–91	9.7	6.1	3.6	1.0	2.8	1.8	1.8	0.2
1991–92	10.2	6.4	3.8	1.4	2.5	2.7	2.5	0.2
1992–93	9.8	6.8	3.0	1.4	2.6	1.8	1.6	0.2
1993–94	8.4	5.8	2.6	1.4	2.7	1.3	1.2	0.3
1994–95	8.9	5.6	3.3	1.3	3.0	1.6	1.1	0.5
1995–96	9.2	5.8	3.4	1.8	3.1	2.1	1.7	0.4
Other government banks								
1990–91	9.4	6.9	2.5	0.9	2.6	0.8	0.6	0.2
1991–92	10.2	7.3	2.9	1.1	2.7	1.3	1.0	0.3
1992–93	9.4	7.4	2	1.0	2.7	0.3	2.1	–1.7
1993–94	8.6	6.5	2.1	1.2	2.6	0.7	2.9	–2.2
1994–95	8.5	5.8	2.7	1.1	2.8	1.0	0.9	0.1
1995–96	9.2	6.3	2.9	1.1	2.9	1.1	1.5	–0.4
Indian private banks								
1990–91	10.0	6.0	4.0	0.9	3.3	1.6	1.2	0.4
1991–92	9.8	5.8	4.0	1.0	3.0	2.0	1.5	0.6
1992–93	9.3	6.5	2.8	1.2	2.8	1.2	0.8	0.5
1993–94	8.9	5.9	3.0	1.3	2.5	1.8	1.2	0.6
1994–95	6.8	4.5	2.3	1.3	1.7	1.9	0.8	1.2
1995–96	9.9	7.1	2.8	1.9	2.3	2.4	0.9	1.5
Foreign banks								
1990–91	11.8	8.2	3.6	2.5	2.5	3.6	2.2	1.4
1991–92	11.3	7.4	3.9	3.4	2.3	5.0	3.7	2.2
1992–93	11.7	8.1	3.6	1.0	2.7	1.9	4.5	–2.7
1993–94	10.0	5.8	4.2	2.2	2.6	3.8	2.1	1.7
1994–95	9.9	5.6	4.3	2.4	2.7	4.0	2.1	1.8
1995–96	10.5	6.7	3.8	2.3	2.8	3.3	1.7	1.6

Source: As for Table 4.4.

Once the prospect of deregulation of banks loomed near, the Reserve Bank of India developed a new line of business by beginning regulation of non–banking finance companies. In 1994 it asked all finance companies with assets over Rs 5 million to register with it, to achieve a 6 per cent capital adequacy ratio, and to get themselves rated. In January 1997, the government passed an act authorising the Reserve Bank to require registration and issue instructions to finance companies.

By 1997, however, there was considerable simplification of interest rates. Deposit rates and lending rates on loans over Rs 200 000 were completely de–controlled; there remained only two subsidised lending rates for small loans, and two rates for export finance. Every bank was required to declare a prime (i.e., minimum) lending rate and the maximum spread of lending rates. As is to be expected in an oligopolistic industry, however, there was little inter–bank variation in rates.

Table 4.5 shows the banks' finances, and the effects of the policy changes on them. Although the minimum lending rates (and after deregulation, prime lending rates) were always over 15 per cent, the average interest earned by banks on their funds was only 10–12 per cent on account of the low return on government securities; interest on them was raised in the 1990s, but was much lower earlier. Subsidised loans also eroded income. Foreign banks, whose non–performing assets were negligible, earned almost 2 per cent more than the rest; they used it to court high–cost term deposits and thereby obtained a more stable resource base. They also had a substantial income from non–fund business, owing to their superior service and financing of foreign trade. The expense ratios of all banks were in the range of 2.5–2.8 per cent except for Indian private banks, which were small; in the strongly unionised industry there was not much scope for variation in costs. Non–fund business made all the difference to performance; thanks to it, the foreign banks' gross margins were twice as high as those of the State Bank group, the more profitable of government banks.

After deregulation, Indian private banks and foreign banks grew faster than government banks. Their share of banks' revenue in 1990–91 was 3.1 and 6 per cent respectively; by 1995–96 it had grown to 5.6 and 9.3 per cent respectively. With growth, the private banks' expense ratio came down, and their profitability went up. So deregulation led to the faster growth of more efficient banks or banks with better service; but the effects on the banking industry as a whole were very mild. In particular, private banks reduced margins as their expenses came down, but otherwise margins were not under pressure; nor were there signs of greater efficiency.

Thus the government banks' membership of the patronage network ensured that they were neither privatised nor faced severe competition; competition was introduced at the margin, and did not make major inroads into the banks' business. The effect of competition was cushioned by reduction of cross–subsidies, neglect of directed credit and infusions of interest–free capital. The 32 000 employees of the Reserve Bank successfully resisted administrative deregulation. Apart from decentralisation of exchange control on current transactions, there was no dismantling of rules and regulations. On the contrary, the Reserve Bank opened up an entirely new area in the regulation of finance companies.

Financial Flows

Section II described how the government pre–empted savings. By the 1980s, the major companies were so dependent on long–term financial institutions that their entire investment plans were worked out in consultation with the financial institutions. The financial institutions together held a substantial proportion — ranging between 20 and 80 per cent — of the companies' equity and, by virtue of the share ownership, appointed directors on to the companies' boards. Together with the management, they generally held a controlling share of the equity; they seldom traded in it. Hence the floating stock was generally small; the narrow market could be driven up and down by transactions on a relatively small scale. The volatility was fed by the peculiar form of forward transactions prevalent in the stock exchanges, which allowed rollovers without settlement virtually forever.

The companies would do favours to the staff of the financial institutions (and the banks), such as selling them shares out of underpriced issues, employing their relatives or giving them supplierships or distributorships, or rewarding them in more direct ways. In this way, Indian industry had turned into an oligarchy in league with the bureaucracy in banks, financial institutions and licensing authorities.

A new element entered this nexus in the mid–1980s. The current account deficit began to mount; the government of India bridged it by borrowing, both itself and through its public enterprises. The public enterprises were forced to borrow; they did not have enough investment opportunities to absorb the borrowings. So they began to place the borrowings in portfolio management schemes with banks. Since, however, they were required to make fixed interest payments on the loans, they also insisted on fixed interest from the banks. They pressed banks for high interest rates. The banks too did not have enough borrowers for the funds. Hence they lent out the funds to sharebrokers either to invest in shares or, more often, to lend them out to speculators. Banks were not allowed to lend against shares by the Reserve Bank, but they found a way around the ban. They gave ready–forward loans to one another through brokers, the brokers retained the funds in transit long enough in their own accounts to give short–term loans to sharebrokers, and the interest they earned was shared with the banks: (Janakiraman Committee, 1994). With the infusion of recycled foreign debt inflows, share prices rose. The sensitive index of the Bombay Stock Exchange rose from 398 in March 1988 to 850 in June 1990, 2 000 in July 1991 and a peak of 4 285 in March 1992 (Ministry of Finance, 1997).

In March 1992, the Reserve Bank raised coupon rates on government securities. Two days before the rise was announced, the State Bank of India, a subsidiary of the Reserve Bank, was discovered to have made heavy purchases of securities, thereby incurring losses. The Reserve Bank enquired into the transactions, and discovered that they were not genuine purchases at all, but book entries made to put cash into the account of the State Bank's principal broker, Harshad Mehta. This discovery led to a broad–ranging investigation by a committee appointed by the Reserve Bank: Janakiraman Committee (1994); this committee uncovered the mechanism through which funds borrowed abroad by public enterprises were diverted by the banks through brokers into the stock market. With this discovery, the stock market boom collapsed in April 1992. Although the government sequestered the property of the brokers involved, very little of the funds were recovered. A special court continued to process the cases, but five years after the event there were still no convictions.

The finance minister saw the stock market as an incendiary device that he could not control; he tried to distance himself from it. In May 1992 he got Parliament to repeal the Capital Issues (Control) Act of 1947, abolished the post of Controller of Capital Issues in the Ministry of Finance, and transferred his powers to Securities and Exchange Board of India, a board that had been created in 1987 in Bombay but had not been given any powers. However, he was persuaded of the distorting effects of price control on share issues, and abolished it.

Table 4.6. **Sources and Uses of Funds in Non–Government Companies, 1987–88 to 1994–95**

(Per cent)

	1987–88 to1989–90	1991–92	1992–93	1993–94	1994–95
Internal sources	**30**	**35**	**29**	**26**	**26**
Depreciation	23	20	16	17	10
Retained earnings	7	15	13	9	16
External sources	**70**	**65**	**71**	**74**	**74**
Capital market	24	15	17	36	42
Equity	*6*	*4*	*4*	*9*	*8*
Premia	*8*	*4*	*3*	*17*	*22*
Bonds	*22*	*26*	*25*	*24*	*4*
Borrowings	26	28	29	27	9
Banks	*12*	*12*	*9*	*12*	*–1*
Financial institutions	*9*	*13*	*16*	*11*	*5*
Others	*4*	*2*	*5*	*5*	*5*
Current liabilities	20	23	15	10	23
Total sources/uses	**100**	**100**	**100**	**100**	**100**
Gross fixed assets	**49**	**51**	**53**	**53**	**45**
Current assets	**51**	**50**	**47**	**47**	**55**
Investments	7	5	3	4	16
Inventories	20	19	15	15	7
Cash	0	4	5	3	7
Receivables	24	22	26	25	25

1. The figures refer to an expanding sample; it consisted of 1 956 companies in1991–92, rising to 2 491 companies in 1994–95.

He was lucky to have got the repeal of the Capital Issues (Control) Act through Parliament, for with the first report of the Janakiraman Committee (1992*a*) in May, the chaos in the securities market came out into the open; the opposition in Parliament saw in it an opportunity to attack the finance minister and the government. It demanded and got a Joint Parliamentary Committee to enquire into the same transactions. It was headed by a Congressman who had deep misgivings about liberalisation. He obtained his committee members' agreement to brief the press on their behalf, and used the opportunity to leak news and views hostile to the ministry. The chairman of Securities and Exchange Board co–operated with him. In this way, political opposition which had nothing to do with the capital market paralysed the Ministry of Finance in its dealings with the market; with the devolution of powers to SEBI, the reforms of the capital market came to an end.

Thus the major changes brought about when the capital market reforms stopped were the end to the underpricing of share issues, and a door opened for foreign portfolio investment. The two combined to change the pattern of industrial finance radically (Table 4.6). Equity (together with premia) emerged as a major source of finance; and with it, debt finance became less important. Government institutions specialising in long–term debt finance were especially hard hit: the demand for funds from them fell, while they lost access they had previously had to low–cost bank funds through the statutory liquidity ratio. In the late 1980s, equity was a negligible source of funds; virtually all funds raised by companies carried fixed interest. Gross profit was like a fixed cost; the inflexibility of the profit margins reinforced the oligopolistic industrial structure. In the 1990s, abolition of industrial licensing intensified competition; at the same time, the shift from debt to equity made profit margins more flexible.

The other major change brought about by the reforms was a rise in the number of public issues from 1034 in 1992–93 to 1725 in 1995–96. There was a structural change in the stock market. With the abolition of underpricing, the elasticity of supply of public issues increased. Whenever the share prices rose, there was a flood of issues bringing them down. Thus the prospects of capital gains dwindled; with it went down investors' interest in shares. The number of issues came down to 1 001 in 1996–97; by August 1997 their number came down to 15 — only three of them from new companies.

Thus the deregulation of the primary issue market led to the entry of new companies, and aided the emergence of competition which became possible with the abolition of industrial licensing. Even before deregulation India had the largest number of quoted companies, more even than the United States; deregulation accentuated the proliferation of companies, but this phase soon came to an end in 1996, and equity capital began to go mainly to strong companies in relatively stable industries, or to conglomerates. While dividend yields remained low, interest rates were kept high by the high level of public sector borrowing. Thus debt has become more attractive to investors relatively to equity. The share of debt in outside funds flowing into industry remained high; in 1995–96 it was 65 per cent.

Table 4.7. **Required Investment Patterns for Insurance Companies and Provident Funds**

(Per cent)

	Life Insurance Corporation	General Insurance Corporation	Employees Provident Fund
Central government securities	>20	>20	25
Deposits with the central government			20
Guaranteed securities	>25	>10	15
Government housing finance	>5	>15	
Other public sector	>25		>40
Other including private sector	<25	<55	
	100	100	100

Source: Ministry of Finance (1997).

Although debt funds remain extremely important to Indian industry, the debt market saw no structural improvement. As pointed out in the previous section, although private and foreign banks increased their market share, banking continued to be dominated by government banks. This is even more true of long–term finance and insurance. Both Manmohan Singh and his successor, P. Chidambaram, were keen to open insurance to private competition. Manmohan Singh went through his normal routine of appointing a committee, which recommended private entry. P. Chidambaram, in his 1997 budget, announced his intention to permit the entry of private competition in health insurance. Both were defeated by the bureaucracy of the two giant government monopolies, the Life Insurance Corporation and the General Insurance Corporation. Both corporations are highly unionised, and the unions have support of the two communist parties. Fear of strikes by them, and the political support they marshalled, deterred both the Congress and United Front governments from introducing private sector competitors.

Apart from the unions, the insurance monopolies had strong lobbies supporting them within the central and the State governments, for they (as well as the Employees' Provident Fund) were legally required to invest a major proportion of their funds in public sector securities (Table 4.7). As a result, a whole range of government agencies — State governments, housing finance agencies, state enterprises — had a vested interest in preserving their monopoly.

Unlike insurance and provident funds, there were a host of government finance companies whose main task was to fund private industry through both equity and debt. One of them, Unit Trust of India, was a mutual fund designed to invest in equity. Once the equity market was deregulated in 1992, new mutual funds emerged to offer it competition, and it suffered for its poor service and poor investments (particularly investments in the equity of public enterprises which were sold mainly to government financial institutions in a pseudo–privatisation programme after 1993). Three finance corporations — Industrial Development Bank of India, Industrial Finance and Investment Corporation of India and Industrial Finance Corporation of India — lost their automatic access to bank funds through the statutory liquidity ratio in 1993. All four used to make easy profits by buying into underpriced equity issues; once the underpricing was removed in 1992, these profits disappeared. In the ensuing crunch they withdrew from purchase of primary issues which was a major part of their business before reforms, and concentrated on debt. They borrowed by floating long–term bonds with terms varying between 5 and 25 years, and lent to industry. The demand for their funds was limited by the high interest rates; at the high interest rates, the maturity of their loans became shorter. They nonetheless retained a high share of the market. In 1995–96, they supplied 36 per cent of outside funds to industry. Private competition in long–term finance was, however, emerging; banks, lease–finance and hire–purchase companies began to grow and diversify into medium–term finance. With the emergence of this competition, the business of term finance institutions was threatened, and they might have to turn themselves into banks. Thus competition began to dissolve the segmentation between banks, long–term financial institutions and non–bank financial institutions which had earlier been imposed on the financial industry.

Meanwhile, the selective opening up of foreign investment had unexpected consequences. Immediately after the opening up, the share of foreign funds in outside funds rose sharply from 1 per cent in 1992–93 to 25 per cent in 1993–94. Admittedly, their share in 1992–93 was at a historical low because of the balance of payments crisis, but the large influx of foreign funds did have a powerful effect on total supply. It supported a big rise in public issues; and a number of Indian companies went abroad and floated Euro–equities. Companies were replete with cash. They repaid bank loans; total bank loans to industry fell. Expensive debt was retired and replaced with cheap — seemingly costless — equity. This bonanza continued into 1994–95.

By 1995–96, foreign investors began to learn the special features of Indian companies — that they paid low dividends, that they did not always follow announced investment plans and instead diversified in unexpected directions or speculated with funds, that they were facing more competition and higher risks; they also learnt to distinguish between good Indian companies and bad. The disillusionment was greatest amongst investors in Euro–equities, who had no presence in India and no first–hand access to information about Indian companies. Hence Euro–issues went into large discounts. Because of the long lags involved, direct investment continued to increase in 1995–96, but foreign portfolio investment declined (Table 4.1).

The decline in portfolio investment left Indian companies short of equity funds. Many who had formed joint ventures could not put in their own contributions; they had to reduce their share of equity or sell out to foreign partners. This was the basic cause of the xenophobia that gripped the big industrialists in 1996.

Under their pressure, the government allowed foreign institutional investors to invest in corporate debt in January 1997. The investors had to jump through a number of regulatory hoops, so little capital actually flowed into the debt market, but failure to service debt is not unknown amongst Indian companies, and legal remedies against defaulting companies work only slowly and uncertainly. Hence foreign investors would be as cautious with their investments in debt as they have become with equity.

Thus incomplete and ill–planned liberalisation of the capital market led to a pronounced cycle in the equity market, an undeveloped debt market, and uneven access of Indian companies to foreign capital flows. The discontent arising from these disturbances led to the rise of xenophobia even amongst those powerful industrialists who had initially supported opening up.

Agriculture

Farmers, especially in the States that led the green revolution, are an influential lobby; their pressure prevents the government from raising fertiliser prices to match cost increases. Fertiliser controls combine a consumer subsidy with complex cross–subsidies — plants with higher costs get a higher “retention” price. Following the payments crisis of the late 1970s, when Indira Gandhi came to power in 1980, she doubled controlled prices of fertilisers. After that, fertiliser prices were not raised till 1991. As a result, the price of urea, the main nitrogenous fertiliser, covered only about two–thirds of the cost of production; the price of superphosphate covered about 60 per cent and that of potassic muriate covered about 30 per cent of the cost in 1991. Capital costs had risen in the meanwhile, so new plants could not be built unless the government promised to allow them higher retention prices. Retention prices of new plants were generally higher than import prices; so to keep costs down, the government had built up considerable imports, which were also subsidised.

The decision to change controlled prices is an administrative matter which does not require Parliament's approval, but as soon as rumours of an impending increase in fertiliser prices emerged in mid–1991, the farm lobby within the Congress began to pressure the Prime Minister against it. The lobby wanted Parliament to be a part of the decision–making; it was sure it could block a price increase there. In a compromise, the Prime Minister agreed to the appointment of a Joint Parliamentary Committee (JPC) to enquire into fertiliser pricing; the farm lobby managed to get one of its prominent members appointed as chairman.

This JPC delayed its report as long as it could. Finally it reported after nine months, in August 1992. It made a recommendation that it was sure the government would reject: that the price of urea be reduced by 10 per cent, and that phosphatic and potassic fertilisers be decontrolled.

Table 4.8. **Breakup of the Cost of Central Food Subsidies, 1991–92 to 1996–97**

	1991–92	1992–93	1993–94	1994–95	1995–96	1996–97
Wheat (Rs/100kg)						
Buying price	275	330	350	360	380	415
Distribution costs	116	174	182	191	184	203
Cost to centre	391	504	532	551	564	618
Sales price	252	279	356	408	416	423
Subsidy	139	225	176	143	148	195
Carrying costs	78	104	117	125	131	145
Rice (Rs/100kg)						
Buying price	267	315	355	355	387	435
Distribution costs	230	270	310	340	360	380
Cost to centre	497	585	665	695	747	815
Sales price	366	442	500	601	611	623
Subsidy	131	143	165	94	136	192
Carrying costs	78	104	117	125	131	145
Sales (million tons)	**19.0**	**17.0**	**15.2**	**13.1**	**14.8**	
Wheat	8.8	7.5	6.2	5.1	5.3	
Rice	10.2	9.6	9.1	8.0	9.5	
Average Stocks (million tons)		**11.6**	**19.9**	**27.1**	**29.9**	22.3
Wheat		4.1	10.5	13.3	14.2	10.6
Rice		7.5	9.4	13.8	15.7	11.7
Subsidy (Rs billion)						
Wheat purchases	2.0	3.8	–0.4	–2.5	–1.9	
Rice purchases	–13.8	–16.4	–17.2	–20.9	–23.7	
Wheat distribution	10.2	13.0	11.2	9.8	9.7	
Rice distribution	27.2	30.1	32.2	28.4	36.6	
Carrying costs		12.1	23.3	33.9	39.2	
Other		–14.5	6.3	2.3	–6.5	
Total food subsidy	**28.5**	**28.0**	**55.4**	**51.0**	**53.4**	61.1
Foodgrain consumption per head (gm)	469	435	428	434	469	**14.8**

Source: Ministry of Finance (1997).

The Ministry of Finance regarded the report as a disaster, but the Prime Minister regarded decontrol of some fertilisers as a step forward. He accepted the report and implemented it without modifications. The price of diammonium phosphate rose from Rs 4 680 to over Rs 7 000 a ton; the price of muriate rose from Rs 1 700 to over Rs 5 000. Their consumption fell, their manufacturers began to agitate, and were supported by State governments, which claimed that agricultural output would fall and that an imbalance in fertilisers consumed would have harmful long–term effects. So a flat–rate subsidy of Rs 1 000 a ton was given on phosphatic and potassic fertilisers. Thus, retention pricing was abolished in these fertilisers, and with its abolition, inefficient plants no longer got a higher subsidy, but the flat–rate subsidy was subject to endless arguments. It was given on the basis of manufacturers' sales in each state certified by State governments. The State governments did not issue certificates, or do so after much delay. The reduction in the price of urea was reversed after 2 years; in 1994, the price of urea was raised by 20 per cent. The new United Front Government raised the subsidy on diammonium phosphate from Rs 1 000 to Rs 2 250, and on muriate of potash from Rs 1 000 to Rs 2 000 (Sule, 1997). So, five years after the partial decontrol of 1992, subsidy accounted for over 50 per cent of the price of urea, 30 per cent of the price of phosphate and 20 per cent of the price of potash (Ministry of Finance, 1997). Apart from the abolition of retention prices for phosphate and potash, there was no reform.

The other instrument for subsidising farmers is the foodgrain procurement system which feeds the public distribution system. The distribution system is run by State governments. Some of them — especially the rice–growing States of Tamil Nadu and Andhra Pradesh — procure rice within the State; but they, as well as the rest, are supplied with rice, wheat, sugar and kerosene by the central government. The subsidies conveyed through the public distribution system are modest: Rs 10–12 per head per month in some north–eastern States and cities of Kashmir, Rs 5–8 in cities, and Rs 3 elsewhere (the comparable per capita GDP per month in the year of study was about Rs 350). In the northern States with over 50 per cent of the country's population, the proportion of population covered is less than 15 per cent (Parikh, 1993).

To convey this subsidy, the central government spent an estimated Rs 61 billion in 1996–97; the composition of this expenditure is given in Table 4.8. The figures are not very reliable; there is no explanation, for instance, for the massive rise in carrying costs from 1993–94 onwards, but the basic facts are clear. Little of the subsidy goes to farmers; in fact, the Food Corporation of India (FCI) charges a sales margin of 60–70 per cent on its purchase price of rice. Rice hulls have to be removed in rice mills before consumption; both FCI and State governments forcibly buy a certain proportion of the rice from rice millers at a low price. Wheat milling is decentralised — even households can mill it — so this type of indirect taxation is not possible. At one time the centre used to force down wheat prices at the harvest season by preventing its movement out of wheat–growing States, but the increased political influence of farmers in the two major wheat surplus States, Punjab and Haryana, makes this impossible.

Almost the entire central government expenditure on food subsidy is accounted for by FCI's costs of distribution and storage. While carrying costs are the same for rice and wheat, distribution costs of rice are unaccountably higher. Storage costs have risen sharply in recent years as stocks have gone up.

In foodgrains the finance minister was never so ambitious as to want to abolish subsidies; even the Fund and the Bank were of the view that they should be continued, but that they should be better targeted towards the poor. However, he argued in the cabinet in 1991 that the subsidy per ton of foodgrains should be capped: that is, when the prices paid to farmers were raised, so should consumer prices charged by the public distribution system. This principle was accepted and followed for three years; as Table 4.8 shows, issue prices were raised more than procurement prices till 1994–95.

Balram Jakhar, the minister of agriculture, was an influential politician. He saw it as his task to maximise the prices farmers got for their produce. Under his influence, procurement prices of wheat and rice were raised so much that government purchases mounted, market stocks were depleted and market prices rose rapidly.

Elections were held in eight States at the end of 1994 and 1995; the Congress lost in all the major States including Gujarat, Maharashtra and Andhra Pradesh. The defeats focused the party's attention on the general elections due in 1996. Inflation led by increases in administered prices was seen to be a factor in the party's unpopularity. From then till the election in May 1996, all administered prices, including foodgrain issue prices, were frozen. The increase in procurement prices was also moderated. As a result, sales to the government dropped, and stocks began to decline. By December 1996 they had fallen so much that there were doubts whether the government could maintain supplies to the public distribution system. Then the government ordered importation of about 4 million tons of wheat. It also announced a sharp rise in the procurement price of wheat from Rs 380 to Rs 475 per quintal for the procurement beginning in April 1997.

Thus the past five years from 1992 to 1997 saw a full cycle. First, procurement prices were pushed up to reward farmers and replenish stocks. This led to a sharp rise in government purchases and stocks of wheat in summer 1993. Issue prices were also raised with the procurement prices; since purchases from the public distribution system fell, this accentuated government stock accumulation. To reduce the stocks, the government began to expand the public distribution system and to release foodgrains for export in 1994; from 1995 onwards it also began to make sales in the domestic market. In the meanwhile, the freeze on issue prices led to a rapid rise in purchases from the public distribution system. From early 1996, stocks began to fall. By the end of the year, offtake far exceeded procurement, and the government was arranging imports in a hurry. With this may begin another cycle of a rise in procurement prices and accumulation of stocks if the issue prices are simultaneously raised, or of rising imports and subsidy if they are not raised. Thus the insulation of the domestic foodgrain market, ostensibly to protect it from international price fluctuations, only replaced the international price cycle by a domestic political cycle.

Infrastructure

Finally there is an entire arena of public policy which saw either no reforms or pseudo–reforms — i.e., policies that were passed off as reforms and were not. It was not the case that attempts to reform were frustrated or distorted; there were no forces, domestic or international, pushing policies to promote competition, neutrality of the state, or openness.

Of the untouched sectors, infrastructural sectors — railways, electricity, oil, coal, telecommunications, ports, airports — were the most important. Lack of action in these sectors does not call for detailed explanation, but certain common features which made them impervious to reforms are worth noticing.

The defences against change in these sectors are provided by three features: large workforces which fear that privatisation or private competition would lead to retrenchment; politicians who fear loss of control over large budgets; and bureaucracies which treasure the security of employment of the public sector as a defence against either superiors' arbitrariness or loss of opportunities for racketeering.

The workforces of Indian Railways, Coal India Limited and the State Electricity Boards of the State governments run into hundreds of thousands. They are highly unionised, and no politician or bureaucrat would take lightly the possibility of industrial conflict in these industries. Not only would it seriously disrupt the economy, but it could result in a law–and–order problem which would require the deployment of the army and the police on a large scale. The risks would be high, and facing them would require high organisational skills. The only major strike in these sectors was the railwaymen's strike of 1974. At that time there was a determined Prime Minister, Indira Gandhi, and a compliant government at her command; despite the massive forces she could muster, the strike went on for weeks and took extraordinary measures to break. It was the beginning of a process which led the following year to the declaration of emergency and suspension of democracy. Narasimha Rao, the Prime Minister in 1991–96, was quite clear that he did not want to take such risks; he gave the highest priority to industrial peace, and was therefore deprived of drastic solutions for the infrastructure.

Equally important were the enormous powers and opportunities of ministers presiding over the infrastructure ministries. Jaffer Sharief, railway minister from 1991 till 1995, repeatedly diverted money budgeted for purchase of wagons to gauge conversion: whereas the cost of wagons was well established, contracts for gauge conversion were capable of greater cost variation. Captain Satish Sharma, minister of petroleum, is charged with having obtained money from companies whom he awarded exploration acreage to bribe members of Parliament belonging to Jharkhand Mukti Morcha, a small party whose support secured majority in parliament for the Congress party. When private competitors in basic telecommunication services were chosen by a tender process, Himachal Futuristics, an obscure tenderer, was awarded the largest number of licences, and Sukh Ram, the telecommunications minister (who was from the State of Himachal Pradesh) was suspected of having favoured it. The charges were not sustained in court. Later one of his houses was raided by the Central Board of Investigation while he was abroad, and Rs 36.5 million was discovered in cash; he was charged with having taken illegal commissions on equipment purchased for the telecommunications department. Even where money is not involved, ministers have the power to reward political supporters. For instance, the petroleum minister was charged with having awarded licences to set up petrol pumps to friends and relatives of politicians and bureaucrats. The United Front minister of railways announced the setting up of new administrative offices in obscure cities and investment plans in politically advantageous districts in the budget he presented in February 1997. Patronage and money are devices used by politicians to keep parties together and reward supporters; infrastructure ministries are major sources of both.

Large ministries have possibilities of patronage. Some are appropriated by ministers, but most are in the hands of bureaucrats. In theory, ministers — or politicians acting through ministers — can appropriate a part of the bureaucrats' powers of patronage by control on their appointments, transfers and promotions. In practice, this power is shaped by service rules and by judicial processes. There is a Central Administrative Tribunal to which bureaucrats who are discriminated against can appeal; beyond it they can appeal to the courts all the way to Supreme Court. Ministerial interference in appointments varies greatly. The minister of petroleum, for instance, generally neither sought to influence the appointment of his senior bureaucrats nor involved them in his bargains with companies; there was recognition of mutual interest between the companies and him, and no intermediary was necessary. Sukh Ram, the Congress minister of telecommunications, got rid of N. Vittal, secretary to the ministry who was honest and intent on preventing dishonesty, and got another who was honest but not such a crusader. He involved Runu Ghosh, a junior bureaucrat, in his dealings; she was later discovered to have amassed disproportionate assets. Jaffer Sharief, minister of railways, held up the promotion of a number of senior managers to make them more co–operative. Whilst most ministers exercise a veto on the choice of secretaries of their ministries, ministerial interference with appointments further down is generally limited in the central government. A large number of recommendations from politicians are received for subordinate posts and taken into account. The recommendations conflict with the rule–based promotions and transfers, and the conflict generates numerous complaints to the Central Administrative Tribunal and the courts.

The existing systems are convenient to politicians and to bureaucrats who work in league with them; they would naturally resist any system change. However, there is a factor working to change the systems, namely shortage of capital. Budgetary support for investment has declined considerably, the government has tried to restrain its borrowings, and as long as the systems of the infrastructure ministries and their enterprises remain arbitrary and non–transparent, they would find it difficult to access the capital market. Till 1992 they borrowed from the government financial institutions, which in turn had access to bank funds through the statutory liquidity ratio. This access was ended in 1992. Whilst the financial institutions financed an occasional loan to electricity boards and railways, their ability to meet the investment requirements of infrastructure ministries greatly declined.

Still the infrastructure ministries could resist pressures towards structural change if they could either bring down the growth of demand, or generate profits. The railways reduced the growth of demand for their services by raising charges. They heavily cross–subsidised transport of a few commodities such as coal for power stations, foodgrains, iron ore etc which are carried mainly for the government; they also cross–subsidised second–class passenger fares and commuter fares. As a result they lost traffic to road transport. This loss of traffic kept the growth of demand within the modest increase in capacity the railways have been able to finance.

The same has come to be true of coal. From 1992 onwards, the government made repeated announcements of its intention to introduce private competition in the coal industry. It also allowed import of coal with a 30 per cent tariff; the imports silenced the steel industry, an influential lobbyist, since the Steel Authority of India, the largest steel producer, is owned by the government and represented in the central cabinet by a minister. Ostensibly to prepare Coal India Limited for forthcoming competition, coal prices were decontrolled. De–control started in 1993 with the highest grades whose tonnage was small and number of consumers small. It was extended to lower grades, until full de–control was achieved in 1997. De–control permitted price increases which kept demand for coal within the capacity that Coal India could build up.

The oil exploration and refining companies averted competition because they were extremely profitable, and hence regarded as cash cows by politicians. The costs of production of domestic oil are much lower than of imported oil; even though the domestic oil producers are given a lower price, they make considerable profits. Similarly, government–owned refineries are given prices which ensure them a handsome rate of return. The price control mechanism embodies considerable cross–subsidisation of kerosene (supposed to be the illuminant of the poor, although it is mainly used as fuel for cooking by the rich and the poor, especially in rural areas where bottled gas is not easily available, and mixed to adulterate more expensive diesel oil), bottled gas (consumed by the politically important urban middle class), diesel oil (because it is used by farmers for tractors and irrigation) and naphtha for fertiliser production. The cross–subsidies are administered through an oil price equalisation account. Since about a half of the crude and a quarter of the refined products are imported, whenever international prices rise the oil price equalisation account goes into a deficit. For some months the loss is borne by the oil companies out of profits and trade credits. When these become inadequate to finance the losses, the government is forced to raise prices.

Thus there is a political cycle in oil product prices. The unwillingness of the weak Janata Dal government to raise oil prices in 1979 was one reason why the International Monetary Fund refused it support; in the 1980 election, the Congress won majority, raised oil product prices and took an IMF loan. In 1989, the Gulf crisis led to a rise in international oil prices soon after the Congress was defeated and the Janata Dal took power. The government raised prices, but not enough, and the oil price equalisation account went into deficit. In the 1991 general elections, the Congress won; in the next two years it raised oil prices considerably. Then again, from 1993 onwards, oil product prices were frozen; by the general election of 1996, the oil price equalisation account was in considerable deficit. The United Front government, which came to power in May 1996, raised prices immediately, but not enough; it made a small further rise in September 1997, just before it fell in November.

Telecommunications is another highly profitable government industry. There is a government corporation, Mahanagar Telephone Nigam Limited, for the four metropolitan cities — Delhi, Bombay, Madras and Calcutta. The rest of the service is owned by the Department of Telecommunications; the ministry prefers it as a departmental activity because of the patronage it provides and because as a department, it does not have to pay corporation tax. There was always considerable excess demand; as a result there was a black market in telephones, and hence overbooking, which inflated the excess demand. In 1994 the government decided to introduce private competition. In mobile phones where the government monopoly had no presence, it decided to introduce two private competitors in each of 24 circles; in cable telephones, it decided to introduce just one private competitor in each circle. The bidders had to be companies or partnerships in which Indians had a majority share.

When the policy was announced, telephone companies from all over the world came and camped in Delhi; for months it was difficult to get rooms in Delhi's better hotels because they were used as camping grounds by the international telephone companies. They all scouted around for Indian partners. Some found large Indian companies, some found small and obscure operators who were prepared to act as a front for them. One by one, most major international telecom actors dropped out of the tenders for basic services because the procedures were not transparent and because there were no Indian partners worth collaborating with. The licences were given to bidders who offered the highest licence fees over 15 years. The entire process was strewn with obstacles arising from suspicions of corruption, and led to appeals to courts as well as heated debates in Parliament. None of the suspicions was confirmed; although Sukh Ram, the minister of telecommunications who presided over the opening up, was discovered to have considerable unaccounted cash and assets, these have not yet been connected with the licences. More important, the telecommunications department tried to extract the maximum rent from the private bidders. This led to three problems. First, some of the private bidders could not marshal the required licence fees and withdrew; others tried to raise money from government financial institutions by pledging their licences. Their attempts have not yet succeeded. Second, the telecommunications department continued to raise new demands, which led to protracted negotiations, stand–offs and litigation. The chief outstanding dispute is over interconnection charges. Long after the licences were awarded, the telecommunications department announced extremely high charges for interconnection between its own exchanges and private ones. After considerable delay, the central government set up a Telecommunication Regulatory Authority under the chairmanship of a retired high court judge. It asked the telecommunications department to reduce the interconnection charges. In the meanwhile, the telecommunications department has installed so many lines in the past three years that the excess demand has been virtually eliminated; the implicit value of the licences sold to private operators fell to uneconomic levels. Since the licences lost much of their value, the licensees refused to pay the promised licence fees or to start services; thus private competition in basic services was foiled. At the same time, corruption at low levels in government–owned telephone services worsened considerably.

Unlike all the above sectors, electricity boards in most States make massive losses; even the most viable ones earn very small surpluses. Hence they are not in a position to plough back profits or attract funds from outside. The State governments that own them are not in much better financial shape. Hence early on in the reform period, a need was felt to change the regime. However, since the electricity boards were owned by State governments, the centre could neither privatise them nor introduce private competition without the State governments' co–operation, which was unavailable. So the central government proposed that private investors should enter as suppliers of power to the State electricity boards, and that if they achieved 68.5 per cent capacity utilisation, they should be given a 16 per cent return on their equity. A large number of private companies, domestic and foreign, were attracted by the proposal, but they were not convinced that the bankrupt electricity boards would pay the promised returns. They were offered escrow accounts, but even an escrow account can work as a guarantee only if sufficient funds accrue to it; in most cases it was not seen to be attractive enough. The investors wanted the central government's guarantee. In 1992 the government promised to give a guarantee to eight projects involving foreign investment, with the aim of attracting foreign investment. Then the Ministry of Finance realised to its horror that it may have eventually to honour the guarantees; it developed cold feet. Ultimately, the Ministry of Finance sabotaged the policy of giving guarantees and none were given. The only major private project that came up was a coastal one set up by Enron for Maharashtra State Electricity Board. Even here, the agreement signed by the Congress government in Maharashtra was repudiated by it after an election in December 1994 brought another party coalition in power. After laborious arbitration proceedings, the agreement was signed a year and a half later.

Thus profits in electricity supply are so low that external funds cannot be attracted without a change of structure. Yet little change has taken place. Industry, which is charged the highest prices by the state electricity boards, has increasingly set up captive generators fuelled by cheap diesel oil. As in transport, so in electricity, overpricing by public enterprises has diverted demand away from them — this time towards captive generation.

As these instances illustrate, the pressure for reform in an infrastructure sector arises when the existing government departments or enterprises cannot meet the demand. There are two ways of resisting the pressure: to expand supply, or raise prices and reduce demand. The Indian infrastructure producers have tried one or both. For instance, railways have priced themselves out of upper–class passenger traffic and general cargo services. Coal India has raised prices to increase internal surpluses; the oil industry, too, has continued to earn sufficient surpluses for investment. Telecommunications have used their surpluses to expand supply, and at the same time raised as far as they could the costs of private entry. In electric power, demand for state–produced power has been reduced by captive private generation, and costs have been reduced by central government's underpricing of diesel oil.

The States

The primary impact of the economic crisis of the early 1990s was that the centre cut down transfers to the States. The centre transferred funds to the States in three forms: it gave them certain shares of its tax revenue which were fixed by a statutory finance commission once every five years; it gave them grants to fund a part of their social expenditures; and it gave them loans to fund a part of their investments, generally as part of the five–year plans. As Table 4.9 shows, the share of revenue from central taxes in the States' expenditure held up fairly well in the 1990s; so did that of central grants, but the share of central loans to the States fell off; so did loans from other sources. Hence the States had to finance a higher proportion of their expenditure out of revenue. The chief consequence was that the losses made by State governments' enterprises were brought down, and the States began to charge more for their services. The consequent savings did not suffice, for as interest rates went up, the States had to pay more interest. Their administrative costs also went up. The main victim was social and economic development expenditures. Thus the average quality of State governments' expenditure declined.

However, these budgetary figures do not tell the whole story. The central reform that had the strongest effect on the States was the abolition of industrial licensing. Industrial licensing was extensively used to direct industry — to the State to which the minister of industry belonged, to States ruled by the party ruling at the centre, and as part of political deals between parties and industrialists. Once industrial licensing was abolished, the States had to compete for industry. There were a number of consequences (Ministry of Finance, 1994, 1995).

First, instead of industrialists courting ministers, chief ministers of the States began to court industry. They would go and speak at meetings of the industry apex organisations, they would organise industry fairs advertising the attractive features of their States, and in general, they tried hard to get closer to industry. Thus the kind of close working of industrialists and governments that characterised the more industrialised States spread to other States as well.

Second, the State governments tried to cut down red tape. They set up "single window" clearance for industrial projects. They set time limits to the giving of various sanctions. Some State governments promised a reduction in visits by government inspectors, such as inspectors from the industry, revenue and labour departments, since the visits of these inspectors occasioned much corruption.

Third, the States tried to simplify and harmonise taxation. The consequence of greater inter–State competition should have been to reduce taxes, but most States were giving tax holidays and exemptions to newly set up industrial firms even before de–licensing; they were generally so short of revenue that they could not afford to give more concessions. In fact, the northern States got together to harmonise their tax rates and reduce inter–State competition, but in general, they tried to reduce harassment by revenue officials.

Finally, they tried to make it easier for industry to acquire land. They delegated the power to change and relax zoning regulations to district magistrates, and to simplify registration procedures. Some tried to set up new industrial States in co–operation with the private sector.

Table 4.9. **Composition and Financing of State Governments' Expenditure, 1990–91 to 1995–96**

	1990–91	1991–92	1992–93	1993–94	1994–95	1995–96
Expenditure	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Interest	10.7	11.3	11.7	12.6	13.0	13.5
Administration	14.6	14.5	14.8	14.9	14.6	16.1
Social services	34.7	32.8	32.6	32.6	31.7	32.3
Economic development	26.3	29.7	27.1	27.9	26.0	22.6
Loans	5.2	3.3	4.8	3.5	3.4	4.5
Other	8.6	8.4	9.0	8.5	11.4	11.1
Revenue	**77.2**	**80.5**	**80.6**	**83.5**	**80.5**	**80.1**
Share of central taxes	17.3	17.4	18.5	18.3	16.6	17.5
Central grants	15.2	15.8	16.3	17.4	15.0	14.6
Own taxes	37.1	37.0	36.6	37.9	36.5	37.1
Losses of enterprises	–1.8	–1.1	–0.3	–0.4	–0.4	–0.2
Interest receipts	3.0	5.5	3.7	3.9	3.5	3.1
Revenue from services	5.6	5.1	5.0	5.7	8.5	7.3
Other	0.8	0.8	0.9	0.8	0.9	0.7
Borrowings and overdrafts	**22.8**	**19.5**	**19.4**	**16.5**	**19.5**	**19.9**
Loans from centre	12.3	9.7	8.3	7.3	10.2	9.9
State provident funds	2.3	2.4	2.4	2.5	2.0	1.8
Other borrowings	7.6	6.6	7.6	4.9	6.7	6.6
Other	0.7	0.8	1.1	1.7	0.5	1.6

Source: Ministry of Finance (1996*b*).

Thus almost every State had to react to the reduced transfers from the centre and to the greater freedom of industry location which followed central reforms. The reaction varied depending on the composition of State legislatures and the strength and stability of the State–level power equations. Whilst some States, especially the most backward ones, reacted passively and simply cut the existing low level of government services, most States took some reform initiatives themselves.

V. REACTIONS AND CONSEQUENCES

The patrimonial State was initially designed to convert resources appropriated from industry into political assets. As time passed, it developed serious cracks. The system generated an excess of politicians and rewarded them poorly. Hence they tended to appropriate the resources themselves, and too small a proportion was converted into political support. The Congress failed to retain power.

Further, the State was the intermediary in the transfer of resources to politically important groups. The bureaucracy was crucial to this intermediation; it appropriated the resources itself, and competed in rent capture with the politicians. The patrimonial State presupposed a monolithic class of politicians who would co–operatively share out the gains from mediated transfers. From the mid–1960s onwards, competition intensified within the political system, and politicians became less and less sure of harvesting the benefits of the transfers.

After 1977, the political competition took the form of rivalry between the Congress and locally dominant parties in the States, and between the Congress and an anti–Congress coalition at the centre. Two coalitions that came to power in the late 1970s and 1980s failed in macroeconomic management because of their heterogeneity and lack of leadership. Each time India was bailed out by the International Monetary Fund. The second time, it undertook significant reforms, which were outlined in the previous section. The timing of the reforms was determined by the political cycle in which the Congress and the anti–Congress parties alternated in the central government. The direction was determined by the fact that the Congress decided to jettison the portion of the patrimonial State which involved direct quantitative control of industrial production, imports, and access to capital. If this move had been thought through and systematically carried out, it would have led to a political reform — to a passing, for instance, from a patrimonial to a corporatist State, or to a State driven by macroeconomic performance. However, this did not happen. The Congress was not strongly enough led to conceptualise the political change and capitalise on it, it could not liberalise the government completely enough because it controlled too small a part of the federal system, and other interest groups moved so as to capture or neutralise some of the gains of liberalisation. This section describes how the reforms faltered and ceased.

Political Crises

There were two major crises in the life of the Congress government, in 1991 and 1992. First, the government was intent on abolishing fertiliser subsidies, but faced strong opposition from the farm lobby which straddled all parties in Parliament. Ultimately the government had to agree to a Joint Parliamentary Committee (JPC) on the subject. The outcome, as described in Section IV, was an untidy compromise which involved subsidy reduction but kept the controls intact.

The second crisis was over a rise in controlled interest rates announced in March 1992. Its outcome, as described above, was a Joint Parliamentary Committee packed by opponents of reforms. The committee submitted a report in December 1993 which made a direct attack on financial liberalisation. The finance minister offered to resign in response to the criticism. He did not, but he never recovered the authority he had at the beginning of the reform process; the reforms virtually came to a halt after that.

In February 1993, the finance minister gave up his plan of bringing down the fiscal deficit and presented a soft budget with major tax concessions — one which no one in Parliament would want to defeat. In the next few months, the Congress secured the support of a number of minor parties in Parliament. The purchase of the support of one such party is the subject of current litigation against Narasimha Rao and some of his ministers. By mid–1993, Narasimha Rao had bought enough supporters to do without the support of the BJP. He commanded a majority in Parliament. By then, as described in Section IV, the balance of payments crisis was also over. After that the sense of urgency, the feeling that the government had to innovate policies in order to stay in power, disappeared.

Eight States held elections at the end of 1994 and the beginning of 1995; the Congress was defeated in six of them. This immediately led to charges that the reforms had hurt the poor and hence led to Congress defeats. The alternative view was that inflation had reduced real incomes and made the Congress unpopular. Neither view had much empirical support, but the government acted as if both views were valid. It stopped further reforms except those that Manmohan Singh continued in fields under his control. To curb inflation, it froze all administered prices in early 1995. This would add to public enterprise losses and the fiscal deficit, but would keep down the rise in the price indices. In early 1995, there was some outflow of foreign portfolio investment which took fright at the results of the elections. The outflow reduced growth of bank deposits, and reduced banks' lending capacity precisely when new industrial capacity was coming into production and manufacturers needed credit to finance inventories. There was a severe shortage of credit. the Reserve Bank allowed it to intensify in the belief that it was thereby curbing inflation. With the combination of administered price freeze and a tight monetary policy, the year–on–year rise in the wholesale price index was brought down to 4 per cent in April 1996, the month before the general election, from 10 per cent a year earlier.

The general election was due by May 1996. Hence the government would have courted the wrath of the Election Commission if it had taken populist measures in the February 1996 budget. Besides, the election could be held earlier if the Prime Minister so desired. Hence the 1995 budget became the last one in which populist measures could be taken, and they were. Grants and loans were announced that were directed at "backward" areas and minorities. These, however, proved fruitless. They had to be delivered through State governments, which did not pass through the handouts. Despite the curbing of inflation and populist concessions, the Congress fared badly in the general elections of May 1996 (Table 3.2).

The benefit of the Congress's misfortune went to the BJP, and to dominant local parties. In the event, the local parties formed government under a United Front, supported from the outside by the Congress. However, both these local parties and the Congress competed for the same voters; whatever the United Front did to gain electoral advantage went against the interests of the Congress. So there was continual friction between the United Front and the Congress. Finally in October 1997, the Congress withdrew support, the United Front government fell, and a general election was held in February 1998.

Taking the four general elections of the 1990s together, we can see how the polarisation between the Congress and the anti–Congress forces which began in the election of 1977 is working itself out (Table 3.2). The anti–Congress forces split into the Hindu nationalist

BJP, and the secular formations which went successively under the names of Janata Party, Janata Dal and United Front. Of the two, the latter is ideologically indistinguishable from the Congress, and has dwindled into insignificance. The BJP has emerged as the principal alternative to the Congress.

Both the parties have been affected by the reforms. Until 1991, the Congress ruled at least half the major States; apart from being the dominant national party, it was also a major regional party. Since then, its hold on the States has weakened; as it dismantled central patronage, it also lost advantage regionally. Although its share of the vote has been changed little and continues to exceed 25 per cent, it has virtually disappeared in the five States of the Gangetic valley — Punjab, Haryana, Uttar Pradesh, Bihar and West Bengal. From being a national party, it has shrunk into a multiregional party, and is on the way to becoming a federation of regional units. This change is related to reforms and deregulation: State–level performance has gained in importance, and determines the fate even of national parties.

The BJP has gained support and has also come to attract about a quarter of the votes. Starting with one or two major States, it has now come to govern four, alone or in alliance, but it has recognised more clearly the increased importance of the States. Its State chief ministers meet frequently as a group, and play an important role in its central committee. It has moved from patrimonialism to corporatism; its 1998 election manifesto was unabashedly xenophobic and protectionist. As a result, it got overwhelming support from industrialists, and was flush with funds.

Thus industrial deregulation has changed the political rules of the game; from redistribution of industrial largesse it has moved towards partnership between politicians and industrialists. The process is not complete. The Congress has not adapted itself completely; nor has it worked out the niche it would occupy to differentiate itself from the BJP. Nor has it dawned upon all the parties that in the new environment, their success will depend upon how well they govern individual States and attract industrial and economic activity to them.

A major obstacle in the emergence of a stable and effective political structure has been the shifting loyalties of politicians: political rewards tend to get distributed unevenly and concentrated amongst ministers and their hangers–own, and those who are left out wander from party to party. However, this source of instability may be about to decline because of certain legal changes.

First, the Supreme Court decided in 1995 that a party could fund a member candidate's election campaign if its accounts are audited. The limit on electoral expenses that can be incurred by candidates is ridiculously low. This did not matter as long as the Election Commission looked the other way, but in 1991, T.N. Seshan was appointed Chief Election Commissioner. Amongst other things he began to enforce the limit on expenses. The immediate effect was a drastic decline in the intensity of election campaigns. In the longer run, there may be more financing of elections by parties, especially if the next legal reform goes through.

This second reform is part of the comprehensive amendment of the Companies Act. In 1968, Indira Gandhi introduced an amendment to the Companies Act banning company contributions to political parties. The intention was to prevent her opponents, who had split the Congress party and who had support within industry, from raising funds. The actual consequence in the longer run was that all political parties, and especially the

Congress, began to receive corporate contributions illegally. This continues to this day. There was a considerable increase in the ratio of cash with the public to bank deposits in the year preceding the 1996 election, as illegal expenses are more often made in cash. In an amendment to the Companies Act which the Ministry of Finance has prepared but has been unable to pilot through Parliament, the ban on corporate political contributions is proposed to be removed. Once such contributions became legal, they could be shown in the accounts of political parties, and be used publicly to finance elections.

The third reform is the insistence of the Election Commission that before they are allowed to contest elections, parties must themselves hold organisational elections. The sudden decision caused considerable turmoil in the major parties. In particular, the Election Commission's order caused a major upset in the Congress, which had not elected a leader for decades. If the Election Commission continues to insist on intra–party elections, every party will have to hold elections at least once in five years. With this, competition for leadership may emerge, and ability to win elections may begin to figure as the major factor in these elections.

Finally, the deposit for contesting an election from 1950 onwards was Rs 500 ($13 at the present exchange rate). The candidate lost the deposit if he polled less than a sixth of the votes, but the cost was low; hence the number of candidates rose with every election. By 1996, there were constituencies in which hundreds of candidates stood; the ballot papers were as big as newspapers. Although the likelihood of election of such frivolous, unattached candidates was low, it was still positive; the result was a long tail of independent members in every legislature. In the 1998 general election, the Election Commission raised the deposit to Rs 10 000. As a result, there was a drastic fall in the number of candidates; out of the 543 seats, only 20 were won by independents. Correspondingly more were won by members of parties.

These four changes together are also likely to strengthen parties as against individual politicians. Parties may cease to be ephemeral, shifting combinations of politicians, and may acquire greater stability. If they do so, the objective of retaining power and building up a broad and stable electoral base may gain as against the objective of winning power somehow. If parties begin to think of retaining power for long periods, they are bound to be struck by the inefficiency of populist subsidies and handouts, which may win one election when they are introduced but are useless as vote–getters in the next. Similarly, selling government favours to selected industrialists is also sensible as part of a strategy for a single election, but not necessarily efficient as a long–term strategy.

The decline of secessions from parties is matched by a decline in secessionist movements outside the party system. Punjab, which faced a serious secessionist movement from the early 1980s onwards, had its first election in ten years in 1992; a Congress government took power. Within a year terrorism virtually disappeared. The Congress was defeated in 1997, and a coalition of the Sikh nationalist party, the Akalis, and the Hindu party, the Bharatiya Janata Party, formed government. A democratic government was elected in Kashmir in 1996. There the secessionist movement survives, but the level of violence has declined. The United Front held talks with the secessionist groups in Assam, though it could not end the insurgency. In general, the sense of confrontation between the government of India and secessionists has declined, and so has bloodshed.

The more relaxed and tolerant atmosphere within the country is also reflected in external relations. Soon after the Narasimha Rao government came to power in 1991, it changed course in the Uruguay round negotiations. It gave up the earlier stance of all–

round obstruction in the name of developing countries, and concentrated on promoting Indian interests, which lay principally in an end to the MFA agreement. It also rapidly improved relations with the United States and China. It sought unsuccessfully to become member of APEC, and got observer status instead. The United Front government continued the policy of relaxed external relations; in addition it has turned towards closer economic relations with neighbouring countries, especially Bangladesh, Sri Lanka, Nepal and Pakistan. India's trade with its neighbours — both in south and in east Asia — grew in the 1990s; this is now being reflected in external relations. The United Front government settled the dispute with Bangladesh on the sharing of Ganges waters, and opened talks with Pakistan.

Thus liberalisation has been accompanied by a move towards more genuine federalism, more freedom of manoeuvre for State governments, a shift of power from politicians to parties, a shift in political objectives from patrimonialism to corporatism, and a lowering of domestic and international tensions. Whilst all these changes cannot be attributed to the reforms, there is a link.

Industry

The abolition of industrial licensing has changed the conditions faced by both the industrialists and the politicians. Competition has intensified, and the pace of industrial change has accelerated. Against that change there are no State–erected protective walls; the only way an industrialist can succeed is by expanding faster than his competitors, and by being more efficient. The competition has destroyed the unity of interest amongst the big industrialists. Import liberalisation has hurt some, but benefited others; industry apex associations can no longer unite on the issue of protection. Foreign investment has helped some expand faster, and brought competition to others; although some of the biggest industrialists are fearful of foreign competition, they cannot unite their peers around the issue of restricting entry of foreign business capital. What liberalisation has done is to destroy the cohesion of the large industrialists and to make them incapable of acting consistently and effectively as a lobby.

Equally, it has weakened the hold of the government on large industry, and the ability of the party ruling at the centre to cash in on the hold. The central ministers in charge of infrastructure sectors still retain considerable power, but the 1996 general election suggested that a ruling party could no longer expect to be adequately funded by monetising the power exercised by the ministers of railways, telecommunications, oil, coal or shipping. Apparently, the funds at the disposal of the Congress were inadequate for the election; the chief factor that led Prime Minister Narasimha Rao to go into an alliance with chief minister Jayalalitha of Tamil Nadu was the large funds at her disposal, but she was so unpopular that the Tamil Nadu unit of the Congress broke away and allied itself with the party opposing her. The secession of this State unit was the most important setback that led to the defeat of the Congress. In the 1998 election, the member parties of the United Front were poorly funded even though they had been in power. The BJP and Shiv Sena, which share power in the industrialised State of Maharashtra, were on the other hand able to run a lavish election campaign.

The ties between politicians and industrialists have not been snapped; they are being remade at the State level. For the industrialists are still dependent upon the State government for land, electricity, water and roads. As a result, alliances are being forged between State politicians and industrialists. The ties of Jayalalitha with Rajarathinam and Khemka, industrialists who came up under her regime and declined with her defeat, are well known. Similar, if less conspicuous, alliances exist in Karnataka and Gujarat. The ties between the Congress and the national industrialists are being replaced by ties between provincial parties and provincial industrialists.

However, these new corporatist structures cannot be nearly as stable as the earlier national ones. For industrial risk has increased, the rank order of industrialists is changing rapidly, and few industrialists can show consistently strong performance. Industrial leadership is being shaken up, the industrial spokesmen of a decade ago now preside over crumbling empires, and the industrial class itself is losing its cohesion and definition. As long as States cannot protect domestic industry, the life of provincial industrialists will be more precarious than that of national industrialists, and so will be the support they can extend to provincial politicians.

As a result, the political class can no longer be sure that it can survive entirely as a rentier class. The stable networks of obligations between politicians and industrialists are passing away; with it, the sustenance of politicians and parties is becoming more uncertain. There are signs that politicians are turning towards becoming men of means in their own right or towards establishing family businesses. Many of them have set up their children in industry, hotels, construction or trade. Equally, small industrialists have begun to enter politics as sidekicks of politicians. Politicians are going into business, and businessmen into politics. The urge to become a man of means explains the increase in the size of political bribes and frauds, as evidenced in the cases being investigated and taken to court by the Central Bureau of Investigation. Thus the political dynasties of yesterday are on way to being replaced by political family enterprises.

The Bureaucracy

A minute proportion of the bureaucracy was involved in initiating the reforms: probably not more than half a dozen bureaucrats, most of them economists, were so involved. Implementation involved a much larger number, and faced sustained obstruction, especially from those services whose self–interest was adversely affected. The obstruction seldom took the form of sabotage; more often, it took the form of shaping the reforms to the advantage of the bureaucracy. In telecommunications, for instance, the Department of Telecommunications was asked to introduce private competition. It brought in the minimum number of competitors: one per circle in basic services, and two per circle in mobile services. Similarly, the Department of Petroleum was asked to allow private competition; it licensed only two private refiners. the Reserve Bank of India, when it was asked to license new private banks, licensed only nine, many of them owned by government–owned financial institutions.

Where they could, bureaucrats replaced controls that had been removed by new ones. One of the first reforms involved the removal of import licences from industrial inputs and capital goods. The Directorate General of Foreign Trade, which issues import licences, thereupon expanded the issue of advance import licences to exporters; whereas it had issued 110,000 licences in 1991–92, it managed to issue 58,000 advance licences in 1994–95. In that year, exporters' pass books were instituted to cut out the paperwork of import licensing as well as to simplify the payment of duty by setting it off against duty credits earned through exports. The customs officers, many of whom earn bribes on imports, sabotaged the pass books by introducing impossible side conditions for their use. The dismantling of exchange controls and bank deregulation reduced the work load of the Reserve Bank, it created new work by bringing non–bank financial institutions under its control.

Deregulation and the accompanying political changes are affecting the bureaucracy in a number of ways. Bureaucratic jealousy was a major factor behind high income tax and government controls on corporate salaries. The maximum personal tax rate has been brought down to 30 per cent, and controls on salaries have been removed. Hence the bureaucracy lobbied strongly before the last Pay Commission (1996) for salaries comparable to those of corporate executives. Under their pressure, salaries were considerably increased, though they are still far below corporate salaries. As the salary increases spread to the States, the proportion of revenue spent on personnel will increase significantly.

Patronage networks between politicians and bureaucrats were mentioned in Section I. As central political leadership weakens, State–level networks are gaining in importance. During the tenure of the last United Front government, ministers brought civil servants from their own States to posts in Delhi. The frequent general elections and consequent changes in the central cabinet have introduced added instability in the careers of senior bureaucrats, and brought new nexuses to the fore.

The Judiciary

In 1992, the Supreme Court threw off the central government's hegemony in judicial appointments; the Chief Justice began to make appointments to the Supreme Court and the High Courts himself. This was not an isolated change; it was related to the judges' role as seen by the Supreme Court. During the socialist era, two trends were very visible. One was laws which discriminated between one citizen and another. For instance, caste was introduced as a distinguishing feature in government appointments; the law of property was modified so as to confer the rights of virtual property upon tenants. The blindness of justice to the status of the person before the court, a fundamental principle in western democracies, was abandoned in various ways. The Supreme Court, being the inheritor of the British system of justice, resisted this trend. Its resistance was overcome in the 1960s and 1970s by means of constitutional amendments; that is why India's is one of the most amended Constitutions. Increasingly, Indira Gandhi resorted to another way of bringing the judiciary to its heels: under her, the government appointed committed judges — that is, judges who were prepared to rule in favour of the poor, or the tenants, or any favoured class, irrespective of the rights and wrongs of the case. They created a case law on labour disputes and tenancy law which had little objectivity.

There is no clear connection between the reforms and the Supreme Court's assertion of autonomy. The Supreme Court no doubt noted the change in the political climate, the absence of a strong political leader, the growing indeterminacy in the structure of legislatures, and decided to insulate itself from the resulting instability. Its move towards autonomy went unchallenged until 1996; then Ramakant Khalap, the law minister in the United Front government, repeatedly tried to reintroduce political initiative in judicial appointments, but he was not been able to muster a strong enough parliamentary majority behind his ideas to push them through. He fell with the UF government, so the autonomy of the judiciary remains untouched.

The Supreme Court used its new freedom for two main purposes. First, it began to insist that the government must implement and enforce its own laws. The laws to which it gave such judicial backing were not particularly socialist laws or liberal ones. The law which it pushed with the greatest vigour was law relating to environmental protection. In this case, what clearly happened was that a pair of judges committed to the environmental cause simply worked out and applied the far–reaching and disruptive implications of the current law, and used it to direct the closing down of thousands of factories in Agra and Delhi and aqua–farms on the east coast. This was neither socialism nor capitalism; it was judicial private enterprise. It will probably be moderated in revised judgements now that the two crusading judges have retired. As the judgements on environment show, there is not much consistency or direction in the judicial activism. The only thing on which the judges seem to agree is the primacy of the law, but often judges have their own views on the direction in which they should take the law.

Second, the Supreme Court took an initiative in pursuing corrupt politicians. Earlier the courts used to try cases involving politicians that were brought before them, but if the government did not pursue the cases, or if it sued guilty parties selectively, the courts did not interfere. The Supreme Court changed that with the Havala case. For the case it took over the direction of the Central Bureau of Investigation, and effectively removed the Prime Minister's control over it; it insisted that all the politicians should be charged unless the case against them could be shown to be unsustainable.

The Supreme Court is not on the way to redefining its constitutional role *vis–à–vis* the elected politicians. For one thing, the Supreme Court has only established the principle of independent judicial action. It does not mean that all its judges are pursuing government errors of commission or omission actively. Each has his private agenda: some are more often pro–government, some anti–government, some publicity–conscious, some evangelical. There are mechanisms against bias: for instance, the allocation of cases by the Chief Justice, the bench system which assigns cases to judges sitting together, and provision for revision of judgements. These mechanisms are weak and capricious; a consistent doctrine of the judicial role and the way it is to be performed is still to emerge.

The Supreme Court's example is being followed only hesitatingly and imperfectly by the lower courts. Some High Courts are following in the Supreme Court's footsteps; the Patna High Court has, for instance, pursued the fodder scandal case against Lallu Prasad Yadav, the chief minister, with the thoroughness and courage displayed by the Supreme Court in the Havala case. Such activity is the exception. For instance, the Havala case is on the way to petering out in lower courts. A Delhi high court judge has exonerated two politicians on the grounds that a diary is not legal evidence; this precedent will lead to the acquittal of many more. The High Court in Madras is most leisurely in the pursuit of the serious cases of corruption against Jayalalitha, the ex–Chief Minister. In the States and the districts, judges depend in various ways on the government — for instance, to get a house, or to get expenses passed, or for security. They are less insulated, and more a part of the local official hierarchy. This junior judiciary is not following the Supreme Court's example with conspicuous zeal.

Nevertheless, Indira Gandhi's moves made in the 1970s to incorporate the judiciary into a committed civil service are in defeat; the relationship between the government and the judiciary has become less well defined, and the possibility has re–emerged of the development of a professional pride and ethos in the judicial service. The courts have imbibed and used the increase in intellectual freedom that has followed the reforms.

VI. THE OUTCOME

India has had liberalisation episodes earlier — notably in 1966, 1976 and 1985. How is the episode of the 1990s different? Will it end up differently? As we described in the last section, the present stage is marked by lack of cohesion and direction. It is reminiscent of the days of the two Janata governments, in 1977 and 1989. Both led within a few years to an external crisis. Thus it is possible to think of a balance of payments cycle: a payments crisis leads to a tightening of fiscal policy and relaxation of the rigours of import control, the economy responds with accelerated growth, shortages develop and lead to new controls, and soon there is another payments crisis. Are we just passing the peak of a cycle? Or is there any change? Is it transient or will it last?

Taking as our reference an open economy that sustains rapid growth through efficiency improvements pushed by domestic as well as external competition, let us ask how much closer to such an economy India has come in the 1990s, where it has failed to do so, and how it could have got closer.

The Successes

The most unmistakable indicator of success is the change in the intensity and character of industrial competition. Competition was earlier prevented, reduced or delayed through three interlocking controls: industrial licensing, import licensing, and allocation of loanable funds. Of these, industrial licensing was progressively removed on a widening range of industries. Now the only significant industry which is under licensing is sugar, but equivalent control is imposed on consumer durables, notably vehicles, through minimum local content and minimum investment restrictions. Import licensing was removed on industrial inputs and capital goods; now it is confined to agricultural goods and consumer goods, and some of the latter can be imported against exports. As import licensing was removed, tariffs became important. Here too, the maximum tariff has been reduced from 350 to 45 per cent, and the collection rate from 44 to 29 per cent, but imports now bear customs duties as well as domestic excise duties; so the effective tariffs can still be over 100 per cent. Finally, controls on the pricing and issue of equity were removed, and private firms were allowed to enter banking and term finance; they had made greater inroads in the latter. In this way, barriers to competition have fallen away in most of industry. This left growth as the only protection against competition; this hunger for growth was the basis of the industrial boom of 1992–96.

The growth of competition has led to a fall in relative prices and in operating expense ratios. Profit margins rose till 1995–96. Indications are that they have fallen in the last years, but as a result, the pressure on costs has increased. The frequency of takeovers, mergers and acquisitions has greatly increased. The performance of these companies which relied on stable oligopolistic positions has become more volatile.

The competition has partly come from imports. It has been particularly keen in capital goods, which firms can import at zero or very low duties if they accept an export obligation. The result is the scrapping of production lines of obsolete machines, and modernisation of products as well as processes. In machine tools, producers have developed closer relations with major users and begun to develop machines specially suited to their needs. Perhaps the most important consequence of import liberalisation has been acceleration of the import cycles: abolition of import licensing of inputs cut down import lags from 6–8 months to a few weeks, and cut down inventory requirements. This had enhanced the export competitiveness of Indian industry.

Next to industry, the most conspicuous success is in foreign trade. Both exports and imports have risen faster than GDP or industrial production; the economy has become more open. The ratio of exports to imports has risen. The share of equity, both direct and portfolio, in capital imports has gone up at the cost of official and semi–official (public enterprise) debt. Exchange reserves rose from $1 billion in the middle of 1991 to $30 billion in September 1997.

The financial markets have changed less radically, but equity issues have gone up relatively to debt issues, and corporate debt–equity ratios have fallen. The rise in profit margins and fall in interest burden have made companies less vulnerable. The regulation of primary and secondary capital markets has improved, and the dematerialisation of financial instruments has begun.

All these changes were carried out with minimum disruption. There was no noticeable increase in unemployment or in firm closures. Distress has been minimised. The economy has grown at a respectable growth rate — over 6 per cent in 1991–97. Structural adjustment has been accompanied by little pain.

The Failures

The greatest failure has been an absence of structural changes in the largely government–owned infrastructure industries which would lead to a reduction in their costs of production or make them profitable and give them access to capital for growth; amongst these industries are railways, coal, oil, electricity, water, roads, ports, airports, airlines, telecommunications and banking. These industries have not entirely escaped change. For instance, licences have been given to two private oil refineries; some private power generators have come up; private airlines have been allowed into the domestic markets; private telephone service operators have been licensed, but all these changes have been flawed. In the circumstances, the government retains too much arbitrary power, and the prospects of private investment in the industry are too uncertain and the risks too great to attract capital for steady growth. The oil industry continues to be under licensing, and its prices continue to be controlled. Private power generators have not been given access to the retail market and must sell to State electricity boards at negotiated prices. The finances of the State electricity boards are so precarious that few private investors would trust them as monopoly buyers of electricity. The government has been negotiating with a private consortium for building an international airport in Bangalore, but the negotiations have been so capricious that they are apt to put off all private investment in airports — or ports. Successive ministers of civil aviation have been so biased in favour of government airlines that a number of private airlines have gone bankrupt or closed down, and the rest can survive only by making non–transparent deals with the government. In telecommunications, high licence fees and interconnection charges have raised the entry and operation costs of private operators far above those of the erstwhile government monopoly; so they are incapable of offering competition to the government operator. The government has been extremely niggardly in licensing private banks; it has set a minimum capital limit that ensures that private competition will be confined to wholesale, corporate and urban business, and it has continued to finance losses of government banks liberally and thereby discriminating in their favour and against private banks. Thus the government has attracted limited private capital into infrastructure industries, and has not created a framework in which private capital can enter the industries unhindered and, where competition is possible, drives down costs to ensure maximum expansion; nor has it regulated industries susceptible to monopoly so as to mimic competitive conditions and ensure fairness between competitors, public or private.

The growth of infrastructure could be ensured, even if at a high cost, if the government either generated a fiscal surplus to invest in it or sufficiently high returns on the investment to be able to borrow from the open market. It has done neither. The total (central and State) fiscal deficit fell from 14 per cent of GDP in 1990–91 to 11.2 per cent in 1995–96, but it is still substantial. Subsidies account for 15 per cent of GDP. Most of these are subsidies to or through government departments and public enterprises, so an indeterminate proportion of them simply maintains government establishment. A high proportion of the deficit is excess government consumption. The capital expenditure of the centre and the States (including loans) was 5.7 per cent of GDP in 1990–91 — considerably below their combined fiscal deficit of 14 per cent. In 1995–96 it was down to 4.2 per cent of GDP — still much below the combined fiscal deficit of 11.2 per cent (Table 3.3; Ministry of Finance, 1996*a*, 1996*b*).

Amongst the subsidies that the government did not touch were food subsidies. Till 1991–92 the government operated a substantially autarkic economy. This meant that domestic imbalances of supply and demand were accommodated by either domestic inventory changes or price changes or both. Industry tended to maintain excess inventories of imported goods; this was one of the causes of its high capital–output ratio; one of the most conspicuous consequences of import liberalisation has been a fall in inventories as well as in the incremental capital–output ratio. In the case of agriculture autarky entailed large inventories of rice, wheat and sugar, which were subsidised and distributed through the public distribution system. For these, as well as other products, however, autarky accentuated domestic price volatility and raised the rate of inflation. In the case of unrationed products it is obvious that failure to trade would lead domestic imbalances to be reflected in prices. This tended to happen even in the case of rationed products whose prices are controlled, for whilst these were often imported in the event of a shortage, the imports were invariably the result of sharp price rises, and not of timely inventory management. Add to this the fact that there was always political pressure to raise the procurement prices of wheat, rice and sugar cane. Hence it is likely that agricultural price and distribution policies accentuated inflation and price volatility. These policies remained unchanged. Hence inflation in the 1990s remained high, and there were serious imbalances, which led to panic exports or imports at various times of wheat, rice, cotton and sugar.

Apart from these economic failures, the most serious failings of the Indian government are in administration, in which there was no change. What is known in India as *licence–permit raj* changed little. The numbers of ministers and officials as well as their powers remained the same. An average factory continued to be visited by the same number of inspectors, each looking for a cut; roads continued to have the same checkposts manned by policemen who collected money. A few central government offices — notably the controller of capital issues and the directorate general of technical development — were abolished; the powers of the chief controller of imports and exports — renamed director general of foreign trade — were curtailed. This was a drop in the ocean; most of the government continues to function in exactly the same way as before.

Chances Forgone

It is risky to speak of lost opportunities without keeping in mind the political constraints that operated. The political temperature was much higher in the early 1990s: there was greater hostility and distrust amongst political parties, and between the centre and the States insofar as they were ruled by different parties. A high proportion of the time of both houses of Parliament was spent in agitations and debates on questions of the moment; less was available for legislation, and the quantum of legislation that could be piloted through was small. The precarious situation of the government made the passage of legislation uncertain. Many ordinances were issued outside Parliament sessions; most of them fell through, and few were converted into legislation.

Industrial de–licensing: Initially in 1991, 18 industries were kept under licensing, and eight continued to be reserved for the public sector. Eventually most of the industries were delicensed, and private competitors were allowed into industries reserved for the public sector. Today, sugar, liquor and automobiles are the only major industries under licensing or equivalent investment controls, and defence and nuclear industries the only major ones in which private firms have not been allowed. Licensing is a poor way of achieving aims in health, environment and public order; these should be achieved by specific legislation.

Foreign investment: The restrictions on foreign investment were relaxed in three separate directions. For direct investment in 31 “priority” industries, up to 51 per cent of equity was given “automatic approval” on application to the Reserve Bank of India. Foreign institutional investors approved by Securities and Exchange Bureau of India (SEBI) were permitted to take up to 5 per cent individually and 24 per cent collectively of the equity of quoted companies. (The individual limit has now been raised to 10 per cent, and the collective limit to 30 per cent if a general meeting of a company approves it). Equally, companies could issue equity or debt in the Luxembourg market with the approval of the Ministry of Finance. All investors who did not fit into these two categories were directed to a new committee called the Foreign Investment Promotion Board (FIPB). As Table 4.1 shows, the first channel has been little used. This could have been anticipated: the priority industries had priority only in the eyes of the government, and were mostly taken out of an outdated list going back to 1973. What was necessary was to deal with the fear of some big industrialists that they would have to face the competition or be bought up by multinationals. This fear had to be taken into account for political reasons, and the way to do so would have been to free foreign direct investment altogether except in the largest firms — firms of the size of those whose owners were fearful and influential. Beyond a certain size of firm, foreign direct investment could have been kept subject to approval. That would have directed foreign investment into the thousands of small firms which are more competitive and which could benefit most from the infusion of technology and management. The big industrialists would have followed once they saw the advantages of such an infusion. A size threshold would also have reduced the work load of the FIPB, and would have enabled it to concentrate on the real question of introducing competition into the previously oligopolistic large–scale industries.

Portfolio investment has gone through unnecessary vicissitudes. The domestic corporate registries and capital markets have been inefficient and riddled with malpractices. Many foreign institutional investors have come and had themselves registered, but few have invested because of these handicaps. Because of their difficulties, Indian companies have wanted to go and float issues in Luxembourg; too many have done so, including some of doubtful quality (issues in Luxembourg also have the advantage that shares so issued do not carry voting rights). All these troubles would have been avoided if the government had insisted that all companies that wanted foreign portfolio investment had first to dematerialise their shares fully and use a single depository, and that all brokers had to use a single settlement corporation. Once their shares had been dematerialised and transactions computerised, companies could have been allowed to define their own limits on foreign portfolio investment.

Foreign trade: The continuation of import licensing of consumer goods was based on the erroneous belief that its removal would bring in a flood of consumer durables and destabilise the balance of payments. Actually, a comparison of domestic and foreign prices after the 1991 devaluation would have sufficed to show how wrong this belief was; if, despite the price differences, some consumer goods came to be imported in problematic quantities, their imports could have been restrained by tariffs. The import licensing of agricultural goods continued because of rampant government intervention in their domestic markets. If these had been repealed or refashioned on the basis of their real objectives, all import restrictions could have been removed. The government continues to labour under the belief that to stabilise farmers' incomes it is necessary to support the price of each major crop. This is not necessary, for land use is versatile, and its diversion between crops in response to relative price changes would tend to stabilise farm incomes. If, in addition, the government is interested in consumer price stability, that requires a buffer stock policy, or a policy of subsidised credit for inventories in the buffer stock. Finally, import licences for exporters can be replaced by passbooks which are credited when goods are exported and debited with the duty payable on inputs when these are imported — if only the hurdles placed by the customs department for self–serving reasons were removed. Thus it was and is possible to dispense entirely with import licensing.

Tariffs: In the initial years, the government was too worried about revenue implications and hence unduly slow in cutting tariffs. The author of this study had proposed a scheme involving the following: (a) all import duties could be scaled down in proportion to the devaluation without loss of revenue; (b) import duties on all exports could be abolished since they were by definition cheaper at home; (c) all goods, especially raw materials and inputs, that are known to be cheaper at home should bear zero duty, and finished goods should bear the same duty as inputs unless there is a special justification; and (d) a standard duty rate should be established close to the post–devaluation collection rate, and most imports should come in at this rate or below. Instead, the government adopted the principle of bringing down the maximum tariff progressively, and other tariffs selectively. It brought down tariffs on capital goods especially radically, with the result that tariffs on metals stayed far above those on machinery; the effect of this negative protection on engineering industry was disastrous.

Public enterprises: The Congress government was too burdened with the fact that it had in the earlier decades nationalised industries and built up public enterprises; it had internal difficulties in privatising. Trade unions in public enterprises were equally opposed to privatisation, in the belief that private managements would shed surplus labour. Wages in the public sector were higher, and non–wage benefits were more generous. The government did decide to refer loss–making enterprises to the Bureau of Industrial Finance and Reconstruction (BIFR), which could in theory recommend their liquidation, and the BIFR did recommend in the case of some either that they should be liquidated or that the government should put in fresh capital; but none had been liquidated. For profitable enterprises it employed an obscure route to divestment: it sold shares to financial intermediaries, and secretly forced institutions owned by the government and by nationalised banks to buy shares in public enterprises. Eventually some shares began to leak out to other investors; shares of sheltered enterprises such as a telephone company and refineries were especially popular. In the event, it would have been wiser to force a hard budget constraint on loss–making enterprises, and to give profitable ones freedom to issue capital and to fix wages.

Alternative Strategies

There is much social differentiation and inequality in the Indian society, but it is not divided into irreconcilable classes. People have loyalties towards their neighbourhood, kin or caste; but the groups so defined are too many and too ill–defined to form the basis for political parties. The Congress originally emerged as a party of educated middle–class people whose opportunities of employment and advancement were limited by slow growth under colonial rule. After independence it acquired the support of various groups in society by incremental bribery — subsidies, protection, reservation, preferential loans and so on. The trouble with these bribes was that they worked only once: once a group had won a certain concession, every party promised to continue it, and to retain it; it was not necessary to vote for the Congress.

After the mid–1970s, when opposition parties began to come to power in the States and occasionally at the centre, they too tried to win support by targeted concessions. This has been the major reason why Indian governments, at the centre and in the States, have invested a declining proportion of their revenue and frittered away an increasing proportion in factional subsidies. Self–help by politicians and bureaucrats is a consequence of this limitless populism. When a politician is giving someone a favour at the government's cost, the chances are high that he will be offered or will ask for a price. When bureaucrats see that it is proper for politicians to help themselves, they too help themselves. In theory, the judicial process could stop this; but only if the prosecuting agency has independence and integrity. The police and investigative agencies have lost both since they themselves have been subject to the orders of ministers. The recent spate of cases against politicians has been possible because the courts have taken over supervision of the Central Bureau of Investigation and prevented it from taking orders from the Prime Minister on those cases, but this development has not yet resulted in the conviction of any politician or bureaucrat.

The further a government develops into an institution for handouts, the less capable it becomes of acting as a service industry supplying public goods. The Indian governments could develop further as intermediaries of patronage and corruption, but the returns to further bribery of sections of the electorate are strictly diminishing. The Congress government did try out selective bribery in its last three years without any electoral success. The state governments have extensively tried it, and the results are mixed. Generally there is competitive bribery; if one party contesting an election promises a bribe, such as cheap rations, free electricity to farmers, or prohibition (which is a great vote–catcher amongst women), other parties too promise it, so the effect on election results is indeterminate. The costs of such bribery are becoming ever more evident. They have led a number of governments to reverse the bribes. The government of Andhra Pradesh, which had reduced the price of rationed rice to Rs 2 — roughly a quarter of the market price — raised it back to Rs 3.50, and selectively repealed prohibition. The Rajasthan government raised the power tariff for farmers. The communist government in West Bengal has developed good rapport with foreign investors; they too have developed a preference for it because it is a hierarchical, disciplined government that can take decisions and keep promises. Recently in a sudden move, it removed squatters and hawkers from the streets of Calcutta, many of whom it had itself settled in its early days of power; it felt that they were detrimental to the image of Calcutta. These instances do not amount to a trend; many governments, including the centre, are simply muddling through. Competitive bribery is no longer a winning strategy, and alternative strategies, which involve a choice between conflicting interests, are emerging. Three of them in particular were important.

First, there is strong evidence that insofar as Indian industry has been protected, agriculture has been unprotected: that terms of trade have been turned against agriculture by means of protection. Agriculture is compensated by means of subsidies and price support; but this compensation is less than the cost of protection, and the distributions of the cost and of the favours are quite different. One aspect of the de–protection is that agricultural exports have been controlled to keep domestic agricultural prices down.

At least the agriculture minister and the finance minister believed that there was de–protection; other leaders would not have disagreed even if they did not feel strongly about it. In the circumstances it would have been possible for the Congress to make this into a political issue, and court farmers' support actively by removing controls on agricultural exports and imports. Domestic prices of most farm products were lower than abroad, and any devaluation would have made them even more competitive. Hence there was no danger in removing import curbs and duties. However, freeing of trade would not have led to a substantial increase in net exports unless the price support and rationing operations had been dismantled. This had a political cost insofar as rationing conveyed subsidies mainly to the population of large cities, and would have been opposed by State governments, but the subsidies per capita are small. The government could have deliberately and publicly presented agricultural deregulation as a pro–farmer policy and built up a new constituency.

Second, the government courted considerable unpopularity by opening up to foreign investment. It accentuated its troubles by setting up a discretionary mechanism for approving foreign investment proposals and being overtly sympathetic to foreign investment. It could instead have first taken steps that would have intensified domestic competition, and justified them by saying that they were necessary for industry to be able to face foreign competition. In particular, it could have abolished all the concessions to small firms, which are the cause of much fraud and evasion. Removal of barriers to competition is far less disruptive than is generally feared; new competitors take time to enter, build up capacity and penetrate the marketing channels, and they generally pay more for land, machinery and labour and are thus at a disadvantage *vis–à–vis* older enterprises. So nothing much would have happened for some years except in industries where existing enterprises were hopelessly inefficient or which had missed out on substantial technical change, but ground would have been prepared for liberalisation of foreign investment.

Third, the government courted considerable hostility of the entrenched trade unions by subjecting public enterprises to competition and sending some of them to the Bureau of Industrial Finance and Reconstruction. Having gone this far, it could have got better returns if it had favoured the efficient against the inefficient public enterprises. It could have released the former from controls and let them expand and issue capital as they wished. It would thereby have broken up the centralised systems of recruitment and wage fixation, created a divergence of interest between workers of successful and unsuccessful enterprises, given an incentive to the latter workers to emulate the success of the former.

Finally, probably the most important generic factor that sets back Indian producers is the high cost and irregular supply of power. Power supply by the State electricity boards is so poor that by now, a high proportion of commercial enterprises from big plants to small shops rely on their own generators. With price discrimination by the electricity boards and cheap, subsidised diesel oil, the costs of public and privately produced power are comparable in many States. The massive inefficiency of this power generation as a cottage industry could have been easily reduced by abolishing the monopoly of the State electricity boards. If it had been abolished, neighbouring factories in industrial concentrations would have set up larger co–operative power plants, and started selling surplus power; in this way, State electricity boards would have been forced to become more efficient and reform their pricing. The State governments which owned the electricity boards would have opposed the abolition of their monopoly, and some would have imposed their own monopolies, but inter–State competition would have finally dissolved the monopolies.

It is generally futile to think about "what–if" situations. For every outcome that happened, there are innumerable outcomes that could have happened; it is generally impossible to settle on the likely options. The above options are mentioned because they are available even today.

Lessons for Reformers

Reformers are usually economists; they view the macroeconomy as a stock–flow model. That, however, is a poor model when it comes to doing reforms, which must be carried through in the political arena. Politics is better regarded as a board game. When amateurs talk of political will as necessary for reforms, they implicitly assume that politicians are leaders. Politicians themselves do not view their role in those terms: they regard themselves as pawns in a game. However, it is a peculiar game in which the board can change in size and complexity, rules can change in the middle of the game and pawns that have been taken can come back into the game. The patterns of the board are so complicated that political science devotes much effort just to delineating the variety of patterns. What matters for reforms is not the patterns, but the moves themselves. Economists who want to succeed as reformers have to understand the particular political game; to reform, a model of the political process is necessary.

The aim of a politician is to occupy and retain political territory, be it votes, seats, money or power. He is naturally inclined to use baits and sticks in doing so; favours, subsidies, and discrimination are his basic instruments, and he has no reason to favour fair, transparent, non–discretionary or non–distorting policies in general. He will pursue such policies only if they give him political advantage or save him from political loss. The reason why reforms often follow crises is because crises hold the near–certainty of political loss; reforms are undertaken as stop–loss strategies. That also means that quick–fix policies which resolve internal or external crises are more likely to be adopted than fundamental, lasting structural reforms; and that reforms are likely to stop once the crisis is overcome — as they did in India.

Reforms do not always have to be born out of a crisis. They can form part of political strategy in non–critical times if politicians can see a way of making political capital out of them. Economists need to develop a pathology of unreformed policies as a tool for use in political battles — an empirical, site–specific pathology.

There are often good reasons why such a pathology does not emerge. In many countries, an independent economic profession does not exist. The economists that are available are recruited by the government as a priesthood to do propaganda for it. Funds, official secondments and other awards go to the priests. The government does not publish objective, usable information. Clearly, economist reformers survive better in large, open, diversified societies in which the government is not the sole source of patronage and information. Wherever there is political competition, there is scope for the use of economic ideas and viewpoints as political weapons. Generating them is not a popular occupation amongst economists; it is plodding empirical work, and where the government is powerful, propagating heterodox ideas may carry few rewards and serious punishments, but the fact cannot be ignored that economic ideas have a force of their own: that they are potential political weapons. Generally speaking, subsidies, concessions and other economic favours are used by politicians to build up loyal constituencies. By the same token, they must harm opposing politicians, who constitute a potential market for reformist ideas.

There is another reason why this sort of pre–reform economic research is important. Most reforms raise detailed empirical questions and present complicated choices. The more these have been anticipated and studied, the more likely it is that the reforms will be of a high quality. The questions will often be legal; reforms do very often require a change in law. Hence understanding of law amongst economists — and vice versa — is essential for sound reforms. Reforms usually have a budgetary dimension; and resistance to them will generally depend on their financial effects on constituents. Hence knowledge of the technicalities of public finance and accounting also contributes to good reform. Economists cannot assume that lawyers and accountants will provide the relevant inputs, for specialist human resources of all sorts are scarce in unreformed governments.

Economic theories of sequencing of reforms have a general utility but are not usually relevant to particular situations: the window of opportunity for reforms is usually narrow, and politicians will do what they think is advantageous or easy, irrespective of what economists tells them. There are, nonetheless, a few empirical rules:

First, one is on safer grounds in deregulating real controls than monetary, financial or trade controls. Investment takes time, so market structures generally change slowly; even a hurried, one–shot deregulation is unlikely to hurt anyone soon. Developments in finance, trade and construction, on the other hand, can be extremely rapid; reforms in these areas call for more forethought.

Second, it often helps to divide the constituencies and tackle them one by one. For instance, if a subsidy scheme involves both a subsidy to consumers and one from low–cost to high–cost producers, it is sometimes strategically advantageous to turn it into a fixed–rate subsidy, and thereby first to eliminate the cross–subsidy between producers. Similarly, if privatisation involves closure and sale of assets, it is politically advisable first to pay off workers and thereby to reduce the number of interested parties. Politicians are fond of saying that the best is the enemy of the good. This is not a very wise saying, but dividing up the best into elements and sequencing them often makes it more practicable.

Third, politicians tend to think that removal of concessions merits compensation. This generally does not make economic sense, especially in the case of meritless concessions, but it may still make good political sense if it buys peace or prevents secession of a valuable constituent. An economist would want to ensure that the compensation does not become worse than the concession it replaces: generally, one–shot, lump–sum compensation is better than an income stream. The two are equivalent only where there is a functioning financial market in which one can be reliably converted into the other.

Fourth, booms are a good time to remove constraints on competition, and slumps are a good time to remove consumer subsidies and concessions. In general, the money value of concessions and distortions varies considerably over time, and study of their variation can help in timing their removal with the least disruption.

Finally, the case for openness, non–discrimination, transparency etc. is obvious to economists, but anything but obvious to others; to present these as the absolute good convinces no one. For all reforms, it is necessary to present more appealing, site–specific, often partisan arguments.

NOTE

1. A number of people have claimed paternity of eximscrips; their time was ripe, and variants of the concept may have occurred to many.

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