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Political Economy of India’s Fiscal and Financial Reform

by

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Although economic liberalization may involve curtailing state economic intervention, it does not diminish the state’s importance in economic development. In addition to its crucial role in maintaining macroeconomic stability, the state continues to play a vital, if more subtle, role in creating incentives that shape economic activity. States create these incentives in a variety of ways including their authorization of property rights and market microstructures, their creation of regulatory agencies, and the manner in which they structure fiscal federalism. While the incentives established by the state have pervasive economic consequences, they are created and re-created through political processes, and politics is a key factor in explaining the extent to which state institutions promote efficient and equitable behavior in markets.

India has experienced two important changes that fundamentally have shaped the course of its economic reform. India’s party system has been transformed from a single party dominant system into a distinctive form of coalitional politics where single-state parties play a pivotal role in making and breaking governments. At the same time economic liberalization has progressively curtailed central government dirigisme and increased the autonomy of market institutions, private sector actors, and state governments. In this essay I will analyze how these changes have shaped the politics of fiscal and financial sector reform. I will begin by analyzing the changes in India’s party system. Next, I will examine how these changes have affected India’s fiscal politics. Coalitional politics makes fiscal reform problematic but not impossible. Overcoming the collective action problems presented by coalitional politics can be alleviated by mechanisms that coordinate different parties. I will compare and contrast the efforts of the National Democratic Alliance Government to implement fiscal reforms at the central and federal levels. I will then analyze the politics of reforming India’s financial sector, giving special attention to the reforms of the capital market and the crisis in the spring of 2001. I conclude by pointing out the uneven progress of India’s reforms, and I offer some preliminary explanations for the political causes of this unevenness.

India’s Changing Party System

The decline of the Congress Party has left an increasingly fragmented party system in its wake. The 1989 elections marked a watershed. The number of parties contesting parliamentary
elections averaged 42 from 1952 to 1989 and 165 from 1989 to 1999. The average number of parties winning seats in the Lok Sabha jumped from 1989 prior to 1989 to 31 afterwards. The fragmentation of parliament, as indicated by the number of “effective parties” increased from an average of 2.1 for the period prior to 1989 to 5.0 from 1989 to 1999. (See Figure 1)

The 1990s have seen an increase in political stability as a consequence of the fragmentation of parliamentary representation. The 1999 elections were the third in three and one-half years and the fifth in a decade. The National Democratic Alliance (NDA) government that was formed in the fall of 1999 was the ninth government to rule India in the previous ten years. The challenge of cobbling together a coalition that would provide stability is dramatized by the formation of the NDA government. With Atul Bihari Vajpayee at the helm, the NDA government ascended to power with a seventy member cabinet, the largest in India’s history. Its size was further increased during the following year.

Simply equating party system fragmentation with instability is misleading. Although the party system is as fragmented as ever, the Vajpayee government has good prospects for lasting its entire five-year term. One reason for the longevity of the NDA government is the growing bipolar structure of the party system. The NDA and Congress-led coalitions control an increasing number of parliamentary seats. Its share of the total has grown from 63 percent in 1996 to 78 percent in 1998 to 80 percent in 1999. BJP coalitions account for all of the increase. (See Figure 2) Their share has risen from less than 36 percent in 1996 to more than 55 percent in 1999. The share of parliamentary seats controlled by the Congress Party has marginally diminished from just less than 27 percent to 25 percent. The high level of opposition fragmentation is one of the most important factors promoting NDA stability since most Indian parties are motivated the perquisites of office. Defection from the government virtually assures loss of office since the opposition is more fragmented than ever and therefore is in no position to form a government.

A myopic focus on the fragmentation of India’s party system obscures other changes that affect coalitional politics and governmental stability. Party system fragmentation has been accompanied by the rise of single-state parties. These are political parties who win
parliamentary elections in only one state. Single-state parties are either identified with a regional culture that does not transcend state boundaries such as the Dravida Munnetra Kazhagam (DMK), All India Anna Dravida Munnetra Kazhagam (AIADMK), Telegu Desam Party (TDP), Shiromani Akali Dal, and Shiv Sena, etc., or they are led by political leaders like Laloo Prasad Yadav, Biju Patnaik, Mulayam Singh Yadav, and Mamata Banerjee whose personal following forms the core of party support but does not transcend state boundaries. Parties controlled by regional leaders were usually formed when these ambitious politicians defected from declining national parties like the Janata Party, Janata Dal, and Congress. Examples include the Rashtriya Janata Dal, the Biju Janata Dal, the Samajwadi Party, and the All-India Trinamool Congress. The share of seats in the Lok Sabha controlled by single-state parties has risen from a low of 7.2 percent in 1977 to 33 percent in 1999. (See Figure 3) At the same time the vote share of these parties increased from 13.1 percent to 35.6 percent.

The growing mobilization of India’s lower castes has been an important factor in the rise of single-state parties. India has become one of the world’s rare democracies where the poor have higher voter participation rates than the wealthy. In the 1999 elections, voter turnout for members of scheduled castes and scheduled tribes were 2.2 percent and 0.4 percent above the national norm. The process of lower status mobilization began with the mobilization of the “other backward classes” (OBC’s). By the 1960s, single-state parties like the DMK rode the support of the OBC’s to power at the state level. As the process spread north from the southern state of Tamil Nadu, it bred defections from the Congress Party and led to the creation of new opposition parties. The mobilization of less affluent OBC’s SC’s and ST’s during the 1990s led to the founding of parties like the Bahujan Samaj Party, the Samata Party, and the Samajwadi Party with relatively narrow social bases.

The rise of single-state parties has contributed to important changes in national politics. It is an important factor in the decline of declining salience of national issues and the growing importance of state-level considerations in coalitional strategies. From 1971 to 1989 national parties framed their election campaigns in terms of national issues in order to mobilize the electorate and win national elections. During this era the number of parliamentary seats and vote share of single-state parties reached their nadir, averaging 11.4 percent and 16.6 percent
respectively. With the decline in salience of national issues during the 1990s, the share of parliamentary seats and votes rose to averages of 23.5 and 26.8 percent.  During the 1990s, state government performance became an important factor affecting national parliamentary outcomes. For instance, during the 1999 election, poor performance by state governments run by the BJP and its NDA allies was more important in determining the outcome of parliamentary elections in Karnataka, Punjab and Uttar Pradesh than national issues such as Kargil and Atal Bihari Vajpayee’s attractive leadership qualities. In Andhra Pradesh, the good performance of the state government run by the Telegu Desam Party, an NDA ally, was crucial in determining the outcome. And the successes of the NDA in Bihar, Rajasthan, and West Bengal was due more to the foibles of opposition-led state governments than to national issues. Maharashtra is the exception that proves the rule since the impact of the poor performance of the state government run by the BJP and Shiv Sena was mitigated by the split within the Congress over the issue of whether Sonia Gandhi as a foreign born citizen should be permitted to become Prime Minister. However, the elections demonstrated that Sharad Pawar, Sonia's rival who raised the issue and then left the Congress to form his own party, was able to garner little support outside of his Maharashtra bastion. What began as a national issue turned into a single-state conflict.

The increasing importance of single-state parties has raised the national profile of state-level leaders and has important consequences for parliamentary coalitions. Under Indira Gandhi, state leaders served at the beck and call of national leaders even when, as in the case of Sanjay Gandhi, they held no elected office. During the 1990s, the support of state leaders is often crucial to making and breaking national governments. In the spring of 1999, J. Jayalalitha, as leader of the AIDMK, brought down the BJP-led national government as a consequence of her efforts to gain advantage over her arch rival in the state of Tamil Nadu. During the spring of 2001, the Trinamool Congress Party defected from the NDA because its leader Mamata Banerjee decided that it would provide advantages in the state assembly elections in West Bengal. Conversely, the BJP has gained alliance partners whose support is essential to the NDA national government because parties such as the Telegu Desam and Samata Party are locked in state-level competition with rivals of the BJP at the national level.
The fragmentation of the national party system and the rise of single party states presents formidable challenges for economic reform. In the days of single party dominance, the Congress Party served as a means for coordinating public policy across the ministries of the central government and between center and state governments. With fragmented coalitions ruling in the center and a broad range of parties controlling India’s state governments, these means of coordination are no longer available. The pivotal importance of single-state parties makes the challenge of coordination even more formidable. National parties are often willing to sacrifice the interest of their units in particular states for the welfare of the party in the nation. Not only do single parties have less incentive to sacrifice their state interests for the benefit of political constituencies in other parts of the nation. They often join national coalitions to gain control over ministries and influence over policies that provide them with resources to improve their position in their home state. For instance, until she left the NDA, Mamata Banerjee was notorious for using her position as Railway minister to channel resources from the railways to her home state of West Bengal. Even noted state-level reformers like Chandrababu Naidu who supports the NDA from outside the government, wields his critical influence to gain more resources for his state of Andhra Pradesh. The importance of single-state parties in India’s coalitional politics has especially important consequences for India’s fiscal politics.

**Fiscal Politics in India’s Decentered Polity**

Recent changes in India’s political system provide important underpinnings for its fiscal politics. The era of coalition politics and the increased prominence of single-state parties is an important factor. Simultaneously, power and authority within India’s polity have become “decentered.” This process has several manifestations. The 1990s has seen a modest horizontal dispersion of power from the governmental cabinet to other central institutions such as the Supreme Court and the President. Economic liberalization has engendered more significant changes. Curtailing of industrial licensing and the relaxation of controls on foreign investment has greatly increased the mobility of private capital at a time when the share of private investment in gross domestic capital formation has increased from an average of 54 percent in the decade of the 1980s to 71 percent in 1997-98. These changes have redistributed power among India’s economic and political institutions in three ways. By increasing the mobility and
autonomy of private industry, they have enhanced its power and influence over public policy. In order to attract private investment and promote competition, the central government – sometimes in conjunction with the states – has created a new locus of authority through its establishment of independent regulatory agencies. Finally, the end of central government investment controls and the increasing mobility and importance of private investment has provided state governments with more autonomy and incentive to pursue their own developmental strategies. The changes in the party system and the decentering of India’s polity create the need for new forms of coordination in order to maximize the effectiveness of Indian public policy.

Prime Minister Vajpayee initiated three important measures to improve strategic coordination and promote economic reform. In the wake of Finance Yashwant Sinha’s disappointing first budget announcement on June 1, 1998, Vajpayee shifted N.K. Singh from the Finance Ministry to the Prime Minister’s Office (PMO). Singh along with Brajesh Mishra, the high profile Prime Secretary to the Prime Minister, have made the PMO an important force in advancing the government’s economic reform program. Shortly after Singh’s transfer, the PMO announced the formation of the Council on Trade and Industry, whose membership included twelve of the country’s leading industrialists, and the Economic Advisory Council consisting of ten high-powered, reform-minded economists. The two councils have contributed many of the ideas behind the Vajpayee government’s economic reforms. Finally, the Vajpayee government has attempted to promote coordination within the cabinet by forming an estimated 35 “groups of ministers” on policy matters ranging from requiring cooperation between different ministries.

Coalition politics poses formidable problems for reducing central government expenditures, especially when it involves a prominent role for single-state parties. Many single-state parties join the NDA with the objective of securing more resources from the central government in order to assist their efforts in promoting development and building political support. The leaders of these parties are loath to see reductions in subsidies and the budgets of the central ministries that they control. Some of the most vociferous opposition to subsidy cuts has come from leaders of important coalition partners like Chandrababu Naidu, a single-state party leader with a reputation for state-level reform. NDA partners such as Haryana’s Om
Prakash Chautala and Punjab’s Prakash Singh Badal have succeeded in raising minimum support prices for food grains well beyond the recommendations of the Commission on Agricultural Costs and Prices and of the Ministry of Agriculture and Food, even while unprecedented stocks of the Food Corporation of India rot away.

Privatization is an important element in the central government’s strategy to reduce its fiscal deficit, but achieving the government’s ambitious goals face difficult challenges. As is often the case, labor unions and opposition parties vehemently oppose privatization. After the NDA struck a deal to sell 51 percent of Bharat Aluminum Company Limited (Balco) to Sterlite Industries on March 2, 2001, seven thousand workers at Balco’s production facility in Chattisgarh immediately went on strike to protest the sale and prevent the new management from operating the plant. The BJP’s own labor federation, the Bharati Mazdoor Sangh (BMS), joined the strike and BMS leader Dattopant Thengadi condemned the sale of Balco as “fraud committed by bureaucrats.” Federalism can complicate matters when an opposition party rules a state. The Congress Party chief minister of Chattisgarh, Ajit Jogi, stoked the fire by charging that the NDA had grossly undervalued the Balco shares as the result of bribes to central government officials. Jogi offered that his state government would purchase Balco instead of Sterlite. On May 8, the Supreme Court issued a decision that ended the two months of tumult by obliging a compromise that completed the ownership transfer.

More insidious opposition to privatization comes from political leaders supporting the ruling coalition. NDA ministers often oppose the privatization of public sector enterprises under their authority since it means losing control over capital, jobs, and prestige. It is hard enough to gain the acquiescence of ministers in a government with a single ruling party, but when the division of control over ministries is divided up among multiple coalition partners, a “not-in-my-backyard” attitude creates even more formidable barriers. The NDA created a Ministry of Disinvestment to advance the ambitious privatization objectives announced in each of its budgets. It has also convened the Cabinet Committee on Disinvestment to pressure reluctant ministers to acquiesce to privatization plans. Ministers still succeed and diverting privatization initiatives. Communications Minister Ram Vilas Paswan of the Lok Shakti Dal has delayed efforts to sell shares of telecommunications companies VSNL and MTNL before compelling a
reduction in the shares that would be sold. Shiv Sena leader Manohar Joshi has slowed efforts to privatize automobile manufacturer Maruti Udyog Ltd., and Aviation Minister Sharad Yadav’s ambivalence toward the sale of Air India’s shares has retarded the privatization of this public sector enterprise. NDA leaders at the state-level also use their influence in the alliance in attempts to prevent privatization. Chief Minister Chandrababu Naidu, has the reputation for promoting reform in Andhra Pradesh, but he single-handedly forced the government to postpone disinvestments of Rashtriya Ispat Nigam Ltd., a central government owned steel company based in his state. Similarly, M Karunanidhi, as chief minister of Tamil Nadu, fought the privatization of Salem Steel.

The difficulties of securing the political cooperation necessary to reduce the fiscal deficit has led the NDA to attempt a strategy of debt reduction through the Fiscal Responsibility and Budget Management Bill. Introduced to Parliament in December 2000, this legislation would establish legally binding targets for the reduction of fiscal and revenue deficits. The legislation would mandate a 0.5 percent of the GDP reduction in the fiscal deficit of the central government for each of the next five years reaching a goal of 2 percent of the GDP in 2005-06. The central government would be required to eliminate its revenue deficit, now at 3.6 percent, by 2005-06. The legislation would require the central government to make proportionate reductions in disbursements should there be a revenue shortfall or an excess of expenditures over a stipulated levels. The legislation has strong support from business associations such as the Confederation of Indian Industry and the Associated Chambers of Commerce and Industry of India. Nevertheless, the bill has been referred to the parliamentary standing committee for finance where strong resistance from the opposition has dimmed its prospects for passage.11

Recent work on the politics of fiscal federalism argues that the increase in the influence of sub-national politicians promotes the decentralization of control over fiscal resources.12 In the last few years, the increasing power of single-state parties and their political leaders has seen the central government assert greater control over the finances of state governments by promoting reforms that make it easier for the center to monitor state finances and setting up an incentive system that sanctions fiscal profligacy by state governments. While the states retain considerable autonomy in their finances, the central government has succeeded in establishing elements of a
principal-agent relationship with them in order to promote greater fiscal responsibility. Through its ability to direct additional revenues to state governments, the central government has also succeeded in promoting fiscal cooperation among the states in ways that promise to increase government revenues.

The state governments’ fiscal problems are grounded in the manner in which India’s system of federalism has encouraged their fiscal profligacy and the populist political competition that began to prevail at the state level. The central government controls the most buoyant revenue sources under Indian fiscal federalism, and two institutions function to redistribute central resources back to the states: the Planning Commission and the finance commissions. The Planning Commission finances developmental projects proposed by state governments. The Planning Commission’s assistance to the states is allocated on the basis of the “Gadgil formula” which accounts for the states’ population, poverty, and revenue mobilization. The central government convenes a finance commission once every five years to redistribute tax revenues to the states. Until recently, the finance commissions have taken a “gap filling” approach that determines the distribution of funds to the states on the basis of the gap between their revenues and non-plan expenditures. The distribution of funding by the Planning Commission -- along with the fact that the Reserve Bank of India has traditionally arranged for state governments to borrow at identical interest rates – has meant that that the cost of funding for development is unrelated to whether the funds are put to productive use. The “gap-filling” approach of the finance commissions creates incentives for the state governments to increase their non-plan expenditures without raising revenues.

It is within this institutional framework that populism came to dominate the terms of partisan competition at the state level. In their eagerness to win elections, populations make fiscally irresponsible campaign promises. Subsidies increased while tax revenues lagged. State governments provide explicit and implicit subsidies amounting to an estimated 9.9 percent of GDP. Most of these subsidies go to power, irrigation, transport and higher education where user charges are low, collections are weak, and overstaffing and inefficiencies inflate costs. Particularly troubling is the power sector where the losses of state electricity boards, responsible for the distribution of electricity, grew from 9.8 percent of state plan expenditure in 1992-93 to
18 percent in 1998-99. User charges for irrigation pay for only 20 percent of the maintenance cost of the system. State subsidies encourage inefficiency, and they benefit the more affluent. Since state governments have been unwilling to improve their tax base, they have paid for these subsidies with growing fiscal deficits and reductions in spending on social and economic infrastructure.

The central government is not without responsibility for the states’ fiscal problems. The cascading effect of the central government’s Fifth Pay Commission is a major factor in the states’ most recent problems. Efforts to bring fiscal discipline to the center have resulted in a decline in transfers to the states. Transfers as a proportion of GDP dropped from 4.8 percent of GDP in 1990-1 to 3.6 percent in 1998-99. The Planning Commission has routinely underestimated the support necessary to meet the demands on the stats’ revenue expenditures in the form of administrative costs and transfers that accompany the state plans. This, along with the costs imposed by centrally sponsored schemes, has contributed to the deterioration of the states’ revenue accounts.

In view of the mounting fiscal problems of the states at the end of the 1990s, the central government began to take measures to alter the institutional incentives that shaped their finances. One of the first steps was taken in the spring of 1999, when the Ministry of Finance negotiated arrangements with a committee of the National Development Council. The Finance Ministry agreed to aid state governments under extraordinary fiscal stressing return for their signing a memorandum of understanding that specified fiscal reforms creating greater discipline. Nine state governments eventually signed MoU’s with the Finance Ministry. This episode served as a prelude to the recommendations of the Eleventh Finance Commission.

When the central government convened the Eleventh Finance Commission on July 3, 1998, it expanded its terms of reference by asking the commission to review state finances and suggest ways in which the states might restructure their finances to restore budgetary stability. On April 24, 2000, the central government further requested that the commission draw up a fiscal reforms program to reduce the revenue deficits of the states. It also asked the commission to recommend how implementation of a state’s deficit reduction program could be linked to the
grants to that the central government provided to cover the states’ non-plan revenue deficits. The commission submitted its report on July 7, 2000, before it had time to formulate a fiscal reform program for the state governments. The recommendations for the reform program were included in the commission’s supplementary report on August 31, 2000. The central government announced its acceptance of the supplementary report only on December 19, 2000.

The supplementary report recommended reforms that begin to alter the institutional incentives of India’s fiscal federalism. It urged that 15 percent of the revenue deficit grants that initially were rewarded to 15 chronic revenue deficit states be reallocated and combined with matching funds from the central government to create a Rs.106 billion “incentive fund” to reward fiscal reform in all states. The objective was to eliminate all revenue deficits of state governments by 2004-05 and reduce the states’ gross fiscal deficit to 2.5 percent of the GDP. The recommendations set up a monitoring group composed of officials from the central government’s planning commission, and finance ministry and from each state government. The monitoring agency was charged with designing fiscal reform programs for each state, and it was authorized to release incentive funds conditional on the states’ performance. In February 2001, the Ministry of Finance sent the states detailed guidelines about the incentive fund. It has also asked the states to make the reports on their finances more transparent and comparable with the financial positions of other states, and it set up the Expenditure Finance Commission to monitor the states’ financial positions. In addition, the Draft Approach Paper to the Tenth Five Year Plan recommended that the Planning Commission set up a fund to augment the resources of those states agreeing to eliminate their revenue deficit in five years and improve their governance.15

The center and state governments have achieved a remarkable degree of cooperation in resolving the collective action problem of limiting tax concessions to lure investment and resolving the thorny issues involved in establishing a common value added tax. Ever since November 1997 when the working group on state resources for the ninth plan recommended a uniform floor on sales taxes for all states, the central government has taken step to encourage states to cooperate in implementing a uniform sales tax floor and ultimately moving to a VAT. By the meeting of chief ministers in Delhi on July 5, 2001 virtually all states had implemented the uniform sales tax floor and withdrawn tax concessions to industry. The chief ministers
agreed that penalties should be imposed on any state that failed to shift to uniform floor rates or withdraw tax concessions. The meeting reaffirmed the commitment to implement the VAT on April 1, 2002. In order to allay the concerns of states that might lose revenues, the central government agreed to provide compensation for their losses according to the criteria developed by a committee of state finance secretaries. The committee will also examine how to implement the VAT on services and imports.

How has the central government achieved such progress in resolving state government fiscal problems when it has met with such strong resistance in advancing solutions at the level of the central government? No doubt, part of the answer is that India’s fiscal federalism is more insulated from parliamentary politics than is central government fiscal policy. The different position of the central government in the structure of the fiscal policy “games” that are played is another important element in the successes in reforming the institutional incentives of India’s fiscal federalism. The central government may be more successful in promoting cooperation among state governments because it can grant them substantial rewards and impose substantial penalties. There is no comparable third party whose authority places it above the fray of fiscal politics at the central level. The Ministry of Finance is at best first among equals in the central government. A final factor is that political leaders at different levels of government have disparate pay-offs. This is especially true for leaders of single-state parties. Single-state party leaders join the central government largely to gain control over governmental resources that they can use to promote development and build political support in their state. While no politician wants to lose control over valuable political resources, this is especially true of single-state parties at the central government level. Leaders at the state-level face different incentives. India’s economic reforms have increasingly moved their environment in the direction of a “market preserving federalism.”\textsuperscript{16} The inter-state competition for private investment under market preserving federalism creates incentives for state government leaders to pursue responsible fiscal policies in order to establish an attractive investment climate. Under these circumstances, central government intervention can be decisive in establishing a “race to the top” equilibrium instead of a “race to the bottom.”\textsuperscript{17}
Politics of Financial Reform

Economic reform has transformed India’s equity markets more than any other sector of the economy. At the beginning of the 1990s, trading was conducted through an open-outcry system that was monopolized by some 3000 brokers who closed membership to outsiders. Settlements were based on two-week account periods that were frequently extended to four or more weeks when brokers encountered financial problems. Registration of transactions was a time-consuming paper chase that was plagued by manipulation. Poor communications infrastructure fragmented the equity market into 23 regional exchanges. Public sector financial institutions dominated even the largest markets, especially the Unit Trust of India (UTI) a distinctive, public sector “mutual fund.” Under the Nehruvian dispensation, the government of India was relatively unconcerned with capital market development, preferring to intermediate savings through public sector financial institutions. The state intervened in the primary market through the Controller of Capital Issues which dictated the number and price of shares for initial public offerings. However, it largely left regulation of India’s secondary markets to the broker-managed stock exchanges. Keen observers of the Indian economy condemned the Bombay Stock Exchange, India’s largest and most modern, as a “snake-pit” that was “well known for its murky practices.” An official commission convened by to review the operations of the India’s stock exchanges charged, “The security business in the country has tended to be in the hands of a few families of stockbrokers whose actions are primarily governed by the need to protect their own interest and bereft of the interests of the investing public…”

By the beginning of the new millennium, much had changed. All trading is conducted through an electronic order book system matching orders according to time-price priority. The National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) rank fifth and seventh of all exchanges in the world in terms of the numbers of trades conducted in 1999. As of July 2, settlement for stocks accounting for more than 90 percent of trading was conducted through rolling settlement on a T+5 basis. As of March 30, 2000 a depository covering 200 cities and 2.5 million beneficiary accounts provided dematerialized trading amounting to between 80 and 90 percent of all deliveries at the NSE and BSE. The *dirigiste* Controller of Capital Issues was long
abolished, and the Securities and Exchange Board of India, the country’s first independent regulatory agency, now regulated markets.

How did change come so rapidly to India’s equity markets when it has been so slow in coming to other sectors of the Indian economy? Part of the answer has to do with changes in the global economy. Financial globalization promoted increased volumes of international capital flows. Although India’s capital markets grew during the 1980s, they were missing out on the opportunities presented by financial globalization. For instance, the BSE’s share of total capitalization compared to other emerging markets declined from 12.5 percent in 1980 to 5.2 percent in 1989, and its share of emerging market value traded dropped from 19.6 percent to just 2.4 percent in 1989-91. Finance Minister Manmohan Singh who since the early 1980s had been eager to promote equity market development in order to enable private sector industry meet its capital needs now wanted to reform the markets to attract foreign investment. At the same time, the volume of international resource flows was growing, the financial sector was experiencing rapid technological change and the declining costs of informatics brought down the costs of cutting edge securities market infrastructure. Finally, international organizations such as the International Organization of Securities Commissions (IOSCO), the International Federation of Stock Exchanges (known by its French acronym FIBV), and the Financial Stability Forum organized by the Finance Ministers and Central Bank Governors of the G7 have helped to promote standards for global best practices. The Financial Institution Reform and Expansion of the U.S. Agency for International Development was especially active in promoting the practices of American exchanges and regulation from 1994. Paradoxically, the spread of these global norms for market based practices empowered the Indian state to promote reform over the resistance of recalcitrant brokers by undermining their claim to a monopoly of knowledge about market practices.

Financial globalization was not a sufficient condition for such rapid reform. Processes comparable to those shaping equity markets were also transforming banking. As the chapters by Hanson and by Bhide, Prasad, and Ghosh document, progress has been more halting in the banking sector. Reforms have liberalized interest rates, enhanced competition, and improved capital adequacy, but the preponderant public sector banks have yet to experience a technological
transformation comparable to the equities market, there remains a serious problem with non-
performing assets, and the legal framework for recovering bad debt is in need of reform.
Recovery of bad loans to failing industrial firms is an important element of the NPA problem.
Examining the politics of reforming this legal regime assists in explaining why reforms have
been slower in the banking sector than in equity markets.

The Board of Industrial Financial Reconstruction (BIFR) is an important element in the
process of recovering nonperforming loans to industrial companies. However, the priority it
gives to the protection of the jobs of workers and proprietors from creditors makes debt recovery
an inordinately time consuming process that encourages proprietors to default on their financial
responsibilities. These problems are not new to India’s political leaders. Since 1993, the central
government has convened three committees to reform the situation. The NDA convened the
third committee headed by V.B. Eradi. Based on its recommendations, it has drawn up
legislation that would repeal SICA and replace the BIFR with a National Companies Law
Tribunal (NCLT). The NCLT is to be staffed by professional liquidators. Though its mandate
still gives priority to rehabilitating companies before winding them up, the legislation proposes
to expedite its proceedings by providing deadlines for each phase of its operations. The bill also
proposes to transfer the power to wind up and liquidate companies from the high courts to the
NCLT making the Supreme Court as the only forum for appeals.

There is a growing consensus among central government officials, financial institutions,
and business associations that the BIFR should itself be wound up, but a political bottleneck
remains. In the wake of Finance Ministers announcement of his intention to abolish SICA in his
February 28, 2001 budget speech, all trade unions have expressed vehement opposition to the
proposal. The vehemence of labor’s opposition reflects their view that the repeal of SICA is part
of a general attack on labor represented by the Finance Minister’s packaging the abolition of the
BIFR with the reform of the Industrial Disputes Act to enable more firms to lay off workers.
Labor’s opposition seems disproportionate to the modest changes proposed, especially in light of
the fact that the new law protects labor’s interest by retaining the priority to reviving sick units
rather than closing them down and by addressing labor’s long-standing complaint about BIFR
delays. Nevertheless, labor’s opposition is that it emboldens the opponents of reform among the
NDA’s parliamentary opposition, especially within the Congress Party. The Congress has become an increasingly opportunistic opponent of economic reforms during the NDA’s reign. The NDA will need the support of at least some of its political opposition in order to pass legislation in the Rajya Sabha where it lacks a legislative majority.

Reforms of the capital market have not aroused formidable political opposition. The strongest opposition to important parliamentary legislation such as the Securities and Exchange Board Act of 1992 and the 1996 Depositories Act has come from the stockbrokers. However, they number only a few thousand in large measure because until the mid-90s they maintained rules that placed exclusionary restrictions on new membership. True, their influence was at times magnified by their allies in the world of Indian business, but ultimately they wielded power within the equity market sector rather than through national politics. Within the equity market sector, they exercised influence through various forms of persuasion, at times backed by their ability to affect the operation of the markets rather than by political clout.

To say that India’s equity markets have undergone a dramatic transformation in the 1990s is not to say that they do not continue to suffer problems. The stock market crisis of the spring of 2001 demonstrates many of the remaining problems. The manner in which the government has subsequently responded highlights the political dynamics of the sector. The problems that contributed to the crisis fall into three issues: market microstructure, regulation, and moral hazard at Unit Trust of India, the public sector intermediary that is the biggest single intermediary in India’s capital market.

In the spring of 2001, two elements of market microstructure combined to make Indian equity markets unique. Settlement was conducted through weekly account periods that were staggered across different days of the week on the country’s 23 exchanges. Liquidity for speculation at the major exchanges for the 200 most actively traded stocks was provided by different versions of carry forward finance that allow investors to carry forward their open positions from one settlement to another for up to ninety days. In combination, these features enabled intermediaries to assume positions that they could transfer from one exchange to another and across the settlements of a single exchange for long periods of time. In effect, they combined
cash and futures markets, and they offered powerful leverage that might be used to manipulate market prices. Beginning in 1999, Ketan Parekh, through his ten brokerages and network associated brokers, used these facilities to speculate on and allegedly drive the boom in select information, communications, and entertainment stocks. His favorite scrips were widely referred to as the K-10 stocks. When the global decline in technology stocks put downward pressure on the K-10, Parekh attempted to maintain his positions. Ultimately, his efforts failed. Ten brokers who were part of Parekh’s network defaulted after causing a payments crisis for three consecutive settlements in March 2001. Ketan Parekh, who became an object of multiple investigations, was arrested on charges of financial fraud March 30.

The practices encouraged by the settlement and carry forward features of market microstructure presented formidable demands on regulation of the stock exchanges. The March crisis reveals the areas where India’s regulatory agencies were not up to the challenge. The first level of regulation occurs through the stock exchanges as self-regulatory organizations. Here, major flaws appeared at the CSE. As a center of trade in cash-based industries such as tea and jute, Calcutta has a large pool of floating cash available to finance the carry forward system of the CSE. In fact, the brokers of the CSE are widely known to operate an “unofficial” carry forward market as well as an official one. The brokers associated with Ketan Parekh increasingly resorted to the “unofficial market” to meet their obligations as they became more desperation to defend their positions. If the “unofficial market” was completely unregulated, the official CSE market was poorly regulated. The exchange did not collect margins or monitor exposures properly. Officials at the CSE admit the problem but pin the blame on flawed software. However, a history of lax regulation of margins and exposures at India’s stock exchange’s along with the fact that the biggest defaulter, DK Singhania, was a prominent member of the CSE governing board suggests that there was more going on than just faulty software, or that there were ulterior motives for using the flawed package for such an extended period.

Problems also appeared at the Bombay Stock Exchange (BSE) when Anand Rathi became the second consecutive president of the BSE to leave the post under a cloud of alleged improprieties. The controversy arose after a tape-recording of the BSE president calling the BSE
surveillance department on March 2 to ascertain information on the outstanding positions of leading players in the market was made public. Rathi -- an active player through his five brokerage firms -- allegedly leaked the price sensitive information to other broker members of the BSE governing board who were sitting with him at the time of the call. In the wake of these charges, the Securities and Exchange Board of India (SEBI) forced all broker-members of the BSE governing board to resign.

The crisis incited strong criticism of SEBI. The agency’s earlier decision to permit the BSE to inaugurate a depository while the exchange management was under investigation for a 1998 scandal and the regulator’s efforts to perpetuate carry forward finance while delaying the introduction of rolling settlement left the impression that SEBI was biased in favor of the brokers. SEBI was criticized for tolerating the CSE’s “unofficial” market and allowing its lax supervision of trading. SEBI also neglected warning signs of market manipulation. Trading levels of K-10 stocks grew to extraordinarily high levels while deliveries remained at low levels suggesting the possibility of circular trading. Leveraged trading on K-10 stocks to sustain long-positions grew as prices steadily declined. Parekh’s desperate search for finance to sustain his positions led to his illicit collusion with the management of Madhavpura Mercantile Cooperative Bank (MCCB). Together, they defrauded the bank of an estimated Rs. 12 billion. They were exposed when only after the MCCB was unable to make good on a Rs. 140 cr. pay order that Parekh had presented to the Bank of India. The revelation embarrassed the Ministry of Finance and caused the Minister of Finance to face heavy criticism in Parliament. It was only after SEBI felt intense pressure from the ministry that it took serious and, in some cases, misguided measures to investigate and rectify the situation.

The decline in the market that accompanied the Ketan Parekh scandal exacerbated long-standing problems in the Unit Trust of India’s (UTI’s) flagship investment fund US-64. UTI was created by a 1963 act of parliament. It began US-64, the following year in order to mobilize investments throughout the country for India’s capital markets. By the spring of 2001, US-64 remained was by far the country’s largest fund accounting for approximately 17 percent of all mutual fund assets. It attracted 4.5 million investors by offering high dividends and fixed redemption prices that held regardless of market fluctuations. The decline in market prices
during the first half of 2001 caused a growing gap between US-64’s administered prices and its underlying value, and a stream of investors began to redeem their units. The situation deteriorated to the point where UTI Chairman P.S. Subramanyam suspended redemptions on July 2. His announcement caused furor that forced Subramanyam to resign two days later.

The causes underpinning US-64’s problems were deeply rooted in its organization and relationship with the government. They were incisively analyzed by the Deepak Parekh Committee, which had been convened by the Ministry of Finance to recommend reforms as part of a Rs. 33 billion bailout in 1999. The Parekh Committee recommended that US-64 convert to net asset value pricing within three years. It declared that management of US-64 should be transferred from UTI to an asset management company. It urged that US-64’s holdings be restructured to reduce its 70 percent holdings in equity to 40 percent, and it recommended that US-64 be brought under the supervision of SEBI. More than two years after the bailout, UTI had made virtually no progress on any of these recommendations. It missed the opportunity to easily convert to NAV when the effective NAV of US-64 exceeded its administered price throughout most of 2000. US-64 continued to operate without the transparency associated with contemporary mutual funds. It lacked a clearly articulated investment strategy, and it informed the public about only 75 percent of its holdings. During the spring of 2001, the market was rife with rumors that UTI had provided funds to bail out Ketan Parekh. On July 9, 2001, Finance Minister Yashwant Sinha announced that he was initiating an investigation of UTI for insider trading.

The Ministry of Finance announced a series of reforms were announced in the aftermath of the crisis. It was under tremendous political pressure, especially after a Joint Parliamentary Committee (JPC) was formed to investigate the crisis. On March 13, the Finance Minister declared that he would introduce compulsory rolling settlement, strengthen SEBI and divorce brokers from exchange management by demutualizing the stock exchanges. On July 2, account period settlement and carry forward finance was terminated for the country’s 200 most traded stocks and rolling settlement was introduced with futures trading was permitted on 31 scrips. The government announced on July 14, that it was ready to amend the SEBI Act to add four full time members to the SEBI board, enhance the regulatory agency’s investigative powers, and
increase the penalties that it can levy. On July 15 UTI initiated a plan to allow redemption at fixed prices until May 2003 for small investors holding less than 3000 units and to convert to NAV by January 2002 for new investors while providing an option for current investors to switch to NAV prices.

**Concluding Remarks**

This examination of the political economy of reform in India’s fiscal and financial sectors has highlighted the unevenness of the reform process. Our discussion of fiscal politics at the national level demonstrates how the fragmentation of the party system and the rise of single-state parties has impeded efforts to curb the central government’s fiscal deficit. Remarkably, these changes in the party system have been less of an impediment to reforms of India’s fiscal federalism. India’s central government has achieved some surprising success in orchestrating the states’ acceptance of incentives for greater fiscal discipline. It has also rose to the challenge of bringing about the coordination among the states necessary for establishing a value-added tax. While important changes have taken place in India’s financial sector, reform has transformed India’s equity markets more dramatically than its banking system. Strong resistance from labor has until now stifled efforts to reform India’s bankruptcy policy for industrial corporations at least since 1993. At the same time, reforms have transformed India’s equity markets in terms of its market microstructure and regulation.

India’s political process is frequently lamented as a bottleneck to its reform process, especially with the fragmentation of the national party system. However, there are pockets, such as equity markets, with substantial reforms. The unevenness of India’s reforms suggests that it is useful to take a more nuanced view of the political process. An important explanation of that unevenness may be that in reform policies are more insulated from the parliamentary process in some sectors. Yet, in the relatively dynamic equity market sector, some of the most important changes, e.g. the empowerment of SEBI and the establishment of depositories, were accomplished through parliamentary legislation. The manner in which policies structure politics may be an important variable in the relative success of reforms. Policies that redistribute resources away from well entrenched groups like organized labor will meet strong resistance
until their opposition can be counterbalanced by other sources of support. Policies that redistribute resources from the leaders of single-state parties at the national level will require the coordination among the national political leadership to overcome the not-in-my-backyard mentality that often delays or stifles reforms. The reforms that have been implemented in India’s fiscal federalism suggest that distributive policies that enable the central government to create incentives for reform by allocating resources in ways that reward reformers and penalize opponents may have more scope for success. Finally, the experience of India’s equity markets suggests that developmental policies that reform market create institutions to make markets more efficient and equitable may be a politically viable path to reform. Economic reformers would do well to study how different policy types shape the incentives of political actors in their efforts to pilot reforms through the political process.
Figure 1: Number of Effective Parties in India’s Parliament Since 1952

Figure 2: Percent Parliamentary Seats Won By India’s Two Main Coalitions, 1996-99
Figure 3: Parliamentary Seat and Vote Share of Single-State Parties Since 1952


The number of “effective parties” is now the standard measure of how concentrated legislative seats and vote shares are within a party system. It is the reciprocal of the Hirschman-Herfindahl index used in the industrial organization literature to measure how concentrated sales are in a given industry. If there are N parties in a parliament, and each party won an identical number of seats, the number of “effective parties would be N. Different numbers of parties and different distributions of seats can arrive at the same number of effective parties. Formally the measure can be stated: \( N = \frac{1}{\sum p_i^2} \) where N is the number of effective parties by seats and \( p_i \) is the percentage share of seats won by party i. See Markku Laakso and Rein Taagepera, “‘Effective’ Number of Parties: A Measure with Application to West Europe,” *Comparative Political Studies* 12 pp. 3-27.


Indira Gandhi began this trend in 1971 with her “Garibi Hatao” or “Remove Poverty” slogan. In 1977, the Janata Party removed Indira Gandhi after the authoritarian interlude that was the Emergency with its slogan “Janata Yaa Tanashahi” (Democracy or Dictatorship”). After the factional infighting of the Janata Party administration, Indira Gandhi returned to power with the slogan “Elect a government that works!” In 1984 it was the “sympathy wave” favoring the Congress after Indira Gandhi’s assassination. Finally, in 1989, “Bofors” -- referring to a deal between the national government and the Swedish arms manufacture in which close associates to Prime Minister Rajiv Gandhi were charged with taking kickbacks – was used to mobilize the anti-corruption vote to oust the Congress Party.

Note that the periodization is slightly different from that for the development of coalition politics. I have altered it based on the inductive observation that “Bofors” was a national issue. If we stick to the previous periodization for the development of coalition politics averages are as follows. The number of parliamentary seats and vote share won by single-state parties from 1971 to 1984 are 11% and 15.7%. The shares for 1989 to 1999 are 21.4% and 25.4%.


For more on the decentering of India’s political system see John Echeverri-Gent, “Politics in India’s Decentered Polity,” in Philip Oldenburg and Alyssa Ayres (eds.) *India Briefing 2002* (New York: Asia Society, forthcoming).


14 Data in this paragraph is from Lahiri, “Subnational Public Finance in India,” p. 1540-41.


17 For an analysis of the race to the bottom versus the race to the top among India’s states see Lloyd I. Rudolph and Susanne Hoeber Rudolph, “Iconisation of Chandrababu: Sharing Sovereignty in India’s Federal Market Economy,” *Economic and Political Weekly* (May 5, 2001) pp. 1541-52. I offer an extension of the Rudolph’s analysis that state governments may not view the new fiscal discipline as a burden because it is a way to defend their autonomy from local political pressures by contending that desire for autonomy is motivated by inter-state competition for private investment.


20 Taiwan experienced extraordinary growth in value traded during the period. Its share of value traded in emerging markets jumped from 17.6 percent for 1980-82 to 76.8 percent in 1989-91. After removing this outlier from both time periods, India’s share still declined from 23.8 percent to 10.3 percent.

21 Interview with Dr. Manmohan Singh, New Delhi, July 20, 1999.

22 Ajay Shah and Susan Thomas estimate that the costs of the core IT infrastructure necessary for an exchange, clearing corporation, and depository dropped from $100 million in the late eighties to just $4 million by the end of the 1990s. See Ajay Shah and Susan Thomas, “Securities market infrastructure for small counties,” Indira Gandhi Institute for Development Research, Mumbai, April 21 2001, p. 9.

23 John Echeverri-Gent, “Economic Governance Regimes and the Reform of India’s Stock Exchanges,” a paper presented at the International Political Science World Congress, Quebec City, August 1-5, 2000.

24 India’s leading business associations, the CII and FICCI have called for winding up the BIFR. The recommendations of the Andhyarujina Committee and the RBI Advisory Committee on Bankruptcy have also built support for reform of India’s bankruptcy laws.


It is widely stated in the press that US-64 has twenty million investors. In fact, it has 20 million unit holders, but since investors often own more than one account the total investors number between 4 and 4.5 million.

For a valuable treatment that suggests that the India’s political process is more amenable to reforms than is commonly perceived see Rob Jenkins, *Democratic Politics and Economic Reform in India* (Cambridge: Cambridge University Press, 1999).