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Author(s): Ashutosh Varshney

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India's Democratic Challenge

Ashutosh Varshney

CHARTING A NEW PATH

INDIA IS attempting a transformation few nations in modern history have successfully managed: liberalizing the economy within an established democratic order. It is hard to escape the impression that market interests and democratic principles are uneasily aligned in India today. The two are not inherently contradictory, but there are tensions between them that India's leaders will have to manage carefully.

Students of political economy know that market-based policies meant to increase the efficiency of the aggregate economy frequently generate short-term dislocations and resentment. In a democratic polity, this resentment often translates at the ballot box into a halt or a reversal of pro-market reforms. In the West, such tensions have remained moderate for at least three reasons: universal suffrage came to most Western democracies only after the Industrial Revolution, which meant that the poor got the right to vote only after those societies had become relatively rich; a welfare state has attended to the needs of low-income segments of the population; and the educated and the wealthy have tended to vote more than the poor.

The Indian experience is different on all three counts. India adopted universal suffrage at the time of independence, long before the transition to a modern industrialized economy began. The country does not have

ASHUTOSH VARSHNEY is Professor of Political Science at the University of Michigan and the author of *Ethnic Conflict and Civic Life: Hindus and Muslims in India* and *Democracy, Development, and the Countryside: Urban-Rural Struggles in India*.

an extensive welfare system, although it has made a greater effort to create one of late. And, defying democratic theory, a great participatory upsurge has marked Indian politics, a phenomenon that is only beginning to be understood by scholars and observers: since the early 1990s, India's plebeian orders have participated noticeably more in elections than its upper and middle classes. In fact, the recent wisdom about Indian elections turns standard democratic theory on its head: the lower the caste, income, and education of an Indian, the greater the odds that he will vote. The ruling United Progressive Alliance (UPA), a coalition with the Indian National Congress at its core, counts on the lower social orders as its most important voting bloc.

India's development experience is also likely to be distinct from East Asia's. South Korea and Taiwan embraced universal-franchise democracy only in the late 1980s and the mid-1990s, two decades after their economic upturn began. Other economically successful countries in the region, such as China and Singapore, have yet to become liberal democracies. Periodic renewals of mass mandates through the ballot box are not necessary in authoritarian countries, but they are in India. Democratic politics partly explains why, for example, privatization has gone so slowly in India compared to in China. In India, workers have unions and political parties to protect their interests. In China, labor leaders who resist job losses due to privatization are tried and jailed for treason and subversion, something entirely inconceivable in India's democracy.

So far, the reform process of the last 15 years has had positive results: by most conventional standards, India's economy is booming. After registering a 6 percent average annual growth rate for nearly a quarter century, the Indian economy has picked up even greater speed. Over the last three years, it has grown at over 8 percent annually, and forecasts for the next few years promise more of the same. Investment as a proportion of GDP has been steadily climbing, exceeding 30 percent lately and raising hopes of an investment boom like that which propelled East Asia's economies. Total foreign direct investment for the current financial year is likely to exceed \$10 billion (compared with \$100 million in 1990-91) and is rising. Exports are growing at a fast clip, with India's trade-to-GDP ratio more than doubling in 2006 from its 1991 level of 15 percent. The manufacturing



B. MATHUR/REUTERS

Unconvinced: Indian protesters carrying an effigy representing value-added tax, New Delhi, March 29, 2005

sector, like the services sector, is becoming a key engine of the economy, and India's world-class information technology sector continues to grow exponentially, employing less than 0.5 percent of India's labor force but producing about 5 percent of the nation's GDP. Corporate dynamism, rarely associated with India in the past, is fast changing the business map of the country, and India, in turn, is rapidly becoming an important factor in the global strategies of the world's leading international firms.

But how long will the boom last? That depends on India's democratic politics, where economic growth has fed pressures for the redistribution of wealth. Mainstream economic theory about markets and human welfare holds that markets will benefit all in the long run. But long-term perspectives do not come naturally to democratic politicians, who must focus on winning elections in the short term. Accordingly, a low-income democracy such as India must nurture the energies of its entrepreneurs while, in the short run, responding to the reservations and resentments of the masses. How well India's politicians walk this tightrope will determine the outcome of the country's economic transformation.

HOW IT ALL BEGAN

IN KEEPING with the prevailing theories in development planning after World War II, in the 1950s India opted for a centrally planned economy with a closed trade regime, heavy state intervention, and an industrial policy that emphasized import substitution. This pro-state and trade-pessimistic development model was characterized by three sets of controls: internal, external, and those relating to the special role of the public sector. The internal regulatory regime heavily employed investment and production controls through an infamous industrial licensing system that regulated aspects of economic activity as varied as plant capacity, output prices, the quantity of capital, the quantity and type of inputs, technology, and the sectors or industries that were required to be reserved for small-scale investors. A host of tariff and quantitative controls were created to protect “infant” domestic producers from external competition. And the public sector was allowed extraordinary authority over the commanding heights of the economy, including the steel, power, telecommunications, and heavy machinery industries.

It was within this thicket of protectionist policies that, in July 1991, reformers in the Congress-led government began to push hard for economic transformation under the looming prospect of a balance-of-payments crisis. Some reforms had already been put in place by Prime Minister Rajiv Gandhi in the mid-1980s, but the big thrust came in 1991–92 as a result of that looming crisis. The finance minister at the time, Manmohan Singh (currently India’s prime minister), argued that the macroeconomic stabilization necessary to stave off a crisis was not enough; it had to be reinforced by reforms to make the decision-making and operational environment of firms more market-based. Thus began a series of incremental reforms, which the BJP (Bharatiya Janata Party) continued after it came to power at the head of the National Democratic Alliance (NDA) coalition in 1998.

In some areas of economic policy, progress has been dramatic; in others, little or no progress has been made. India’s investment regime has undergone the most extensive reform. The industrial licensing system has been almost completely abolished. Firms are free to make decisions about investment, pricing, and technology.

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Only three industries—rail transport, military aircraft and ships, and atomic energy generation—are now reserved for the public sector (instead of 18 in the past), and these, too, are beginning to welcome collaboration with private industry on some activities. The rules governing foreign investment have been substantially liberalized. Complete foreign private ownership in a large number of industries, and majority private ownership in most industries, is allowed, excluding airlines, insurance companies, and the major retail trade. And since 1992, foreign institutions have been allowed to buy and sell stocks in Indian firms. Indian companies, in turn, are now free to issue equity in foreign markets.

A great deal of progress has also been made in reforming India's trade and exchange-rate regimes. India now has a flexible exchange-rate system. The average tariff on imports has come down from over 100 percent to just under 25 percent today, and all quota restrictions on trade have been lifted.

Progress has been limited, however, in five areas: fiscal policy, privatization, small-scale industry, agriculture, and labor law. India's fiscal deficits continue to be high. Large agricultural subsidies for inputs, grain, and power are some of the main contributors to these deficits, and almost every attempt at lowering the subsidies has been met by political protests on behalf of farmers. A start toward privatization was made in 2001, but unions and some political parties have vigorously resisted it. To help millions of small producers, many manufactured products continue to be reserved for "small-scale investors" (a status that caps investment at \$250,000 per industrial unit), although in 2001, garments, toys, shoes, and auto components were finally removed from the reserved list. No proposal for a complete dereservation of all industries has yet been seriously entertained, hampering the ability of many Indian companies to compete with their counterparts in other developing countries, notably China. And labor laws have not been reformed, meaning that no company operating in India employing more than 100 workers can fire any without government permission—and permission is almost never granted.

How long will the boom last? That depends on India's democratic politics.

WHAT'S IN IT FOR ME?

WHO HAS really reaped the benefits of the reforms? India has always had a small number of affluent individuals, symbolized by its maharajahs and business tycoons. Now the proportion of the population that is rich has undoubtedly increased, and a substantial middle class has emerged, numbering anywhere between 200 million and 250 million, depending on the measure used. In what is fast becoming an emblem of the rising Indian middle class, six million cell phones are bought every month, making India the fastest-growing market for cell phones in the world. Businesses in the cities are booming, five-star hotels are fully booked, airports are clogged, and flights are regularly oversold.

At the same time, the begging bowls and emaciated faces of malnourished children, historically the most visible signs of mass deprivation on the streets of Indian cities, have not appreciably receded. Poverty has clearly decreased since the reforms began, when roughly a third of the country was below the poverty line, but close to a fourth of the population still lives on less than \$1 a day, much to the disappointment of many reformers who had expected a faster decline. The nation's growth on the whole has not been employment-intensive.

Where inequality is concerned, two issues are hotly debated: urban-rural imbalances and the interpersonal income distribution. Over the last ten years, India's economy as a whole may have grown at more than 6 percent per annum, but agriculture, which still supports, fully or in part, around 60 percent of the country's population, has grown at a mere 2.2 percent annually. To be sure, growth rates in agriculture are rarely as high as those in manufacturing and services, but the gap in India has become noticeably large. It is now widely accepted throughout India that urban-rural inequalities have grown since the reforms began.

The statistics on interpersonal income distribution are less conclusive, partly because such data tend to be highly unreliable for developing countries. But opinion polls make it quite clear that a very large proportion of the population believes the reforms have mostly benefited "the rich," which in the public's eye includes the middle class in India. The largest-ever sample drawn for election analysis in India, by the National Election Study (NES) in 2004, showed that those who believed

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the reforms had benefited only the affluent outnumbered those who thought the reforms had benefited the whole nation; the more one climbs down the social ladder, the greater the former belief. Upper-caste respondents were nearly split on the question, but a wide margin of respondents lower on the socioeconomic scale—especially ex-untouchables, Muslims, and other underprivileged groups—believed the reforms had mainly benefited the rich. The survey results also showed that those who believed the reforms had benefited the whole country voted in large numbers for the BJP-led NDA, whereas those who thought the rich were the only beneficiaries voted disproportionately for Congress and its allies.

These perceptions may not necessarily match reality. It is particularly unclear how the masses interpret the term “reforms.” The NES polls focused on only one side of the economic reforms by asking questions such as whether the number of employees in government service should be reduced, whether public-sector businesses should be privatized, and whether foreign companies should be allowed to freely enter the Indian economy. But other questions, reflecting a fuller view, were not asked: Should import tariffs be dropped further so as to allow for the greater availability of cheap consumer goods? Should the rules regulating how banks and post offices function be made easier and more transparent? Should big companies continue to be protected by the government, or should new and smaller companies be allowed to emerge and compete with them? Should the government interfere less in regard to where and at what price to sell grain? Should loss-making government firms be privatized if a substantial proportion of their proceeds could be reserved for public health and education? It is unclear how the masses would respond to a complete picture of reforms and, accordingly, whether the underprivileged segments of society would support deeper reforms.

Whatever better statistics may finally prove, mass perceptions matter in politics. And the overall picture that emerges from current perceptions of the reform process is one of two Indias: an India of booming businesses, growing cities, and a vibrant middle class and an India of struggling agriculture, poor villages, and a large lower class. The rising tide produced by economic liberalization appears to have lifted many boats, but not all. Too large a segment of the population

feels ignored by the new economic policies. The current Indian government has thus unsurprisingly made two objectives clear regarding the economy: keep growth strong, but make it more inclusive through public policy. Leaving markets entirely to themselves is not politically feasible in a low-income democracy such as India.

THE DEMOCRATIC CONSTRAINT

THERE ARE two aspects to the challenge reformers face within India's democratic context: perceptions of the reforms to date and the short-term pain likely to accompany the deeper reforms to come. The economic reforms undertaken thus far have not been those that would directly affect the lives of India's poor masses, and this has fed their resentment against the reforms, which they believe have only benefited the upper and middle classes. The employment effect of the reforms—while significant in skill- and capital-intensive sectors—has not been substantial enough throughout the economy to ameliorate this resentment. Further pro-market reforms—the large-scale privatization of public-sector firms, the implementation of a hire-and-fire employment policy, changes in agricultural policy, radical changes in small-industry sectors, and the drastic reduction of fiscal deficits—will undoubtedly have a direct effect on the lives of the masses, but the long-term benefits of these reforms for India's lower classes are likely to be accompanied by considerable short-term pain. The electoral consequence of this likelihood has meant that Indian politicians have proceeded gingerly on these deep reforms, embracing instead those that directly affect the elite.

It is therefore helpful to think of India's reform politics as following two tracks: what may be termed elite politics and mass politics. This distinction is absolutely crucial in understanding India's reform dynamics. In India, the elite consists mainly of English-speaking upper-caste and urban citizens. Elite politics in India typically takes place in the upper realms of the public sphere: in the interactions between business and government and in the dealings between New Delhi and foreign governments and international financial institutions. Outside government, the upper end of the public sphere includes English-language newspapers and television and the Internet. To the elite, India's economic future has never looked brighter.

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But India's mass politics is dancing to a different tune. It is the plebeian social orders that make up this political constituency. Streets and the ballot box are the primary sites of the mass politics, and voting, demonstrations, and riots its major manifestations. Economic reforms are viewed by the poor masses as a revolution primarily for everyone but them. Economists may recommend a more passionate embrace of neoliberalism as a solution to India's poverty, but the poor appear to have plenty of reservations about economic reforms—and they have voting clout in India's democracy.

One can therefore see why elite-oriented reforms (making investment in real estate easier, deregulating the stock market, liberalizing civil aviation) have continued under the current government in India, whereas more radical reforms (changing labor laws, privatizing public enterprises, eliminating agricultural subsidies) have stalled. The latter have run into what might be called a mass-politics constraint. As a result, it is now customary to argue that India has a “strong consensus on weak reforms.”

Three factors are typically critical in determining whether any particular policy enters the arena of mass politics: the number of people affected by the policy, how organized those people are, and whether the effect is direct and immediate or indirect and over a long time horizon. The more people affected by a policy choice, the more organized they are, and the more direct the policy's effects, the more likely it is that a policy will generate mass concern.

By this logic, some economic issues are more likely to arouse mass opposition than others. Inflation, for example, quickly becomes a contentious matter in mass politics because it affects most segments of the population. A financial meltdown has a similar effect, because a large number of banks and firms collapse and millions of people lose their jobs. In comparison, stock markets directly concern mainly shareholders, whose numbers are not likely to be large or very organized in a poor country such as India. As a result, short of a financial collapse, stock-market issues rarely, if ever, enter the fray of mass politics in less developed countries. Ethnocommunal conflicts, not economic issues, have until now driven mass politics in India. The consequences of ethnic

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cleavages and ethnically based policies tend to be obvious to most people, and ethnic groups are either already organized or can organize quickly.

Unlike the economic reforms already implemented, the deeper changes that many economists argue India needs for long-term growth are, by directly affecting the masses—and affecting them negatively to begin with—likely to arouse the passions of the lower class. In India's highly adversarial democracy, political leaders will continue to find it extremely difficult to stake their political fortunes on economic reforms that are expected to cause substantial short-term dislocations and are likely to produce rewards only in the long term. Meanwhile, identity politics—especially caste-based affirmative action and Hindu-Muslim relations—continue to occupy the center of the political stage, consuming substantial political attention and determining electoral fortunes. As a result, what is of great consequence to mainstream economists is of secondary importance to politicians, who prefer predictability in and control over their political universe.

THE SOURCES OF CONGRESS' CONDUCT

NONETHELESS, ECONOMIC reform has been growing in importance in India's electoral politics over the last decade. In a survey of mass political attitudes in India conducted in 1996, only 19 percent of the electorate reported any knowledge of the economic reforms that had been implemented, even though the reforms had been in existence since 1991. In the countryside, where more than 70 percent of Indians then lived, only about 14 percent had heard of the reforms (compared with 32 percent of voters in cities). Nearly 66 percent of college graduates were aware of the dramatic changes in economic policy, compared with only 7 percent of the illiterate poor. (In contrast, close to 75 percent of the electorate—urban and rural, literate and illiterate, rich and poor—reported knowing of the demolition of the mosque in Ayodhya in 1992, and 87 percent took a stand on caste-based affirmative action.) Economic reforms were a nonissue in the 1996 and 1998 parliamentary elections. In the 1999 elections, the biggest reformers either lost or did not campaign on pro-market platforms.

The 2004 parliamentary elections that returned Congress to power, however, hinted at the rising importance of economic reforms to India's

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mass politics. In dramatic contrast to 1996, when a mere 19 percent of voters even knew of the reforms implemented up to that point, in 2004, according to the NES election survey, over 85 percent expressed clear judgments of them—and the main verdict was that the reforms were primarily elite-serving.

To be sure, economic issues were still not the main reason for the NDA's election defeat in 2004. Its loss had more to do with regional politics and party alliances. Coalition partners in India tend to be regional parties that are strong only in one or two states (India is made up of 28 states), and national parliamentary elections consequently depend heavily on how regional parties in the large states perform. In two significant states, Andhra Pradesh and Tamil Nadu, the regional allies of the BJP did disastrously. The key issues in these and other states were more regional in nature, rather than related to national or economic issues. The way coalition arithmetic translates to parliamentary seats further undermined the NDA. In a first-past-the-post parliamentary system such as India's, parliamentary seats are not allocated in strict proportionality to ballots won. In the 2004 election, although the BJP-led NDA trailed the Congress-centered UPA by a mere 0.6 percent of the overall popular vote, the latter won a 33-seat advantage (222 seats as opposed to 189 for the NDA).

Nevertheless, the 2004 electoral results suggest that the pressure on politicians to make reforms relevant to the masses is rising, even if it has not yet reached a critical threshold. Resentment of reforms may well prove decisive in the next election, due by 2009. The increasing mass disaffection with the economic reforms helps explain the economic policies of the current government. The 2004 election led Congress' strategists to the conclusion that the party needed to focus its program on the lower and middle echelons of society, which have become the party's main constituency. The Indian government today has some of the ace reformers of post-1991 India, including Prime Minister Singh, Finance Minister Palaniappan Chidambaram, and the economic planning czar, Montek Singh Ahluwalia. But two of its biggest initiatives have been distinctly antimarket: the National Rural Employment Guarantee Act and the extension of affirmative action in higher education. The first measure, passed by Parliament in August 2005, guarantees every unemployed rural household that

each year at least one of its members will get 100 days of work. (The scheme, currently in operation in 200 districts, is slated to be extended to the entire country over the next two years.) The second reform reserves 27 percent of the spaces in government-aided institutions of higher education, including the Indian Institutes of Technology and the Indian Institutes of Management, for the “other backward castes.”

The UPA is dependent on the left for its parliamentary majority, but this is only part of the story that explains these antimarket measures. More germane is the character of the constituency that now forms the main pillar of Congress’ support. Until the mid-1980s, Congress was an umbrella party drawing substantial support from all segments of

Antimarket
interventions form
the centerpiece of
Congress’ new
political strategy.

society, but the BJP and its coalition have since come to represent the socially privileged, the educated, and high-income groups. The upper segments of society constitute no more than 25–30 percent of India’s population. Given the kind of support they have given the BJP and its allies over the last ten years, getting them back under the Congress umbrella is not as electorally promising as consolidating gains in

the much larger middle and lower segments—especially given the latter’s higher rates of voter turnout. It is therefore no surprise that targeted antimarket interventions on behalf of the lower social orders form the centerpiece of Congress’ new political strategy.

The BJP, although less constrained than Congress, cannot entirely escape these pressures either. If the BJP is to regain and hold on to power, it will have to resolutely move down the socioeconomic ladder for support, something it has already begun doing. Even a BJP-led government would therefore be expected to push a program of targeted state interventions. Unless the upper segments of Indian society regroup and begin to participate in elections more, they will dwindle as a power in electoral politics, in spite of their control of the press. And until the middle class becomes a majority of the population and starts to participate more vigorously in elections, the plebeian pressures will remain in politics and India’s economic reforms will continue to have an ostrich-like character: moving ahead on policies directly affecting the elite but lagging behind on policies that directly, and negatively, hit the masses.

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A TORTOISE TO CHINA'S HARE?

ALTHOUGH THE mass-politics constraint on India's economic reforms is now beginning to emerge, it need not be a reason for alarm. India's democracy is a short-term constraint but a long-term asset for pro-market reformers. The stability of Indian democracy is not in question. Whichever coalition of parties comes to power, reforms on the whole will continue. Since 1991, four coalitions have ruled India, and none has departed from the path of reforms. The differences have been those of degree and pace, not direction. There is no going back to the old statist economic regime. A middle class with rising incomes that boasts 200 million to 250 million people will continue to attract investor attention. The nation's remarkable human capital at the middle-class level will also draw investors. Moreover, there will continue to be economic reforms largely impervious to the constraints of mass politics: changes to the financial sector, greater rationalization of tax structures, further simplification of investment rules, the liberalization of real estate development, and the modernization of airports.

The mass-politics constraint does mean, however, that reformers in India will have to juggle two separate tasks in the short to medium term: continuing reforms in the elite-oriented sectors and responding to mass needs through further antimarket state interventions. And if market-oriented economic reforms are to be embraced in areas directly relevant to the masses, politicians will have to answer the following questions: How will the privatization of public enterprises, the reform of labor laws, and the lifting of agricultural subsidies benefit the masses? And how long will the benefits take to trickle down? All of these reforms are likely to enhance mass welfare in the long run. Therefore, for democratic politicians, this problem will effectively mean taking measures such as reserving a substantial proportion of the proceeds from privatization for public health and primary education, constructing safety nets for workers as labor laws are reformed, and coming up with a plan for a second green revolution in agriculture in return for drawing down the current huge agricultural subsidies. The last one, in particular, will require both opening up agriculture to market forces and greater public investment in irrigation, agricultural research, and rural infrastructure and education.

But although democratic politics makes life challenging for reformers, it could also turn out to be a huge benefit in the long run. Consider the counterexample of China. It is hard to believe that the single-party state in China will not eventually be challenged from within the existing party structure, by the burgeoning middle class, or by rising peasant and labor unrest. The attendant economic consequences of a political transition or upheaval in China are uncertain. In contrast, democratic India has a viable solution to the problem of political transition: the party, or coalition of parties, that wins elections will run the government. Transition rules are now deeply institutionalized in India, and long-term political stability is a virtual certainty.

The long-term benefits of India's democracy are enhanced by its rule of law and advanced capital markets. Firm-level innovation is normally facilitated by copyright laws and the rewards that capital markets bring to innovative firms. The rule of law continues to evade China, and its capital markets are heavily government-dominated. Who knows what will happen to China's economic progress when, faced with competitive pressure from lower-cost producers, it loses its comparative advantage in labor-intensive mass production. India's innovative firms and skilled labor, on the other hand, are already beginning to make a mark on the international scene—a trend that is likely to continue in the coming years. 🌐