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## Mass Politics or Elite Politics? India's Economic Reforms in Comparative Perspective

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This chapter addresses two questions: (i) why was India's minority government in 1991 successful in introducing economic reforms, whereas a much stronger government, with a three-fourths majority in parliament, was unable to do so in 1985? and (ii) why have post-1991 reforms made substantial progress in some areas but stalled in others? In answering the two questions, my argument draws a distinction between mass politics and elite politics. It is a distinction that has not been adequately appreciated in the truly voluminous literature on the politics of economic reforms.<sup>1</sup> Scholars of economic reforms have generally assumed that reforms are, or tend to become, central to politics. Depending on what else is making demands on the energies of the electorate and politicians—ethnic and religious strife, political order and stability, corruption and 'crimes' of the incumbents—the assumption of reform centrality may not be right. The main battle lines in politics may be drawn on issues such as how to avoid (or promote) further escalation of ethnic conflict, whether to support

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<sup>1</sup>This is also true of the two most comprehensive and widely read political economy texts on reform: Haggard and Kaufmann (1995), and Przeworski (1991).

(or oppose) political leaders if there has been an attempted coup, whether to forgive (or punish) the 'crimes' of high state officials. Paradoxically, it may be easier to push through reforms in a context like this, for politicians and the electorate are occupied by matters they consider more critical. Economic reforms may not cause the political opposition they otherwise would.

Elite politics is typically expressed in debates and struggles within the institutionalized settings of a bureaucracy, a parliament, a cabinet. Mass politics takes place primarily on the streets. Touched off by issues that unleash citizen passions and emotions, the characteristic forms of mass politics include large-scale agitations, demonstrations and civil disobedience: riots and assassinations are also not excluded. Whether or not we like such politics, it has profound consequences. In democracies, especially poor democracies, mass politics can redefine elite politics, for an accumulated expression of popular sentiments and opinions inevitably exercises a great deal of pressure on elected politicians. Elite concerns—investment tax breaks, stock market regulations, custom duties on imported cars—do not necessarily filter down to mass politics.

What, analytically speaking, determines whether a policy—economic, cultural, or political—would enter mass politics? Three factors are typically decisive: (a) how many people are affected by the policy, (b) how organized they are, and (c) whether the effect is direct, obvious, and short-run, or indirect, subtle and long run. The more direct the effect of a policy, the more people are affected by it, and the more organized they are, the greater the potential for mass politics.

Ethnic disputes tend quickly to enter mass politics because they isolate a whole group, or several groups, on an ascriptive basis. They also directly concern political parties—both ethnically based parties (which may defend, or repel attacks on, their ethnic group) and multiethnic parties (which may fiercely fight attempts to pull some ethnic groups away from their rainbow coalitions). Because they invoke ascriptive, not voluntary, considerations, the effect of ethnic cleavages and ethnically-based policies are obvious to most people and, more often than not, ethnic groups are also organized, or tend to organize quickly. Not all aspects of economic policy invoke passions and have such effects; some do, others do not. For example, by affecting more or less everybody, high inflation

quickly gets inserted into mass politics.<sup>2</sup> Contrariwise, capital markets directly concern only the shareholders, whose numbers in most developing economies are not likely to be large and who may not be organized. As a result, stock market disputes rarely enter mass politics in developing countries.<sup>3</sup> Other examples of economic policies that can enter mass politics are discussed later.

It is important to keep these considerations in mind because in large parts of the developing world, two different political processes—one provoked by ethnic conflicts and the other stemming from market-oriented economic reforms—are simultaneously under way. However, scholars of economic reform and their counterparts in the field of ethnicity and nationalism have on the whole constituted two separate groups. Such segregation has made the discussion of the politics of economic reform unduly restrictive. In multiethnic societies, economics may simply be one of several issues on the political agenda, and not always the most contested one. Ethnicity may be more contested, stirring mass passions and determining alignments of political parties.

Consider the evidence from India. In the largest ever survey of mass political attitudes in India conducted between April–July 1996, only 19 per cent of the electorate reported any knowledge of economic reforms, even though reforms had been in existence since July 1991 (Yadav and Singh, 1996).<sup>4</sup> Of the rural electorate, only about 14 per cent had heard of reforms, whereas the comparable proportion in the cities was 32 per cent. Further, nearly 66 per cent of the graduates were aware of the dramatic changes in economic policy, compared to only 7 per cent of the poor, who are mostly illiterate. In contrast, close to three-fourths of the electorate—both literates and illiterates, poor and rich, urban and rural—were aware of the 1992 mosque demolition in Ayodhya; 80 per cent expressed clear opinions about whether the country should have a uniform civic code or religiously prescribed and

<sup>2</sup> With the exception of those whose incomes are protected by inflation indexation.

<sup>3</sup> Again, in countries where mass privatizations have taken place and shares have been distributed to the masses, this may not be true.

<sup>4</sup> The survey was conducted by Yadav and Singh on behalf of the Centre for the Study of Developing Societies (CSDS), India's premier research institution for election studies. For the larger audiences the findings were summarized in *India Today*, 31 August 1996. All figures cited below are from the CSDS survey.

separate laws for marriage, divorce, and property inheritance; and 87 per cent took a stand on caste-based affirmative action.

These statistics should clarify that the raging debate over economic reforms in India is, for all practical purposes, confined to the English-language newspapers, the country's graduates, the discourse on the internet, the Bombay stock market, and Delhi's India International Centre and its economic ministries. That is the circle of India's elite politics. Economic reforms were simply a non-issue in the 1996 and 1998 elections (Yadav and McMillan, 1998). Ethnic and religious disputes, secularism, caste-based affirmative action, and social justice have been driving India's mass politics over the last 10–15 years. Expressions of India's identity politics, these issues have led mass mobilization, insurgencies, riots, assassinations, desecrations and destructions of holy places. In mass perceptions, the significance of identities has been far greater than the implications of economic reforms.

Is India peculiar in this respect? Has the predominance of identity politics hurt India's economic reforms? Are there elements in the reform package that can bring it in mass politics? My answer, and the principal argument of this chapter, is that the passions aroused by identity politics have facilitated economic reforms in India, not hurt them. How to stop Hindu nationalists from gaining politically and coming to power was the primary objective of most mainstream political parties between 1990–1, and 1997–8. New alignments of political interests thus came into being. Whether or not politicians in the past were opposed to a market-oriented liberalization, they increasingly began to support reforms once it became clear that it was more important to fight Hindu nationalists on questions of religious politics versus secularism than oppose the government of the day on economic reforms. *The political logic induced by explosions of communal passions gave the reformers room to push reforms.*

The same logic, however, has also defined the limits of economic reforms. Afraid that the masses and their own party cadres or supporters might turn against their parties, India's reformers have failed to privatize public sector, restructure labour laws, introduce agricultural reforms, and reduce fiscal deficits to low levels.<sup>5</sup> These

<sup>5</sup> The 1998 budget, presented on 1 June to parliament, made some moves in the direction of privatization, but there is no visible progress on privatization yet.

policy areas can potentially bring reforms in mass politics, which the reformers have resisted. Instead, considerable overall progress has been made on liberalizing the investment, trade, and exchange rate regimes and reforming capital markets. Touching very few people in *India* directly and in the short run, these latter reforms have been an elite concern, though elsewhere in the developing world they may well be integral parts of mass politics.<sup>6</sup>

My argument should not be construed normatively. It is primarily empirical and explanatory. It is not a celebration of ethnic conflicts, of rigid labour laws, or sick public enterprises. Rather, it is an attempt to understand, and explain, why India's politicians have behaved very differently with respect to the various aspects of reform, embracing some policies warmly but showing great caution on others. The elite-mass distinction is simply to disaggregate politics and present an explanation for these puzzling, varying rhythms. In the reform literature, both on India and elsewhere, the intra-clite distinctions—for example conflicts between the ISI-protected versus exporting sectors—have often been noted, but elite-mass differences have not been.<sup>7</sup> At least in a democracy, the latter differences can be a serious issue in politics.

The first section deals with mass politics and economic reforms in comparative perspective, asking whether India is peculiar in having reforms as part of its elite, not mass, politics. The second section catalogues the record of Indian reforms so far. The third section explains why a conjunction of ethnic conflict and economic reform helped India's reformers in 1991. The fourth section turns its attention on why, despite a remarkable transformation of economic policy overall, India has had inadequate or little success with fiscal balances, labour laws, agriculture, and privatization. The concluding section draws some normative conclusions.

<sup>6</sup> This is not to say that trade policies and exchange rate, by affecting a whole range of prices, do not have a bearing on mass welfare. In economies, however, where trade/GDP ratio is not substantial, these policies do not have a *short run and direct* impact on mass welfare, which can be *easily demonstrated* in electoral politics. That is why, as argued later, the impact of trade and exchange rates on mass politics is on the whole much greater in economies where trade/GDP ratios are high. Trade can easily enter mass politics in such economies.

<sup>7</sup> Strikes and trade union politics would qualify as mass politics, but they have not been conceptualized as such in the reform literature.

## ECONOMIC REFORMS AND MASS POLITICS IN DEVELOPING COUNTRIES

If ethnic conflict has been the most obvious and recurrent source of mass politics in much of the developing world, its absence in the mainstream of economic reform literature has an obvious reason: the initial spate of literature was dominated by Latin America and East Asia. Scholars of ethnic conflict have long argued that Latin America and East Asia are about the only regions of the developing world where ethnic issues have not been central to politics after the Second World War (Horowitz, 1985). Ethnic disputes have not rocked the politics of South Korea, Japan, and Taiwan—at least not yet—nor have they led to deep fissures in Latin America. Ethnic politics, to be sure, is not absent: the concern with indigenous groups in much of Latin America is a case in point. However, it is generally agreed that ethnicity has shaped Latin America's local politics, not national politics (Dominguez, 1994). Economics has often touched off class and sectoral politics at the national level. Since economic reforms attacked the existing balance of economic forces—favouring exporters over those dealing with internal markets, reducing the anti-countryside bias of import substitution regimes, cutting subsidies to the urban working class, lowering the protective walls for domestic businesses—they have tended to define the main outlines of post-reform national politics, mass as well as elite.

In contrast, ethnicity has repeatedly arrived at the centre of political struggles, or has forcefully emerged after the democratization of recent years in South and South East Asia, Africa, the former Soviet Union, and much of Eastern and Central Europe. A dualistic structure of political agenda, consisting both of ethnicity and economic reform, changes the political dynamics of economic reforms in multiethnic societies, calling for an understanding of links between the politics of identities and the politics of economic reforms.

Such an understanding could, in principle, have emerged from Eastern and Central Europe, which has been the focus of much recent literature on reforms. The connections, however, could not be established, partly because both reforms and ethnic conflicts have been on the political centre stage. The entire old order—economic and political—collapsed. In the former Communist

countries a market-oriented economic reform is not strictly a reform. It is basically an economic revolution. It has necessitated a radical overhauling of the existing economic system: de-freezing administered prices, ending astronomical subsidies to collectives and firms, and creating, most of all, a whole new set of institutions and practices appropriate for the market economy (stock markets, private property, a regulatory framework, a rudimentary legal system, etc.). Collectives, social security systems, and many state firms have precipitously declined. The consequent 'shock' has tended to push economic reforms in mass politics. In the Russian federation, for example, five nationwide elections took place between the fall of the Soviet Union and the fall of 1996.<sup>8</sup> Studies show that reforms were critical to the vote. Rural *rayons* (roughly counties) voted consistently against reforms; and urban *rayons* in favour (Clem and Craumer, 1996).

In South and South East Asia (with the exception of Vietnam), the basic institutions of a market economy—a regime of private property, a large private sector, a body of corporate laws, a regulatory framework—were in existence. Economic reforms required incremental changes, not a revolutionary overhaul. It is in the extreme and rare condition of a financial collapse that they stormed into the realm of mass politics. Otherwise, they have primarily been in elite politics.

Compared to the incremental nature of economic reforms, ethnic conflicts in these societies are accompanied by bursts of collective emotions and deep group anxieties. Some ethnic conflicts have remained unresolved; others, if resolved earlier, have been simmering with changed meanings; and still others have newly flared up. India has had multiple such disputes; in Malaysia, Chinese–Malay differences have long been central to politics, and a new fundamentalist challenge to the nation's syncretistic Islam has emerged; in Sri Lanka, Sinhala–Tamil conflict has repeatedly flared since the mid-1950s, becoming a civil war in the north by the early 1980s; the Philippines has faced a Muslim (Moro) insurgency in the south; and cultural, racial, and religious divisions often surfaced in Indonesia, even during the harsh political regime of President Suharto. Nation building, therefore has been a key

<sup>8</sup> A referendum, two parliamentary elections, an election to approve the new constitution (along with one of two parliamentary elections), and two presidential elections.

political concern in these countries, and ethnic politics is never far from the minds of politicians.

Ethnic conflict is, of course, not the only competitor of economic reforms on the political stage. In countries where military coups are not uncommon, considerations of order and stability can motivate mass politics, allowing greater room for reforms even though the short-run consequences of reforms are difficult. In Peru, President Fujimori's popularity in polls survived a three and half year economic downturn after 1990. As Susan Stokes (1996) argues:

Economic policy was the cleavage that starkly separated the two major Presidential candidates in 1990, and we might have expected after the campaign that Fujimori's term would be judged on his economic performance. But it was only partially so. Instead, an event occurred during the term that was unanticipated in the prior campaign.... The April 1992 coup d'etat was an extraordinary event... that ratcheted the president's approval upward.... (W)hen Peruvians had thrust on them the evidence that their president was creating order out of chaos, they rewarded him with approval ratings any chief executive would envy.... (T)he range and protean quality of standards... shielded the popularity of Peru's president from (economically) hard times (p. 545).

To sum up, economic reforms are inevitably a big issue in elite politics, but depending on the historical role played by ethnicity, order, and stability in a given country, reforms may not be an important concern in mass politics. Because ethnicity has a greater potential to arouse passions and cause anxieties about national viability, voters and politicians may be more willing to go through the short-run pains of reform than risk ethnic warfare and a political collapse. Paradoxically, thus, *the peripheral role of reforms in mass politics can go to the advantage of reformers*. This argument, of course, does not mean that an ethnic civil war is the best context for reforms. A distinction between ethnic conflict and ethnic breakdowns is required. It is the latter which is being highlighted above. National anxieties about increasing ethnic violence or declining ethnic relations turn the political attention of politicians and the voters on ethnic issues, thereby providing a niche for reformers to push measures that might otherwise generate considerable political resistance.<sup>9</sup>

<sup>9</sup> Theoretically speaking, this view is precisely the opposite of the so-called instrumentalist argument about ethnicity, which has typically seen ethnic

In what follows, I will show how such a political logic of reforms unfolded in India. However, before I can do so, we must first know what economic policies have been reformed in the last five years, and what policy areas remain untouched.

### HOW FAR HAVE INDIA'S REFORMS GONE?

In July 1991, a balance-of-payments crisis was the occasion for a fundamental transformation of India's economic strategy, initiated under Finance Minister Manmohan Singh and Prime Minister Rao. Singh summarized the nature of the immediate crisis to the lower house of parliament as follows:

The (current account) deficits, which were inevitably financed by borrowings from abroad, have led to a continuous increase in external debt which... is estimated at 23 per cent of GDP at the end of 1990-1. Consequently, the debt service burden is estimated at about 21 per cent of current account receipts in 1990-1. ... The balance of payments has lurched from one crisis to another since December 1990. The current level of foreign exchange reserves... would suffice to finance imports for a mere fortnight.<sup>10</sup>

Until the 1970s, a macroeconomic crisis of this kind typically required a short-run economic stabilization plan under an IMF stand-by arrangement. Since the mid-1980s, however, imbalances in the current accounts have not only tended to produce a rethinking on macroeconomic policy but also on overall economic strategy, now almost universally known as structural adjustment. An economist by training, Singh was aware of the short- and long-run implications. 'Macroeconomic stabilization and fiscal adjustment alone cannot suffice', he argued; 'they must be supported by essential reforms in economic policy... (facilitating) a transition from a regime of quantitative restrictions to a price-based mechanism.... Overspecialization and excessive bureaucratization have proved to be counter-productive.'<sup>11</sup>

politics as an expression of economic conflicts. In ethnically divided countries, the relationship may well be the reverse.

<sup>10</sup> Budget Speech to the Lok Sabha (lower house of parliament), Manmohan Singh, *Lok Sabha Debates*, Series 10, 24 July 1991, p. 272.

<sup>11</sup> *Ibid.*, p. 276. Parenthesis and emphasis mine.

Thus began a whole series of economic reforms, introduced incrementally each year. By now, these reforms have transformed India's economic life substantially. In some areas, progress has been dramatic; in other areas, moderate; and in still others, no progress has been made.

### A RESTRUCTURATION OF INVESTMENT RULES

Of all reforms undertaken so far, those dealing with India's investment regime have gone through the greatest change. In the organized industrial sector, India had two kinds of investment controls before 1991: regulation of private investment through licensing and reservation of some industries for the public sector. Licences regulated how much could be invested and where, how much produced, what technology was to be used, etc. Investment licences, requiring up to eighty permissions,<sup>12</sup> were necessary *before* an industry could be set up. By late 1998, reforms had abolished investment licensing in organized manufacturing in all but nine industries. The exclusive monopoly of the public sector over key industries—the so-called 'commanding heights of the economy'—had also been more or less abandoned. Especially striking is the de-reservation of the power sector. A third of the domestic airline industry, exclusively in the public sector until 1992, was already in private hands by late 1996 (*The World Bank*, 1995: p. 43). Railways and insurance are about the only public monopolies left today in the organized sector. In the unorganized sector, however, licensing restrictions on small-scale industries, including agro-industries, continue. An estimated 800 products are still covered by the reservation for small-scale industries (*The World Bank*, 1996: p. 22).

Rules governing foreign investment, both direct and portfolio, have been dramatically liberalized. 'We have now reached a stage of development', argued Manmohan Singh, 'where we should welcome, rather than fear, foreign investment.'<sup>13</sup> 'Concern', he

<sup>12</sup> Calculated at one stage by the late Raj Krishna, 'Ideology and India's Economic Development', Coromandel Lecture, Delhi, September 1984, published in three parts in *The Financial Express* (Delhi), 22-5 July 1985.

<sup>13</sup> Manmohan Singh's, 1991 Budget Speech, *Lok Sabha Debates*, Series 10, 24 July, 1991, p. 276.

further argued, 'is sometimes expressed that the policy of welcoming foreign investment... may jeopardise our sovereignty. These fears are misplaced. We must not remain permanent captives of a fear of the East India Company, as if nothing has changed in the past 300 years.'<sup>14</sup> Until 1991, foreign equity could not exceed 40 per cent. And companies with 40 per cent foreign equity could not borrow funds in India, take over business interests of a resident Indian, acquire or dispose of physical assets within India, appoint foreign technicians and manager without government clearance. After 1993, companies with foreign equity of any size are treated at par with domestic investors. In about 48 industries, foreign investment up to 51 per cent of equity, and in 9 industries up to 70 per cent of equity, is automatically approved, no questions asked. Private investment in power has no equity restrictions; 100 per cent foreign equity is allowed. India's foreign investment regime, believes the World Bank, 'now compares favourably with East Asian countries' (The World Bank, 1996: p. 22). The primary difference lies in the myriad administrative regulations that still exist at state level, and differ across states. Before the reforms began, annual foreign investment used to be about \$ 80-100 million. Direct foreign investment went up to \$ 600 million in 1993-4, rising further to \$ 1.3 billion in 1994-5, \$ 2 billion in 1995-6, \$ 2.6 billion in 1996-7, and 3 billion in 1997-8 (see Table 7.1).

There was no foreign portfolio investment in India before 1992, when foreign institutions were allowed for the first time to buy and sell stocks. Indian companies can now issue equity in foreign markets; in 1993-4, they raised about \$ 1.4 billion abroad and in 1994-5, 1.8 billion. Total foreign portfolio investment was a mere \$ 92 million in 1992-3; it reached \$ 3.5 billion a year later, peaking at \$ 3.7 billion in 1994-5, and declining to \$ 2.7 billion in 1995-6, \$ 3.3 billion in 1996-7, and \$ 1.6 billion in 1997-8 (see Table 7.1).<sup>15</sup>

Also important has been a fundamental transformation in the principles of institutional oversight over capital markets. The office

<sup>14</sup> Manmohan Singh's 1992 Budget Speech, *Lok Sabha Debates*, 29 February 1992, p. 20.

<sup>15</sup> The World Bank (1996), p. 14. As is well-known, however, China attracts many times as much FDI.

Table 7.1  
Foreign Direct and Portfolio Investment in India

	1990-1	1991-2	1992-3	1993-4	1994-5	1995-6	1996-7	1997-8
Foreign Direct Investment	165	150	341	620	1314	1981	2600	3000
Portfolio Investment:								
of which								
Foreign Institutional Investment	0	0	1	1665	1503	1892	1800	1000
Euro-issues/GDR	0	0	86	1463	1839	204	750	600
Others	0	8	5	365	239	-	448	-
Total Portfolio Investment	0	8	92	3493	3581	2096	2998	1600
Total (Direct & Portfolio)	165	158	433	4113	4895	4077	5598	4600

Sources: For 1997-8 figures, Ahluwalia (1999, this volume) For 1996-7 figures, Centre for Monitoring Indian Economy, *Monthly Reports on Indian Economy*, May 1997, p. 8; for all other years, The World Bank, *India: Country Economic Memorandum*, 8 August 1996, p. 7.

of the Controller of Capital Issues (CCI) was replaced by a new institution called the Securities and Exchange Board of India (SEBI).<sup>16</sup> The CCI's prior permission was required before a company could issue equity at a given price. The CCI was effectively a price setter. A long gap between the time of request and the time of permission would typically introduce unnecessary price distortions in the stock market. SEBI is not a price setter, but a 'market-friendly' regulatory body. 'The practice of Government control over capital issues, as well as pricing of issues', explained Manmohan Singh, 'has lost its relevance in the changed world of today.... Companies will be allowed to approach the market directly provided the issues are in conformity with published guidelines relating to disclosure and other matters relating to investor protection.'<sup>17</sup>

#### TRADE AND EXCHANGE RATE REGIMES

A great deal of progress has also been made on the trade and exchange rate regimes. Two devaluations of the Indian rupee were among the initial macroeconomic moves of the Rao government in July–August 1991. They made the exchange rate realistic. Tariff barriers and quantitative restrictions on foreign trade have also been sharply reduced. Average tariff came down from about 87 per cent in 1990 to 20.3 per cent 1997–8,<sup>18</sup> and quantitative restrictions on trade have been lifted, except for consumer goods and agricultural commodities. In late 1997, the government announced a plan to end the latter quantitative restrictions also within a period of six years, in line with a WTO-sponsored agreement with India's main trading partners. One should, however, note that India's average tariff rates, though substantially lower than before, are still high by comparative standards. In Latin America and East Asia, average tariffs range between 5–15 per cent (China, still having high average tariffs, being a prominent exception).

<sup>16</sup> Manmohan Singh's 1991 Budget Speech, *Lok Sabha Debates*, x Series, 24 July 1991, p. 280.

<sup>17</sup> Manmohan Singh, *Lok Sabha Debates*, 29 February 1992, p. 22.

<sup>18</sup> In the budget presented on 1 June 1998, the Government of India has proposed that the average tariff be raised by 8 per cent for a whole range of imports. On the trade regime, this is the first step backwards after the consistent lowering of tariff since 1991.

#### FINANCIAL REFORMS

Three sectors are typically critical to financial reforms: capital markets, banking, and insurance. Of the three, as indicated above, capital markets have been radically altered in India; insurance was left untouched till late 1998; and banking has gone through moderate reforms. Locking up substantial funds for government use before the reforms began, commercial banks had to hold 38.5 per cent of their incremental deposits (the 'statutory liquidity ratio' or SLR) in low-yielding government securities and deposit 25 per cent with the Reserve Bank of India as reserve requirement (the 'cash reserve requirement', or CRR). By now, the SLR and CRR have been brought down substantially. Officially fixed before, interest rates on deposits and loans were deregulated in October 1994. Since the nationalization of banks in 1969, India's banking sector has been dominated by 28 public sector banks, accounting for nearly 87 per cent of deposits until 1992. In 1994–5, new private banks were licensed to operate, including foreign banks. Banks have also been allowed to raise funds in the capital markets, diluting thereby the extent of government ownership of the banks. However, the government's equity share in public sector banks continues to be high, and government-mandated lending policies for banks still require that up to 40 per cent of bank credit be reserved for the priority sectors (agriculture and small-scale industry). Further reforms would, among other things, require a serious reduction in, and eventually abolition of, government pre-emption of bank finance. The government pre-empts bank funds to finance its budgetary deficits and service its debts.

#### FISCAL DEFICITS

Compared to 1991, India's fiscal deficits are down but they have still not been reduced to the levels that were promised and planned. By 1996, the fiscal deficit of the central government was to come down to 4 per cent of GDP; it dropped to 5.6 per cent in 1995–6 and 5 per cent in 1996–7. In view of the political pressure for food and farm subsidies discussed later, considerably bigger cuts in fiscal deficits may be hard to make unless revenue receipts go up substantially and/or deficits of public enterprises go down appreciably. Revenue-elasticity is not possible in the short run because typically in a market-oriented economic reform, taxes are

lowered across the board. In India, consistent with this general picture, the central government's tax/GDP ratio declined from 10.9 per cent in 1991–2 to 9.5 per cent in 1993–4, rising to 10.1 per cent in 1995–6 to 10.5 per cent in 1996–7, but remaining still below the 1991–2 level. In addition, following the new market orientation, the government has agreed to pay a higher interest rate for its debt than it previously used to, increasing thereby its interest burden.

Taxation in India primarily relies on two direct taxes—on personal and corporate income—and two indirect taxes—customs and excise.<sup>19</sup> Until 1991, the latter constituted approximately 80 per cent of total tax revenue. It was widely believed that the taxation system had negative effects on economic growth and was also subject to widespread evasion. A tax reform, it was further believed, would have to, *inter alia*, reduce the share of indirect taxes and increase that of direct taxes in the total gross tax revenue, lower the marginal tax rates, and simplify tax laws. Considerable progress towards these goals has been made. The share of direct taxes went up from 19.2 per cent of the total in 1990–1 to 30 per cent in 1996–7. This has, moreover, been achieved not by increasing marginal taxation rates on income, but by lowering them across the board and by simplifying the variety of tax rates. As for indirect taxes, external trade tariffs have already been discussed. Excise on production has been simplified and reduced on existing dutiable items and extended to include services, which were earlier more or less excluded from the excise net. As always, however, agricultural incomes remain untaxed.

#### AREAS OF NO REFORM

Finally, on privatization, agriculture and labour laws, no progress has yet been made. Public sector companies have been asked to issue equity in the market, but outright sale or a serious dilution of government control over these companies has not yet been implemented, even though it would help the government deal better with its fiscal burdens, and could allow it to undertake

<sup>19</sup> This is true of the central government, which splits revenues with state governments. At state level, sales tax is a major source of revenue apart from the state's share of the central revenue.

investments in health and education.<sup>20</sup> An argument about ending agricultural subsidies and exposing agriculture to a border (international) price regime has often been intellectually aired (Pursell and Gulati, 1994), but no firm indications are yet available about the government's policy preferences. Nor have labour laws been reformed. India has a lifelong employment system. Once hired as a regular employee, a worker cannot easily be retrenched. This has implications for firm entry as well as exit: the former because recruitment in new firms cannot be made assuming that workforce, if necessary, could be restructured later; and the latter because loss-making firms cannot close down or restructure their labour force. They must find other ways of turning themselves around, or the 'sick firm' is handed over to the government.

#### ECONOMIC PERFORMANCE SINCE 1991<sup>21</sup>

After growing at 0.8 per cent, 5.3 per cent and 6.2 per cent annually in the first three years of reform (1991–4), GDP grew by 7.8 per cent in 1994–5, 7.2 per cent in 1995–6, 7 per cent in 1996–7, and 5 per cent in 1997–8. Unlike Latin America and Eastern Europe, India has not had a single year of negative growth rate in GDP since reforms began in 1991. After a slow recovery, annual manufacturing growth rates have been 9.4 per cent, 12.1 per cent, and 9 per cent during 1994–7. Agriculture has maintained its trend growth rate of 3–3.5 per cent, leading to record food production of 195 million tons in 1996–7. Services have also maintained a robust growth rate.<sup>22</sup>

On the external front, remarkable accumulation of foreign reserves has taken place. In January 1999, India had \$ 27.4 billion in reserve, a dramatic difference from July 1991 when the country had virtually run out of dollars. The current account deficit declined

<sup>20</sup> After seven years of reform, the government, in the June 1998 budget, has finally announced that government equity in all 'non-strategic' public sector companies would be brought down to 26 per cent. However, no large-scale privatization has been introduced. It is still to be seen what kind of resistance will emerge in politics.

<sup>21</sup> The figures cited in this subsection are based on the various reports of the Centre for Monitoring Indian Economy, and on Ahluwalia (1999, this volume).

<sup>22</sup> However, all growth rates, except those for agriculture, declined in 1997–8.



from 3.5 per cent of GDP in 1990-1 to 1.3 per cent in 1996-7. Exports grew at over 20 per cent annually between 1993-6, declining to below 5 per cent in 1996-7 and 1997-8. Textiles, garments, gems and jewellery, and engineering goods, including software, have been the four largest exports since 1990-1.

Despite the current deceleration the economy, on the whole, has been doing quite well. It is generally believed that a 6-7 per cent *trend growth rate* of GDP is now possible. As far as progress of reforms in various policy areas is concerned, it is also clear that they fall into three categories. The greatest progress has been made on reforming investment, exchange rate and trade regimes, and capital markets; reforms in banking and fiscal policies have been moderate; and no reforms have been made in labour laws, agriculture and the vastly inefficient public sector has not been privatized.

Why have reforms gone as far as they have in the first place? And why have they gone farther in some policy areas than in others? I turn now to these questions, presenting first a political explanation of the overall success of reforms and concentrating later on the variations between areas of substantial and little progress.

#### DID ETHNIC CONFLICT HELP INDIA'S REFORMS? COMPARING REFORMS UNDER RAJIV GANDHI AND NARASIMHA RAO

By now, it has become customary to say that India's reforms are irreversible. It is hard to recall how gloomy the reform prospects were in July 1991. Lacking a majority in parliament, the Rao government did not even seem stable; only six years earlier, the Rajiv Gandhi government, despite enjoying massive majority in parliament, had found it politically hard to push market-oriented reforms. India's new Finance Minister in July 1991, Manmohan Singh, though a highly respected economic bureaucrat, was not a professional politician. Many members of the Congress party were resentful of his rise to power, for he had never been a party man. The country was going through massive Hindu-Muslim upheaval on the one hand and serious dispute over caste-based affirmative action on the other. To make matters worse, two insurgencies—one in Punjab, another in Kashmir—were showing no signs of

abatement. The nation's head of government, Rajiv Gandhi, had been brutally assassinated in the recent past. Let alone reform optimism, many commentators were concerned whether India would even make it as a nation in the 1990s.

As it turned out, in spite of lacking clear majority in parliament, the Rao government was able to push many of reforms on which Rajiv Gandhi's government, even with a three-fourths majority, had had to retrace its steps in 1986. Unless the logic of this paradoxical outcome is uncovered, it will be hard to understand the political dynamics of economic reforms in India. I will argue that the economic crisis in 1991 was a necessary, not sufficient, condition for the success of reforms. In turning crisis into success, the differences in the *political context* of the two reforms were critical.

#### RAJIV GANDHI'S STALLED REFORMS (1985-9)<sup>23</sup>

In December 1984, two months after the assassination of Indira Gandhi, Rajiv Gandhi led the Congress party (the Congress hereafter) to its biggest election victory since Independence. Winning 48.1 per cent of the national vote, the Congress obtained 415 out of a total of 545 seats in the lower house of Indian parliament. No opposition party could get more than 30 seats (see Table 7.2).<sup>24</sup>

For the new leadership, it was a moment of unrivalled power. With a remarkable groundswell of support behind it and the opposition more or less decimated, the new government felt it had considerable autonomy to institute new, market-oriented policies and programmes. Like Rajiv Gandhi himself, some of the closest associates of the new leader came from a corporate background,<sup>25</sup> and many of the top positions in the economic bureaucracy also went to those inclined towards pro-market

<sup>23</sup> For detailed studies of Rajiv Gandhi's economic reforms, see Echeverri-Gent (1990), Nayar (1989), and Kohli (1987). For a succinct account of India's economic policy until then, Bhagwati (1993), Chs 1 and 2.

<sup>24</sup> For a summary overview of the election performances of parties, see Butler, Lahiri, and Roy (1996), Ch. 9.

<sup>25</sup> Arun Singh and Arun Nehru, two of the most powerful ministers in the Rajiv Gandhi Cabinet, had served as business executives in the private sector before joining politics. Rajiv Gandhi was himself a pilot.

economic liberalization. It was an archetypical strong executive that the reform literature considers necessary for successful economic reform (see Haggard and Webb 1994).

Table 7.2

Party Positions in the Lower House of Parliament 1984-9 and 1991-6

Party	Seats 1984-9	Seats 1991-2	Seats 1992-6
Congress	415	220	232
BJP	2	120	120
Janata	10	59	59
CPM	22	35	35
CPI	6	14	14
TDP	30	3	13
ADMK	12	11	11
Others	46	52	53
Total	543	524	537

Notes: (i) Elections were not held in Jammu and Kashmir at all, bringing the total seats in the Lok Sabha down to 537 in the tenth Lok Sabha (1991-6). J&K has six seats in the lower house.

(ii) Elections in Punjab (13 seats) were held in February 1992, and results announced in March 1992. Column II does not, therefore, include the seats in Punjab. The figures for 1992-6 include the results of the 1991 elections and the 1992 Punjab elections.

The new leadership quickly seized the opportunity and set about restructuring the country's economic policy. The first indication of the new thrust was given by the Prime Minister himself. In January 1985, within weeks of assuming power, Rajiv Gandhi argued:

Only a few decades ago, made-in-Japan was synonymous with shoddy goods. Today, and for several years past, Japanese technology, finish and servicing have become a byword for the best that is available... I am sure we in India can do the same—and in a much shorter period. And this will, of course, involve close interaction with the outside world... We are taking a judicious combination of deregulation, import liberalization and easier access to foreign technology.<sup>26</sup>

Two months later, in February 1985, Finance Minister V. P. Singh's presented his budgetary proposals for 1985-6. The budget

<sup>26</sup> *The Times of India*, 6 January 1985.

de-licensed several industries;<sup>27</sup> increased the ceiling of investment by the big business houses;<sup>28</sup> relaxed rules for importation of foreign technology; sought to replace quantitative trade restrictions with tariffs, and lowered tariff barriers overall;<sup>29</sup> reduced marginal tax rates on personal and corporate income and simplified tax rules; and, finally, announced that public sector reform was necessary. Soon after the budget, Rajiv Gandhi personally launched a critique of the import substitution strategy (ISI): 'There was no point in developing each and every component... (even if) a component priced at a few dollars abroad was manufactured locally at an exorbitant cost.'<sup>30</sup>

Indian politics had not seen such forthright criticisms of the ISI by the Prime Minister.<sup>31</sup> The metropolitan press was ecstatic. 'Towards a New Era', editorialized *The Times of India* on its front page on 17 March 1985. Abroad, in an editorial entitled 'Rajiv Reagan', *The Wall Street Journal* wrote:

Anyone who thinks the world never learns from experience ought to look at what's happening in India these days. Prime Minister Rajiv Gandhi's new government introduced its first budget last weekend, slashing taxes and cutting

<sup>27</sup> The de-licensed industries included special alloys, 'steel structurals', electrical equipment, electronic components, automotive ancillaries, bicycles, industrial machinery, machine tools, and agricultural implements. 'Several Industries Delicensed', *The Times of India*, 18 March 1985.

<sup>28</sup> To avoid the formation of monopolies, investment ceilings were imposed by the MRTP (Monopolies and Restrictive Trade Practices) Act, 1969. It had the perverse effect over time of disallowing increases in plant capacity, even if technological changes and cost reduction required it.

<sup>29</sup> Especially in sectors such as electronics that were integral to Rajiv Gandhi's philosophy of modernization. 'Electronic Policy Relaxed', *The Times of India*, 22 March 1985.

<sup>30</sup> Prime Minister's address to industrialists, cited in *The Times of India*, 23 March 1985. Later in December 1985, Rajiv Gandhi made the clearest announcement of his liberalizing intentions at the centenary meet of the Congress. For a report, 'Industries on a Shaky Base Can't Last Long', *The Times of India*, 29 December 1985.

<sup>31</sup> Only one political party, the Swatantra, had opposed the ISI the 1950s and 1960s. Winning very few seats, it couldn't make a political impact. The Hindu nationalists, currently represented the BJP had traditionally opposed planning but not ISI. They were for internal deregulation, but not for external liberalization.

regulations in a way worthy of another famous tax cutter we know. The budget amounts to a minor revolution for a country long enamored of a socialist mirage.<sup>32</sup>

The opposition came, first of all, from the expected quarters: the leftist parties,<sup>33</sup> trade unions, and left-wing economists who had traditionally dominated India's economic thinking and bureaucracy. However, with the euphoria of new government continuing, these opponents were unable to deflect the government from its new economic path. Dissent in parliament was ineffective; the opposition parties, after all, had been virtually wiped out. Elite politics was firmly in control of Rajiv Gandhi's men.

With parliamentary arithmetic so dominated by the new regime, factions *within* the ruling Congress could have been an effective source of dissent, playing in effect the role of opposition. However, so soon after Rajiv Gandhi's massive victory, intra-party dissent was still in its formative stage.<sup>34</sup> The party, moreover, was beholden to its leader for a most authoritative electoral triumph.

In January 1986, a year after the elections, an economic opening for mass politics finally emerged. Indeed, it was provided 'on a platter' by a confident economic policy team. To take reforms further and attack fiscal imbalances, the Rajiv Gandhi government announced several new measures. Subsidies on petroleum and petroleum products, food, and fertilizer were scaled down.<sup>35</sup> To underline the importance of cutting government expenditure, especially subsidies, a long-term fiscal policy was announced. Defending the cuts in the subsidy for foodgrain and fertilizers, the Finance minister said that 'the issue was subsidy versus investment. The subsidies had gone up to astronomical levels...'<sup>36</sup> adding that 'the prices of kerosene and cooking gas are less than their production costs'.<sup>37</sup>

<sup>32</sup> *The Wall Street Journal*, 21 March 1985.

<sup>33</sup> Budget 'Anti-poor, Says CPM Front', *The Times of India*, 18 March 1985.

<sup>34</sup> Moreover, the new government kept the new momentum of popular goodwill going by concluding agreements on Assam and Punjab, states where insurgents had begun to dominate politics. Demonstrating a refreshing ability to come to negotiated settlements, Rajiv's 'accords' promoted moderates and undermined militants. For details, see Weiner (1989).

<sup>35</sup> *The Times of India*, 1 February 1986.

<sup>36</sup> *The Times of India*, 22 February 1986.

<sup>37</sup> 'Price Hike to Fuel Development: V. P. Singh', *The Times of India*, 13 February 1986.

Even as market-oriented economists and the business press applauded the continuing thrust, a political revolt began. Since the prices of some key commodities of mass consumption—food, fertilizer, and petroleum products like kerosene—had been raised, the opposition argued that the government was insensitive to the needs of the poor. It mobilized the people for protests, and called strikes. Protests in various big cities drew large crowds.<sup>38</sup> It was the first nationwide protest since the new government's assumption of power fourteen months earlier.<sup>39</sup> The success of the mobilization alarmed the rank-and-file of the ruling Congress party. It also finally gave state- as well as some national-level leaders a chance finally to express dissent. Some party members threatened to speak out openly against the government in parliament.<sup>40</sup> Others met the Prime Minister in groups. And still others wrote against the new policies in press: 'Rightly or wrongly, the impression is gaining ground that the policies of the government are leaning more toward the rich and the private corporate sector is the only major concern of the government.'<sup>41</sup>

Given the intensity of mass reaction and dissent of partymen, the Congress government offered to lower the cuts in subsidy. The administrative prices of foodgrain, fertilizer, petroleum and petroleum products nonetheless registered a net increase, for the cuts were lowered, not eliminated. Such reductions, which left prices higher than they were before the government changed them, were hardly enough to silence the opposition. Indeed, the price-increase provided new life and new bases of support to the weak opposition parties. The argument that the new leaders were pro-rich acquired a momentum of its own in the press and, more importantly, in the political process. The new government, after all, had cut taxes on corporate and personal income in the previous year, and now it was raising prices of mass consumption goods.<sup>42</sup>

<sup>38</sup> 'Parties Threaten Stir on Price Hike', *The Times of India*, 2 February 1986; 'Bengal Bandh Plan on Prices', *The Times of India*, 4 February 1986; 'Women's Stir against Price Rise', *The Times of India*, 6 February 1986; 'Trade Unions Plan Stir', *The Times of India*, 17 February 1986.

<sup>39</sup> *The Times of India*, 20 February 1986.

<sup>40</sup> 'Congress MPs Sulk over Price Hike', *The Times of India*, 15 February 1986.

<sup>41</sup> See, for example, Solanki (1986).

<sup>42</sup> Reflecting a large body of intellectual and political opinion, some of the

From this point onwards, as Kohli (1987) has argued, 'the society...hit back: the state lost the temporary autonomy it had gained' (p. 316). The government began to make compromises. The next budget in 1987 increased allocations for poverty alleviation programmes, restored the earlier level of fertilizer and food subsidies, disallowed across-the-board cuts in excise duties, and made tariffs on capital goods higher.<sup>43</sup> The last two budgets of the Rajiv Gandhi government—1988 and 1989—continued the same process.<sup>44</sup>

Asked in 1988 why deeper reforms were not being launched, Rajiv Gandhi's chief economic advisor argued that '*there seems little room for too many more concessions*'.<sup>45</sup> By 1988, Rajiv Gandhi himself was convinced that 'the process has to be gradual', even though the direction he had selected for the country was right.<sup>46</sup> Only a couple of years earlier, he had been willing to confront 'vested interests in almost every field...including our own party, including industry, in business, in administration, the whole lot, the farmers'.<sup>47</sup>

#### THE SUCCESS OF THE RAO GOVERNMENT (1991-6)

The progress of reforms since 1991 is a study in contrast. Compared to Rajiv Gandhi, Prime Minister Narasimha Rao was weaker in parliament. Unlike Rajiv Gandhi's three-fourths majority in parliament, the Rao government did not have majority support when it came to power in July 1991; it added some more seats to its strength in March 1992 but it was still short of a majority (Table 7.2). Yet, whereas Rajiv Gandhi de-licensed only a few industries, the Rao government de-licensed all but a few.

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sharpest comments were made by Rajni Kothari (1986), the country's leading political scientist of the time and ace political commentator.

<sup>43</sup> For a summary, 'A Prime Minister's Budget', *Business India*, 9-22 March 1987.

<sup>44</sup> For reports, *Business India*, 7-20 March 1988 and 6-19 March 1989. Commenting on the 1989 budget, the magazine said that 'it seeks to protect the poor...and it gently squeezes the rich'.

<sup>45</sup> Montek Singh Ahluwalia, interviewed in *Business India*, 7-20 March 1988, p. 55.

<sup>46</sup> Interviewed in *Business India*, 30 April 1988, p. 15.

<sup>47</sup> Interviewed in *The Telegraph*, 12 March 1986.

Rajiv Gandhi lowered corporate and personal income taxes; the Rao government reduced them further. Average tariff rate was 87 per cent when Rajiv lost power; it was brought down to 25 per cent in 1995 through successive reductions. Under Rajiv, capital markets had no foreign investors: under Rao, foreign portfolio institutions were allowed, rules for FDI were liberalized, and in 'key' sectors, such as power, 100 per cent foreign ownership was permitted. Finally, unlike Rajiv Gandhi, the Rao government had to sign a stabilization agreement with the IMF, which is often politically controversial in the developing world. Arguments about the Rao government mortgaging the nation's economic sovereignty could easily be made.

Why, then, was the Rao government more successful? There is no doubt that the external crisis of 1991 opened the way for reforms. In and of itself, however, the depth of the crisis cannot sustain reforms. It is necessary to know how the crisis was perceived and resolved in India's political institutions. A serious change in economic policies cannot be authorized by an executive decree if parliamentary approval is a requirement. Was the latter necessary in India's political process?

Because a restructured economic policy is reflected in national budgets, and national budgets must be approved in parliament, economic reforms must necessarily pass parliamentary scrutiny in India. Unlike a Presidential system, in a parliamentary system the government will most likely fall if the national budget is not approved in the legislature. *If India's parliament had not passed the budgets, the new economic policies would have been still-born, not because of faulty economic logic but due to the institutional constraints of a parliamentary system.* Why did India's parliament, in which the Congress government did not have majority support between 1991 and 1993, pass the budgets in September 1991, May 1992, and May 1993? These three budgets contained the bulk of India's reforms.

The debate on the first two budgets—in July–August 1991 and March–April 1992—was bitter and charged.<sup>48</sup> Opposition politicians made trenchant arguments in parliament about the actual or impending loss of economic sovereignty to the IMF and the World

<sup>48</sup> *Lok Sabha Debates*, X Series. See especially speeches in 1991 by: Jaswant Singh, BJP, 29 July; Atal Bihari Vajpayee, BJP, 5 August; and Indrajit Gupta, Communist Party of India, 31 July. Also relevant were speeches cited in later notes for 1992.

Bank. In February 1992, it was alleged that the budget proposals had been submitted to the IMF for its prior permission before being presented to India's parliament. 'None of us ever thought that India will one day come to depend on the mercy of the IMF and the World Bank', said the parliamentary leader of the BJP.<sup>49</sup> 'The sovereignty of parliament has been breached and the economy of the country had been subjected at the feet of the World Bank and IMF', said the leader of the third largest party and former Prime Minister.<sup>50</sup> 'Will all the conditionalities which are being imposed on us, be imposed on the US, if their budgetary deficit is twenty times more than that of ours?' said a third important opposition leader.<sup>51</sup>

A second set of political criticisms was about the pro-rich and pro-urban orientation of the new policies. 'I would call this budget anti-poor, anti-farmer, anti-development, and pro-inflation', argued an important member.<sup>52</sup> 'The Government television... (is) propagating unlimited consumerism of big companies through advertisements', argued another.<sup>53</sup> Finally, there was the apprehension that reform would lead to retrenchment from public sector undertakings. 'What is going to be the result of all this? 9 lakh workers belonging to public sector banks will be unemployed in the next two years.... Where will they find jobs?'<sup>54</sup>

Yet, despite these criticisms by leaders of all major non-Congress parties, the first three budgets of the Congress government (1991, 1992, and 1993) were passed. All opposition politicians were willing to launch criticisms, but only some were willing to block the budget at the time of voting and unseat the government.

Why did opposition politicians vigorously criticize the budget but not vote against it? Let us recall the political context of 1991–2. The Rao government had initiated reforms at a time when Hindu nationalism was a rising force. In 1991, having 120 seats in parliament, the Hindu nationalist BJP was the second largest party in the country. In 1990, it had led the movement for

the demolition of the Babri mosque, touching off ghastly Hindu-Muslim riots, polarizing the electorate and national politics, and causing a great deal of anxiety about law and order in the country. Out of a total of 524 elected members in the Lower House in July–September 1991, the Congress party had 220 seats, as also the support of 11 members of a regional party (ADMK), bringing the aggregate of its house support to 231, whereas 263 was the halfway—and winning—mark. Similarly, at the time of vote on the next budget in May 1992, the Congress tally of seats had gone up to 232 out of a total of 537 seats. Combined with 13 seats of pro-Congress regional parties, it had 245 votes in all, 24 short of the majority (Table 7.2). The 1991, 1992, and 1993 budgets would have been blocked and reforms stalled if the remaining opposition parties had coordinated their moves and jointly voted against the government.

They did not do so because by 1990, India's politics had become *triangular*.<sup>55</sup> Between 1950 and 1990, the principal battle-lines of politics were *bipolar*. The Congress was the party of government, and all other parties were opposed to it. Between 1990 and 1997, a triangular contest developed between the left, the Hindu nationalists, and the Congress party. Coalitions were increasingly formed against the Hindu nationalists, not against the Congress. To begin with, the left—the Communists and the lower caste Janata Dal and its allies—disliked the reforms, but *they disliked Hindu nationalism even more*. Especially to the lower caste Janata Dal, Hindu nationalism posed the greatest threat. The former wanted to organize the lower Hindu castes against the upper castes, whereas Hindu nationalists were trying to build a united Hindu community against the Muslims, seeking to override and displace caste as an issue in political mobilization. The triumph of one implied the eclipse of the other. The Congress party, a foe in the past but declining ideologically, was no longer the principal enemy of the Janata party.

For the Janata, then, economic reforms were secondary in importance. For the BJP, too, building a temple in Ayodhya, the campaign for which had brought such remarkable electoral dividends, was much more important than the economic reforms. Both

<sup>49</sup> Atal Bihari Vajpayee, BJP, *Lok Sabha Debates*, 23 March 1992, p. 1015.

<sup>50</sup> V. P. Singh, *Lok Sabha Debates*, X Series, 29 February 1992, p. 1.

<sup>51</sup> Chandra Sekhar, former Prime Minister, *Lok Sabha Debates*, 25 March 1992, p. 962.

<sup>52</sup> H. P. Deve Gowda, Janata party, *Lok Sabha Debates*, 31 July 1991, p. 296.

<sup>53</sup> Atal Bihari Vajpayee, BJP, *Lok Sabha Debates*, 23 March 1992, p. 1011.

<sup>54</sup> George Fernandes, *Lok Sabha Debates*, 25 March 1992, p. 929.

<sup>55</sup> This situation has some similarities with the games analysed by Alt and Eichengreen (1989).

the Janata and BJP bitterly criticized several aspects of the reforms in 1991 and 1992, but neither was prepared to issue a 'parliamentary whip' to its party men in the house to vote against the budget. On matters of high political importance, such whips are issued to enforce party discipline in voting. Vote on the budget being left to their conscience, some Janata members would vote against the reform, others in favour, and some would simply abstain. The same was true of the BJP in 1991 and 1992.<sup>56</sup> Coordinated voting between the BJP and Janata and its allies was necessary to defeat the budget, but that did not happen. The 1991 and 1992 budgets, as a result, received parliamentary approval despite the Congress lacking majority in the lower house.

Once Hindu nationalists demolished the mosque in December 1992, the Janata and its allies became even more convinced that Hindu nationalists had to be contained. Most Janata members voted in favour of the 1993 budget, where all BJP members present in parliament opposed the budget for the first time.<sup>57</sup> That was not enough to defeat the budget; full floor coordination between the various opposition parties was required. Thus, three annual budgets, embodying the bulk of India's post-1991 reforms, were passed in India's parliament. *India's economic reforms kept progressing because the political context had made Hindu-Muslim relations and caste animosities the prime determinant of political coalitions.*

The political context in 1985-6 was very different. Rajiv Gandhi did face a Hindu-Sikh cleavage in the state of Punjab, but never

<sup>56</sup> In 1991, both the BJP and Janata and its allies abstained from the house at the time of vote on the budget. Cf. *Lok Sabha Debates*, 14 September 1991, and *The Hindu*, 15 September 1991. In 1992, only 56 votes were cast against and as many as 227 in favour of the budget. Virtually the entire team of Congressmen voted in favour of the budget in both years. Cf. *Lok Sabha Debates*, 6 May 1992.

<sup>57</sup> Of the 120 BJP MPs, 99 were present at the time of budget vote. All voted against the government. Most Janata MPs abstained. Cf. *Lok Sabha Debates*, 5 May 1993, and *The Hindu*, 6 and 7 May 1993. The Communist Party Marxist (CPM) was the only party which voted consistently against the budget between 1991 and 1993, not the BJP or the Janata, showing that reforms were of greater ideological importance to the Communists than to the others. The BJP and Janata were, on the whole, strategic, not ideological, about voting on the budget. After 1993, the Congress, partly by offers of patronage, managed to get a near-majority in parliament and did not have to be concerned about parliamentary vote.

had the same nationwide intensity as the Hindu-Muslim divide. It was confined to north India. Moreover, Rajiv Gandhi had already concluded an agreement with Sikh politicians for peaceful resolution of Sikh demands in 1985. The agreement would unravel in 1988 and violence would touch dangerous levels. But 1985 and 1986 were years of cooled passions. The BJP had a mere two seats in parliament; the movement for the demolition of the mosque was still to take off; and the Kashmir insurgency was not on the horizon. In a political context of this kind, when economic reforms were introduced, politicians could easily use the price of food, fertilizer, and petroleum for mass mobilization.

To sum up, economic liberalization became a victim of its splendid solitude on the political agenda in 1985-6. In 1991, economic reforms were crowded out of mass politics by issues that aroused greater passion and anxiety about the nation. Because they were crowded out, reforms could go as far as they did.

#### WHY SOME REFORMS, NOT OTHERS?

Let me now turn to a different question. Why have some reforms been successfully executed, but others neglected or unsuccessfully pursued? Economic logic alone cannot explain the selectivity and rhythm of reforms. Reforms that touch, directly or primarily, elite politics have gone the farthest: a large devaluation of the currency, a restructuring of capital markets, a liberalization of the trade regime, and a simplification of investment rules. Reforms that are economically desirable but concern mass politics have been of two types: those that have positive political consequences in mass politics (for example inflation control) and those that have potentially negative or highly uncertain consequences in mass politics (labour laws, privatization of public sector, agriculture). The former have been implemented with single-minded determination; the latter have either been completely ignored or pursued with less than exemplary policy resolve (fiscal balances).

What arguments can be given in support of the claims above? Why are some economic issues part of elite politics, others of mass politics? To recall an earlier argument, at least three factors determine the political placement of reforms: (a) how many people are affected, (b) how organized they are, and (c) whether the effect is direct and short run or indirect and long run. The more direct

the effect of an economic policy, the more people are affected by it and the more organized they are, the greater the potential for mass politics. Thus inflation, by affecting everybody with the exception of those whose salaries are inflation-indexed, quickly becomes part of mass politics. Affecting fewer but still large numbers of people who, moreover, are organized, a change in labour laws and privatization of public enterprises also bring reforms in mass politics. Similarly, agriculture remains politically sensitive, partly because farm lobbies have become strong in the last twenty years (see Varshney, 1995); and partly because few understand what the benefits of agricultural reforms are whereas everyone knows where the cuts will be made—viz. in producer, fertilizer, irrigation, and credit subsidies. Contrariwise, given India's low external dependence and relatively closed economy till 1991, currency devaluations and trade reforms could affect very few people. Investment liberalization, similarly, could hurt the heavily protected industrialists and licence-giving bureaucrats, not the masses. And capital markets directly concern shareholders, still a small proportion of the population.

#### INFLATION

The mid-1960s and early 1970s were about the only two times in post-1947 India when annual inflation rates reached 20 per cent, low by Latin American standards but the highest ever in independent India. Since food prices constituted a very large share of the consumer price index and so many people were close to the poverty line, the rise in food prices led to widespread hunger, raising fears of famine and provoking food riots.

What were the political results? In the 1967 elections, the ruling Congress party was defeated in many states for the first time. And in 1973–4, despite a large Congress majority in parliament, strikes, demonstrations, and anti-government movements made it difficult for the Congress party to govern the country (see Rudolph and Rudolph, 1987, Ch. 8). That is why it is often said that India has low inflation tolerance. Until incomes increase substantially, reducing markedly the share of food expenses in a typical household budget, no serious politician in India can allow the annual inflation rate to touch 20 per cent, or allow it to stay in double digits for very long.

It should not be surprising that attacking inflation was a matter of macroeconomic priority for Finance Minister Singh when he took office (Government of India, 1992, p. 2), a task at which he succeeded remarkably. Between 1991–2 and 1995–6, annual inflation rate declined from about 13–14 per cent to 4.5 per cent.<sup>58</sup> The voter surveys of 1991 had shown that prices were a matter of great concern, competing with the mosque in Ayodhya and affirmative action.<sup>59</sup> In 1996, prices were not an issue in the elections.<sup>60</sup>

The inflation control policy has not been an unmitigated blessing. Its sins and blessings yet again reflect the difference between mass and elite politics. Tight money supply was the primary vehicle of inflation-control,<sup>61</sup> which led to higher interest rates making capital for investment expensive.<sup>62</sup> The government was less worried about high interest rates, which are of considerable concern to businessmen, than about bringing down the inflation rate. The former, needless to add, is of direct relevance to elite politics only; the latter an acute concern in mass politics.

#### LIBERALIZATION OF CAPITAL MARKETS, TRADE AND EXCHANGE RATE REGIMES

Compared to inflation, consider now the effects of capital markets. Though the numbers of stockholders in India may have risen

<sup>58</sup> Government of India (1996), p. 10. These figures are based on the wholesale price index (WPI), not consumer price index (CPI). The latter was higher than the former.

<sup>59</sup> *India Today*, 15 July 1991.

<sup>60</sup> That, of course, did not help the Congress party electorally, but the reasons for the Congress defeat had little to do with economics *per se*. All one can say is that electoral damage to the Congress could have been far worse if inflation rates had continued to be as high as they were 1991. A reasonable hypothesis for Indian electoral politics so far, though it is still to be systematically tested, is that good economic performance on the whole does not electorally help ruling parties but bad economic performance, especially if leads to double-digit inflation, hurts.

<sup>61</sup> Government of India (1996), p. 10. The subsidiary factors were high levels of open market sales of foodgrain and liberal import policy with respect to essential commodities.

<sup>62</sup> The government readily admitted that there was a link between the low liquidity situation of 1995–6 and high costs of capital borrowing. See Ministry of Industry (1996).

greatly of late, India's capital markets even today affect a very small segment of the population. Stock markets make headlines in business magazines, not vernacular dailies. The latter find stock markets newsworthy if and only if scams involving leading politicians are strongly suspected. Reforms of capital markets do not yet concern the masses. Corruption of the political elite, if demonstrable, is the link through which they read or hear about stock markets.<sup>63</sup>

What of trade liberalization and currency devaluation? Are they necessarily part of elite politics? In countries like Mexico, they are known to have seriously affected mass politics. In Venezuela, they were followed by a military coup, and a link between reforms and the coup was explicitly made (Naim, 1993, Ch. 5).

Were a country's economy heavily dependent on foreign trade, a lowering of tariff walls, a reduction in quantitative trade restrictions and a devaluation of the currency would be of great concern to the masses, for it would immediately affect mass welfare. In 1996, trade constituted more than 50 per cent of the GDP of Singapore, Malaysia, Thailand, the Philippines, Mexico, Hungary, South Korea, Poland and Venezuela, and between 40 and 50 per cent of the GDP of Israel, Chile, China and Indonesia. Changes, especially dramatic changes in the trade and exchange rate regimes of these countries have a clear potential for mass politics. However, if trade is a small part of the economy, as has been true of India and Brazil historically, changes in trade and exchange rate regimes tend not to be direct and of short-run importance to the masses.<sup>64</sup>

One can argue that even if the trade dependence of an economy is small, several long-run or indirect linkages can be shown to exist

<sup>63</sup> Thus those reforms that are normally a concern for elite politics but have the greatest potential for corruption can enter mass politics. Otherwise, they leave mass politics unaffected.

<sup>64</sup> The overall size of the economy complicates the meaning of low trade-GDP ratios. Smaller economies tend generally to have a high trade-GDP ratio, making trade very important to their political economies. With the striking exception of China, however, the largest economies of the world—the US, Japan, Germany—are less trade dependent. (Indeed, the trade-GDP ratio for India and the US was roughly the same in 1996.) Still, trade politics, as we know, has aroused a great deal of passion in the US and Japan. The meaning of the same ratios can change if the leading sectors (autos, computers) or 'culturally significant' sectors (rice for Japan, agriculture in France) of the economy are heavily affected by trade.

between mass welfare on the one hand and overvalued exchange rates or relatively closed trade regimes on the other. Anne Krueger (1993), for example, has argued that by making 'import competing' industrial goods dearer for the countryside and also discouraging exports, ISI-type trade and exchange rate regimes systematically discriminated against the countryside all over the developing world. The implication is that a majority or large plurality, of developing countries' population was hurt. Thus even when trade is a small part of the economy, trade regimes can have an effect on mass welfare, not simply elite welfare.

Why, then, have agrarian politicians in most developing countries rarely, if ever, agitated for open foreign trade regime, focusing instead on the unfavourable urban-rural trade which may, as Krueger argues, have caused less overall damage? The answer should be clear by now. If such *indirect links* were not even clear to economists, who continued until the 1970s to look at rural welfare primarily from the viewpoint of internal terms of trade, how can a politician be expected to mobilize peasants over the underlying and subtle, though hugely important, links between foreign trade and mass welfare in a poor country? *Underlying long-run and indirect links do not work well in mass politics: the effect has to be simple, intuitively graspable, clearly visible, and capable of arousing mass action.* It is easy to demonstrate the differences, or links, between urban privileges and rural misery, rather hard to make the connections between foreign trade and rural poverty. The latter, of course, has been an article of faith in elite politics in recent years, as international financial institutions have sought to change the economic discourse of policy makers in the developing world.

#### PRIVATIZATION AND LABOUR LAWS

India's central government is a majority shareholder in 240 enterprises, 27 banks, and 2 large insurance companies. Only some of these enterprises generate profits. To reduce public sector expenditures, the government is pushing public sector companies to raise resources from capital markets instead of providing them with budgetary hand-outs. But no loss-making public sector company has yet been sold by the central government. Despite the fiscal burden, privatization so far has been a non-starter. In June 1998, seven years after the reforms were introduced, the government finally announced its intention to push through privatization,



but it is still to be seen how far it will go, how much resistance will surface in politics, and whether the government will succeed.

It should be noted, first of all, that on economic grounds alone privatization, while desirable, may not be as critical in India as in Eastern Europe where the private sector did not exist. Since India has a long and established private sector, it has had the option to attach, compared to privatization, greater importance to increasing deregulation of the private sector and to an end of government monopolies in banking and infrastructure. In China, too, the state sector has not yet been substantially privatized yet, though, like India, the government has finally announced its intention to privatize. China has primarily made it easier for the non-state sector to flourish (Sachs and Woo, 1994). However, whether or not privatization was necessary earlier in India, its desirability is becoming rather clear now. If the public sector is not privatized, it may well create a serious macroeconomic crisis by making fiscal deficits impossible to plug.

The hurdles for privatization are primarily political in India. Given the overstaffing of the public sector and of older private sector units, privatization will entail massive lay-offs. As a result, labour in the organized sector is opposed to privatization. Compared to the unorganized and rural sectors which account for a 280–300 million strong workforce, the labour force in organized industry and services may be small in terms of numbers. But in absolute terms, it is sufficiently large and more critically, it is also unionized. In 1992, about 20 million people were employed in the public sector and 8 million in the organized private sector. A confrontational relationship, especially between the government and public sector unions, can bring banks, railways, telecommunications, coal and steel production to a virtual halt, and create serious political turmoil. This is not simply a theoretical point. A large railways strike in May 1975 was the immediate occasion for the suspension of democracy and for India's only authoritarian phase, which luckily lasted only eighteen months. *Unlike Mexico where a long-standing, corporatist relationship exists between the ruling party, PRI, and labour unions, and Argentina where the Peronist government has had influence over the labour movement, no single political party in India controls the unions.* An agreement between the unions and government on the necessity of retrenchment cannot be assumed. Its possibilities have to be creatively imagined and worked upon.

Moreover, in a society where millions are unemployed, the economic idea of firing existing employees on grounds of rationality is hard to present politically. There is deep irony in this situation. It can be argued that the privileges of the organized workforce are a significant explanation for why employment in India has not grown as much as the economic and industrial growth rates since the early 1980s would seem to warrant. If labour markets had been more flexible, there would have been greater employment in the country. Turning this economic logic into political rhetoric, however, requires statesmanship, or an exceptional political period when the government's popularity or legitimacy is very high. As far as the average person is concerned, it is the government's responsibility to create jobs, not take them away. It is not easy to convince the electorate that taking away jobs today is equal to giving better jobs back tomorrow. Moreover, a large proportion of the organized working class still has rural links: organizing a large part of the electorate, let us say the peasantry, is easier if the target is the state, not if the target is the industrial working class. In other words, both for ideological reasons and for the difficulties of coalition building against organized workers, a reform in labour laws or privatization poses serious political difficulties.

Can privatization be, and be shown to be, socially sensitive? Must workers be fired in a privatization programme, or can they be kept?

State governments may have begun to come up with an answer, even if Delhi has not. Faced with loss-making units and revenue inelasticity, some have begun to privatize, requiring however that employees not be fired. Tata Steel, for example, bought OMC Alloys in Orissa in 1991, and has also turned the company around without firing a single worker. Higher capacity utilization ratio after privatization appears to have been the trick. In state hands, OMC Alloys was working at about 50 per cent of its capacity; under Tata Steel, it went up to 90 per cent. The workforce remained the same but productivity went up, turning profits for the company. Presumably, many such companies exist, meaning that a higher capacity utilization ratio can be a positive-sum game in many cases. This is a possibility worth exploring systematically.

If somehow privatization can be decoupled from large-scale retrenchment, it will be easy to make a political case for it. If not, it is likely to be launched in sectors not critical to mass politics—for example hotels and tourist businesses, not banks and railways.

Politically it will be easier to launch a bigger privatization programme after the economy has started generating enough jobs,<sup>65</sup> or if a large enough structural renewal fund can be created providing social security and funds for retraining.<sup>66</sup>

#### FISCAL DEFICITS

Can fiscal deficits be cut further? The fiscal debate is mostly on expenditures, not revenues. It is generally believed that India faces considerable revenue inelasticity in the short to medium run (Bagchi, 1994). Tax revenues constitute 16–17 per cent of GDP, which at the per capita income level of India are relatively high by comparative standards. Thailand, whose per capita income level is much higher, has a tax–GDP ratio of 17 per cent, and other South Asian states, all in the same income category as India, have a ratio of 12–14 per cent. Very few believe that the tax–GDP ratio can be substantially higher in India in the near future. The tax debate is essentially about increasing the ratio of direct taxes and reducing the level of indirect taxes, in a manner that can keep the tax–GDP ratio intact for the time being. Further simplification of tax rules is also considered both feasible and desirable.

Cutting government expenditures thus is the main short- to medium-run issue. Governmental handouts to the loss-making public enterprises on the one hand, and food and fertilizer subsidies constitute the main potential areas of cuts. The political aspects of privatization have already been discussed. What about food and fertilizer subsidies?

Food and fertilizer subsidies—adding up to 1–1.2 per cent of GDP—are widely viewed as excessive. What the government collects in personal income taxes—about 1 per cent of GDP—is spent on just two subsidies, food and fertilizer. The aim is to keep farmers and food consumers happy. In a poor country where an average household still allocates 65–70 per cent of its budget to

<sup>65</sup> In an interview with the author (Delhi, 12 January 1992), Finance Minister Manmohan Singh unambiguously stated that given the desperation for jobs, he neither had the conscience to fire people nor was it politically feasible—until alternative opportunities could be provided.

<sup>66</sup> India's central decision-makers have talked of a structural renewal fund, but no effective fund has yet been set up, partly because the financial requirements are quite high.

food expenditure, it is not clear how, without significant increases in the income of the poor, food subsidy can be lifted. Reduction of waste and selective targeting is all one can hope for.

Fertilizer subsidy, too, has drawn a great deal of critical economic attention. The power of farmers in the political system is the primary reason a drastic cut has not been made, despite its fiscal burdensomeness. Nor can it easily be made unless a deal is made with farm leaders that, while taking fertilizer subsidy away, something is offered in return. Agricultural reforms, which can somehow respond to the government's fiscal constraints as well as be shown to be pro-agriculture, may well be the only solution. What such reforms entail remains a question that has not been studied enough.

In addition, in a country where only 52 per cent people are literate with millions unhealthy as well, government expenditures are required for health and education.<sup>67</sup> If in the process of cutting government expenses, the reform programme gets associated with making people less healthy, more illiterate, and hungry, it will lose a lot of political ground. Ultimately, the big solution, of course, is for the state to pull out of loss-making public enterprises in manufacturing and services, and re-focus on the social sector. *Privatization and social welfare may thus be more integrally linked than is often realized.*

#### CONCLUSION

Concentrating on India's economic reforms and drawing examples from other reforming and democratic countries, this chapter has argued that if we wish to understand why some reforms are successfully initiated and implemented while others get stalled in a democracy, it will be helpful to draw a distinction between mass politics and elite politics. Mass politics often tends to be more pressing in a democracy than elite politics, as politicians must periodically renew their popular mandates, a requirement with which authoritarian governments are not routinely burdened. While at the time of elections, popular consideration may be absolutely compelling in a democracy, even between elections a

<sup>67</sup> For India's social sector needs, see Dreze and Sen (1995). For educational needs in particular, see Weiner (1992).

vibrant and free civil society has the capacity to mobilize and press the government against reforms which, though providing benefits to the masses in the long run, may entail short-run costs. Those reforms which do not easily enter mass politics—investment liberalization or trade and exchange rate reform in an economy where the trade–GDP ratio is low—are easier to push through than privatization, elimination of fiscal deficits, and a reform of labour laws to make labour markets flexible. The latter set of reforms inevitably affects a large number of people directly and in the short run. Trade reforms in economies that have high trade–GDP ratios may also easily enter mass politics, but that is not so in all economies. The existing trade dependence of an economy determines whether trade reforms will trigger mass politics and large-scale political mobilization.

Popular resistance, however, can be overcome if some other policies, or political issues, that can generate support for the government are also on the agenda and, compared to economic reforms, are able to attract greater popular attention. One can, for example, show that ethnic conflicts in many pluralistic societies are more likely to arouse mass passions than disputes over economic reforms. Paradoxically, the relegation of reforms to a secondary political status can work to the advantage of reformers, for mass preoccupation with ethnic issues provides political room to push reforms. The biggest lesson of India's economic reforms, as well as other reforms briefly surveyed in this chapter, is that given a *multiplicity* of salient political issues, even minority governments can press ahead with economic reforms. Contrariwise, strong governments, with solid majorities in the legislature, can fumble if reforms become the sole focus of political contestation in a country.

It is often argued in economic circles that if only politicians paid greater attention to economic issues, economic reforms would be so much easier or more successful. That argument may work well in authoritarian settings, but has only limited relevance in democracies. Whether or not reforms succeed in democracies depends not only on how the government leverages its popular support, a point well understood, but also on the availability of political issues not related to reforms but occupying popular attention and mass energies.

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## The Regionalization of Indian Politics and Its Implication for Economic Reform

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The economic liberalization undertaken by India's central government has initiated an economic reform process by the state governments. Some state governments have encouraged private domestic and foreign investment in sectors previously reserved to the public sector, cut their fiscal deficits, promoted investment in electronics, information technology, electric power, roads, air transport, and ports, and reduced subsidies. State governments compete with one another for private capital, as well as for investments by the central government. But for the most part the reform process in the states has proceeded slowly. State governments maintain large fiscal deficits that are a drag on the national economy. With few exceptions the states have done little to address the needs of the social sector, significantly reduced bureaucratic regulations, privatized or reformed inefficient state-run public sector enterprises, stimulated investment in infrastructures essential for an expansion of private investment, expanded and reformed primary education or improved tax collection. This chapter examines the role of state governments in India's economic liberalization and the impediments to accelerating their reform processes.

India's state governments share with the central government responsibility for developing the country's infrastructures, most notably in electric power, road construction, irrigation facilities, and water supply. State governments, for example, control nearly two-thirds of the country's power-generating capacity. These governments have major responsibilities in the fields of