The Budget, Government Style and the Sustainability of Economic Reform in India

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October 1998

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I. Why Budget 98 is different: Changing the Government Style

The Union Budget presented on June 1, 1998 by Yashwant Sinha received a lukewarm reception. A frequently repeated criticism was that the budget lacked a sense of direction. The business press was especially harsh. In bold language, rich with metaphor, one sample of the business reaction ran as follows:
" Void of vision but brimming with bravado...Union Finance Minister Yashwant Sinha ... served up a Molotov cocktail .... that blew apart the hopes of a comprehensive financial package to Viagra the industrial sector. "[1]

Since the economic reforms were launched in 1991, the annual budget of the Union Government has assumed a special aura—as a key signal about the direction of economic policy—or more precisely, as a barometer for liberalization. Earlier budgets presented by Manmohan Singh and P. Chidambaram were received with great enthusiasm by business, and succeeding governments have claimed to have broadly pursued the economic reform agenda Yet seven years down the road, there is little evidence that India has entered a phase of high and sustainable growth In fact, the economic trends point in the opposite direction. The main pillars on which the revival of Indian economic growth was to have been founded - industrial production and exports—have revealed their vulnerability. In both the major material production sectors-(industry and agriculture) growth is in the doldrums. Declining and decelerating industries had more than half the share in the manufacturing sector in 1997-98. On the macro-economic front, the fiscal deficit remains as great a threat as ever, having risen. Foreign portfolio investment flows are down sharply, negating gains from the up trend in FDI. Further domestic investment intentions have fallen sharply (See Tables 1-3, and Chart 1)

Cowered by recession, the industrial and agricultural lobbies are now highly vocal in their demands on the State for protection, subsidies and "pump priming" of the economy What do these events signify? Have the market reforms stalled? What exactly has changed in the reform process?

When examined from this perspective, it is clear that Budget 98 cannot be viewed in isolation. It must be seen as part of a political-economic process in which the political agenda of the government interacts with entrenched economic interests Moreover, the budget reflects constraints posed by the condition of the economy. These constraints, in an era of unstable coalition politics, have been in turn influenced by policies of preceding governments. This paper therefore attempts to situate the budget within a longer view—the political economy of the evolving reform process and what it implies for the overall direction of the Indian economic policy.

One important issue at this juncture is whether or not Budget 98 represents *a sharp break in ideology with respect to the role of government* in the economy. If so, the long term strategic implications of the budget are significant. One noteworthy feature of the expressed views of most political parties (barring the Left) since 1991, has been a broad acceptance of the idea that economic reforms were necessary and ought to be continued. Few parties have campaigned on the promise to jettison the reform process. Most have, however, suggested modifications to the original Manmohan Singh blue print. But it is useful to note that the zone of consensus has broadened. Broadly speaking, several ideas, which had appeared path breaking in 1991, have now come to be accepted as part of the mainstream. For example, reform ideas on which there is now a fair degree of political consensus include the following:

- Balance of payments sustainability is crucial
- The Indian economy should not revert to the closed trade and foreign investment regime of the pre-reform period
- There should be a moderation in internal borrowing by the government, so that an internal debt trap does not emerge
- The bureaucratic control-dominated policy framework had become dysfunctional, and reforms should continue on this dimension
- Market forces should be encouraged provided their negative impact on income distribution is kept within politically manageable limits.

If this assertion is correct, then it means that on the ideological plane *as far as reform objectives are concerned*, there is a fair degree of consensus on the key elements It would therefore appear that political differences are not so much on the basic objectives of reform, but on the particular approach to policy making . What then is the difference in approach, which has caused such misgivings about Budget 98? There are clearly two aspects that stand out. The first is the Swadeshi component of the Budget's design, and the second relates to doubts about commitment to fiscal discipline and macro-fundamentals [2] The real concern is that the two aspects may be related, i e , that swadeshi policy might lead to the downgrading of macro-stability as the main policy objective, and the overall reform itself may thereby be seriously compromised. This paper will focus on whether the implicit policy approach embodied in Budget 98 has significant implications for the *nature of engagement of the government with economic actors*[3] Is there a fundamental change, and might this lead to a conflict with the process of liberalization. This issue is important because, once political processes that modify the "government style" are unleashed, these can become entrenched and thus very difficult to reverse.

What exactly is Swadeshi about Budget 98, and how might it conflict with liberalization? One aspect of it is obvious—the desire for providing higher *protection* from external competition has now been made explicit in the indirect tax proposals. This aspect has proved to be controversial. Here the opposition comes from a mix of sources. Some are opposed to this on ideological grounds. This line of criticism sees this as an attempt to back away from the trend toward trade liberalization, and the GATT-WTO agenda. However, the basic worry is based on two pragmatic considerations. First, whether this would dampen international capital flows by projecting a nationalist-autarkic image abroad; and second, whether this would upset the *internal* playing field by introducing differential protection to different sub-sectors and economic groups. Indeed, the major *systemic worry* is about the degree to which the budget reflects a heightened degree of *politicization* of the budget process. If true, critics fear that expediency rather than collective economic rationality may determine policy. Rather than being 'arms length' and 'even-handed' in approach, tax and subsidy policy may turn discretionary and particularistic in response to lobby persuasion.[4]

This impression of uneven treatment in Budget 98 is strengthened by the widely varying content of the remarks of different industry leaders to the budget speech, and from other independent assessments.[5] Thus, the fear is that on the pretext of being "swadeshi", Budget 98 is actually and deliberately *discriminatory* among domestic industries and business groups Further, the manner of discrimination is not transparent in terms of its strategic design and economic logic. This tendency to discriminate between economic groups has also been carried over to the external sector A feature of the budget speech, which was widely noticed, was the neutral tone with respect to foreign investments. This was in stark contrast to predecessor speeches, wherein wooing the external investor groups was high on the agenda In contrast, Budget 98 has tried to make a *sharp distinction among external investors* More precisely, the political signal being given is that of *special treatment in favour of NRI investors*, together with a lukewarm approach to the international investor community

Thus, a pattern emerges in the *operational content of swadeshi economic policy* of the present government This consists of an explicit effort to forge links between the state and certain segments of industry and external NRI interest groups. This approach marks a departure from the way that the government has hitherto dealt with economic groups in the reform period[6]. The government apparatus is being used to forge certain specific alliances with independent economic actors. Supporters might claim that the government has shown that it is ready to be "responsive" to concerns of groups who are affected by policy. Others, however, would characterize this as a way to convert the economic policy process into a forum for lobbyists. Of course, all governments in democratic contexts are open to pressure, and follow policies that are aligned to the underlying political support base. However, this appears different in the explicit attempt to draw organized, large industry into the political landscape as players who may have to choose sides. As far as industry is concerned, we find therefore an attempt to modify the relationship with government.

It may be useful to contrast this with the government style that underlay the earlier phase of reform. The liberalization agenda, as outlined by Manmohan Singh and continued by P.Chidambaram, drew *ideological inspiration* from the neo-liberal philosophy of economic reform.[7] The key propensities of this philosophy are anti-bureaucracy, anti-planning and macroeconomic discipline. In policy terms, these translate into decontrol of the economy, and the downgrading the status of long term economic strategic function of the state. A further objective is for a lower share of taxes and government expenditure in GDP. The implied government style of this reform agenda is therefore one where the government would concentrate on setting "rules of the game", and generally distance itself from market processes.

Thus, when we compare the implied government styles in Budget 98 with its reformist predecessors, we can see that there is a difference in essence. This is perhaps the reason why some critics have complained about the supposed return to the "Nehruvian era".[8] Absurd as such comments may sound, they reflect the prevailing confusion about the institutional dimensions of governance. This is hardly surprising, because there has been little substantive analytical debate nationally on this aspect of reform in the past seven years. As a result, any policy approach that deviates from the neo-liberal package tends to be seen as a large blur. Even intelligent commentators appear unable to distinguish between discretionary economic policy, socialism, planning, trade protectionism and state investment in infrastructure. As long as successive governments broadly pursued the neo-liberal agenda, such distinctions might have seemed 'academic' and irrelevant. Budget 98 has, by attempting to change the government style, inadvertently brought this dimension to the fore It can no longer be ignored It may be useful therefore to examine more closely the significance of this change

In the following section, we elaborate on the concept of "government style" in some detail, and try to relate it to the Indian reform. The remaining sections of the paper address the question of why the particular (neo-liberal) government style with which the economic reform was associated from 1991 to until Budget98 has faltered, and does not appear to be sustainable The logic of the argument is put forward through a diagrammatic model. We should emphasize here that our focus on this question does not imply that we are suggesting that the present approach, as currently conceived, will succeed in its objectives We treat this issue as beyond the scope of this paper.

II A Dichotomy of Post-Reform Government Styles:

Following Okuno-Fujiwara, we shall draw a distinction between two main government styles: ***rule-based*** and ***relation-based***. This distinction, in our view, captures the difference in the approaches to economic reform of the Congress-led and UF-led governments on the one hand, and the BJP-led government. on the other. In their pure or ideal form, the two styles are mutually exclusive. In the rule-based government style, the government sets the *ex-ante* rules of behaviour for market participants The role of the state is to look after the social and legal framework of competition In economic intervention, it avoids discretionary, discriminating policy acts, which "distort" incentives for market participants The entire thrust on removal of controls can be seen as a move towards a rule-based government style. By contrast, in the relation-based government style, policies are made through negotiations between policy makers and economic actors In the latter set up, the government engages in *ex-post* interventions, and continuously modifies policy in response to evolving circumstances The government is not a passive observer, but plays an active role in market processes It does very consciously distort market incentives in pursuit of its economic objectives [9] These two government styles represent alternative models for economic governance for a country like India Indeed, we have observed a tension between these two styles as the reform has evolved

Recognition of these alternative government styles facilitates a richer and more nuanced approach to the institutional agenda of reform in a market economy. First, it allows us to see that *the systemic issue for India is not simply replacing controls with the market.* The alternative to a neo-liberal governance style in the 1990s in India is not necessarily "bureaucratic controls" and "socialist planning". For some time, the dominance of the neo-liberal reform movement on the world stage had obscured the distinctions between its alternatives. But as the 1990s have progressed, and many transition experiments have belied initial rosy expectations the debate on government styles has become serious and substantive. Even in the World Bank, itself once a cornerstone of neo-liberal thinking, there is evidence of intense re-thinking on the role of the state in development. Before the present economic crisis, the East Asian economies had achieved superlative performance for three decades or more. Many sought to draw lessons from this experience.[10] An early example of a World Bank publication that broke from the pure neo-liberal mould and sought to find a compromise between rule-based and relation-based thinking came in 1993.[11] The main focus and argument of the book is summarized in this brief passage:

> What caused East Asian success? In large measure the HPAEs (High performing Asian economies) achieved high growth by getting the basics right...Fundamentally sound development policy was a major ingredient...Macroeconomic management was unusually good....providing the essential framework for private investment...All the HPAEs kept price distortions within reasonable bounds and were open to foreign ideas and technology.
> But these fundamental policies do not tell the entire story. In most of these economies, in one form or another, the government intervened—systematically and through multiple channels—to foster development, and in some cases the development of specific industries. Policy interventions took many forms.....Some industries were promoted, while others were not At least some of these interventions violate the dictum of establishing for the private sector a level playing field, a neutral incentives scheme.[12]

The tension between the two perspectives on the role of government is apparent. While the Bank was careful not to endorse the policies mentioned in the second paragraph quoted above, it acknowledged their presence in the 'miracle economies', and adopted a rather agnostic posture arguing that it was " virtually impossible to measure the relative impact of fundamentals and interventions on HPAE growth "[13] The report was, however, quite explicit in accepting the idea of establishing an "institutional basis for shared growth", devoting a full chapter to the subject.

Subsequent experience with reform, and further research outside and within the Bank, have steadily brought increased emphasis on institutional reform in the World Bank's agenda The theoretical foundation for such recommendations has become more firm. The 1997 World Development Report is "the third World Bank report in seven years to consider the role of the state (and) signals an *emphatic shift in agency thinking*. Early enthusiasm for neo-liberal policies... is now tempered by explicit rejection of their more radical forms."[14] In arguing for an "effective state", the WDR 1997 is careful to state that its message is not one of simple dismantling of the state, and that "there is no *unique model* for change". In other words, even the World Bank would concede that there are *other market-enhancing alternatives to the neo-liberal state.*

It is therefore useful to examine the relative merits of alternative styles in order to understand the significance of the switch in government styles that has been taking place. Returning to our dichotomy of government styles, the first point to note is that neither the rule-based nor the relation-based style is *intrinsically superior.* They each have their advantages, as we shall see presently. Equally important, within the same policy domain, they tend to be *mutually exclusive*. This is because, when used in conjunction, they tend to undermine each other. The rule-based system, as noted earlier, relies on ex-ante regulations. But the relation-based style is based on policy negotiations between policy makers and economic agents. If ex-post negotiations are permitted, then this would compromise the ability of the government to pursue a rule-based style, for rules would then be altered and the reputation of the government as an impartial setter of the 'rules of the game' would suffer. Eventually, the two styles cannot be adhered to simultaneously within the same policy domain.[15] It may, however, still be possible – we would contend—to have different styles in separate policy domains.

Does government style matter for policies to be effective? Rule-based and relation-based government styles each have their relative advantages.[16] In the abstract, the two styles can be assessed on the following dimensions:

(1) *Ex-post flexibility in policy implementation*: In some situations, for example in case of an uncertain environment, this may be an advantage. Policy needs to respond rapidly to changing circumstances In such conditions, **relation- based style is superior to the rule-based style.**

(2) *Effectiveness in the context of asymmetric information*: When economic agents, such as firms, have greater information about their activity context, it makes monitoring rather difficult The policy makers cannot judge whether private firms are acting according to the rules of competition Lack of information also makes it difficult to produce verifiable evidence of rule violation to satisfy a third party, e g a court of law. In these circumstances, again, a **relation-based policy style would be superior to a rule-based policy style.**

(3) *Stability of Ex-ante Incentives for Private Sector:* When making decisions with long term payoffs, such as investment in R&D, private perception of risk can be affected by policy uncertainty. In these circumstances, private agents have a greater incentive to invest if the future business environment could be predictable. In a relation-based style, policies would tend to be adjusted more frequently. Hence from the viewpoint of providing stable ex-ante incentives, the **rule-based style would be superior.** Indian fiscal policy-makers have appreciated this principle for some time.[17]

(4) *Ease of Collusion between Regulatory Authorities and the Private Sector:* In many types of markets, even after liberalization, there remains a need for regulation. A good example is financial markets. Such regulatory functions can be severely compromised if there exists collusion between the regulators and the parties to be regulated. Here, once again **the rule-based style would have an advantage.** At any rate, relation-based styles in these policy areas would need to have rigorous safeguard features to block such collusion.[18]

(5) *Fairness and Transparency of Policy Formation and Implementation:* For markets to function properly, it is important to preserve a basic faith in the non-arbitrariness of the policy regime[19] Otherwise, there would be incentives for competition to spill over from the economic to the political domain. This does not necessarily mean that policy should not discriminate between market actors, but that there should be fairness and transparency. Under a rule-based government style, there is much less opportunity for favouritism. Hence from this consideration, **rule-based style is preferable to a relation-based style.** Of course, if the policy making body has acquired a *strong reputation* for fairness based on past behaviour, then this can to some degree counter the fear generated by low transparency in the minds of market actors.

(6) *Ability to adhere to hard budget constraint:* When the need arises for enforcing a hard budget constraint, say in meeting fiscal deficit targets or bolstering similar macro-fundamentals, it is generally argued that a relation-based governance style would run into difficulty. This style would be more vulnerable to political pressures and threats It would be difficult for example to cut funding which might threaten employment. Hence, **a rule-based style would be more amenable to imposing fiscal discipline**, as it would be relatively 'insulated' from political pressure.

The above assessment of alternative government styles illustrates their relative strengths and weaknesses in their *pure form*. In reality, however, we see a co-existence of the two styles in most societies For societies undergoing market oriented reforms, and in which the state has long played a dominant role in the economy, this co-existence is all the more likely. Even in the advanced capitalist countries, such as the US, we see the simultaneous presence of the rule-based style embodied in the independent functioning of the Federal Reserve Board, with the visible lobby-sensitive policy making in the area of foreign trade. In most countries, the two styles are in constant tension and form the core of policy debates.[20] The institutional agenda of reform for a country like India should, therefore, be to find the optimum blend between the two styles—a mix that is optimum in relation to its level of economic development, political structures and national objectives. Moreover, each of the dimensions on which the policy capacity of alternative styles has been evaluated above —(flexibility, monitoring ability, creation of stable incentive environment, avoidance of regulatory 'capture', fairness and transparency, and macro-discipline), is important. Rather than sacrificing any one dimension, on the basis of some ideological pre-disposition in favour of a particular style, it is better to seek an institutional mechanism that allows the policy maker to combine the positive features of both styles [21]

The reform agenda of the Narasimha Rao government included a significant effort to establish a rule-based government style, particularly in the microeconomic governance of industry. To understand this line of argument, and to appreciate its rule-based underpinnings, it is necessary to recapitulate—albeit in a brief and stylized form, the basic logic of the economic reform initiated in 1991. The Rao-Manmohan Singh economic reform had two basic components: macro-economic stabilization, and micro-economic reforms. *It is the latter which embodied the rule-based transition agenda.*

The basic objective of macro-economic policy reform was to stabilize the external balance of payments and reduce inflation, and thereby enhance the confidence of foreign investors. This was expected to lead to a higher flow of foreign investment, augment domestic savings, and lead eventually to higher growth of GDP. Higher growth would also ease the burden of bringing the fiscal deficit under control, and equally important, it would facilitate the adjustments required by the micro-economic reform

Micro-economic policy changes were targeted at *altering in a fundamental way the working of the economic system*. By deregulating the economy, market forces were given a far greater role, and through the mechanism of competition, its aim was to raise efficiency in the economy. A number of favourable conditions for the private sector were created by these reforms These included enhanced freedom of operation.

greater avenues of investment opened up by the de-reserving of industries from public sector monopoly, and greater opportunities for accessing funds both through domestic and external financial markets. While the transition to the new rules of the game may require some time for adjustment, eventually these micro-reforms would lay the groundwork for high growth. This high growth would in turn, would facilitate the macro-economic adjustment. Thus, the reformers had hoped for and expected a synergy between macro and micro reforms. The key link between the two was the growth rate during the transition process. A prolonged slump had the potential for undoing both the macro as well as the micro reforms.

The micro-economic reforms were fairly pervasive and covered a large number of areas[22]. In this paper, we shall focus specifically on those relating to the industrial and external sectors. The rule-based character of these reforms can be seen from the following key features:

Industrial Policy Reform:

- Abolition of industrial licensing was a major aspect of rule-based reform—a transition from discretion to rules. The government's Industrial Policy Statement of July 1991 explained the logic of de-licensing in terms of letting " the entrepreneurs make investment decisions on the basis of their own commercial judgement." From exercising control through ex-ante mechanisms of granting permission, the government's role would now shift to one of providing support by "essential procedures fully transparent and eliminating delays". In other words, replacing the rather extreme form of relation-based control system, would be a system that fixed and upheld the rules of the game for market competition.
- On foreign investment, the shift towards a rule based system was apparent, though the policy change was far more gradualist and cautious. The aim of reform was to reduce the "selective" approach of earlier policy, and permit a much wider domain of operation for foreign direct investment.[23] The reform permitted foreign direct investment up to 51% in a defined list of 34 industries, and also eliminated various restrictions on firms with foreign holdings [24] For those who wished to invest beyond the 51% limit in the listed industries, and also for investments in industries other than those in the specified list, the relation-based or discretionary mode continued. However, the approving authority was now to be very high-powered bodies—the Foreign Investment Promotion Board, together with a cabinet level committee on foreign investments. The rule-based agenda included 'leveling the playing field' for competition between domestic and foreign capital in industry. The industrial policy statement declared that "there shall be no bottlenecks of any kind in this process....This change will go along way in making Indian policy on foreign investment transparent"

In brief, therefore, we can see clearly the main direction of the reform policy with respect to industry: *to remove or to reduce discretionary control* mechanisms relating to entry, expansion, and location decisions, and to *introduce transparent rules*.

Trade and Exchange Rate Policy Reform:

A similar pattern can be found in the external sector policies as well. The earlier framework had relied heavily on discretionary instruments—a managed (overvalued) exchange rate, quantitative restrictions on imports, high import tariffs, and complex export subsidies.

- The new policy regime drastically reduced quantitative controls (except for final consumer goods). Tariff levels were reduced substantially. Subsidies on exports were removed.
- The exchange rate was devalued and put on a market –determined trajectory

In both dimensions, the approach was gradualist, but the government clearly signalled the direction of change, which was further liberalization. Through these changes, once again, the government sought to put in place a greater degree of market competition, allow freer access to imported inputs, without the dysfunctional control mechanisms. However, there were economic losers and gainers in the process. For this reason, there remained areas where liberalization was going to be slower, reflecting the political difficulty of switching from controls to a rule-based system. Consumer goods imports, and imports of certain intermediate products, and capital account convertibility are examples of "slow track" areas of liberalization.

To sum up, it is clear for the above, that the essential content of the design of the micro-systemic reform initiated in 1991 was to move to a rule-based system of economic governance. It was, however, partial in scope, and gradualist in the speed of implementation.

III Why did the Indian Reform Transition to a Rule-based Style falter?

The interesting question from a policy and strategy perspective is the following: Why did the rule-based reform agenda (initiated by Prime Minister Narasimha Rao and Manmohan Singh) falter? We shall argue that this happened mainly due to *institutional lacunae in the reform* *process*. In our view, this aspect received inadequate emphasis in the reform design, and consequently state capacity to implement the reform remained undeveloped.[25] Our emphasis on the need for developing state-capacity even in the context of rule-based reforms may strike some readers as odd. This is understandable, since a common perception has been that market reforms simply means downsizing the state, and preventing it from interfering with markets. But both economic theory and the evidence of the last two decades with market reforms now clearly support the view that such 'market fundamentalism' is overly simplistic. We would argue that the requirements for state capacity have been often under-estimated in reform design. Ultimately, this lacuna in the Indian case led to the political unraveling of the transition to a rule-based system. This institutional weakness proved more decisive than any intrinsic flaw in economic logic that might have characterized the reform.

Why did this reform agenda fail to keep its momentum? Why do we now find that the rule-based transition is under serious challenge from the relation-based style introduced in Budget 98?[26] These questions can be examined from two perspectives. The first is the static perspective of what factors can sustain a rule-based system that has already been established. The second perspective is dynamic, viz., what factors sustain a transition from a controlled economy to a rule-based economic system. These considerations allow us to judge the implementability of the reform agenda.

Recent analytical work on the political and institutional dimensions of policy making can help in understanding the Indian reform experience. It is a truism that any economic system rests on an institutional and political foundation. In order to succeed within a democratic political milieu, a rule-based policy framework would require certain enabling pre-conditions. The most basic requirement is that rules be obeyed. Consensus on some basic ground rules can play a crucial positive role. For example, in the arena of market competition, the market participants must accept the legitimacy of competition, and the rewards and punishment that the competitive process generates. Both success and failure must be socially acceptable. If this is not the case, there will be a strong tendency for participants to try to change the rules of the game through a variety of non-market mechanisms. These can range from political lobbying to change the rules of the game ex-post, to cheating and corruption. All these activities are not merely a nuisance to the reform process, but actually have the more dangerous potential to undermine the system itself A chain reaction characterized by myopic pursuit of immediate self-interest can set in, which can lead to the eventual breakdown of the norms and laws of the social infrastructure of competition.[27] A rule-based system cannot function effectively without stability of rules, and will not thrive if the dominant tendency is to change rules all the time.

Adherence to the rules of the game, on the other hand, smoothes the competitive process and lowers the cost of governance within a rule-based system. It accomplishes this by reducing frictions in market contracts, ensuring better enforcement of agreements, and enabling market contestants to focus the competitive effort on economic (rather than political) dimensions. Why would market participants voluntarily agree to play by the rules? This is a key issue for the sustainability of a non-dictatorial rule-based system. A fundamental consideration is the *fairness* or impartiality of rules. The belief, that under a fair rule-based system, the individual's economic well being is protected *over the long run*, allows them to transcend the myopic temptations of rule breaking.[28] This in turn gives the rule-based system its stability. But when do participants believe that the rules are fair? As Dixit notes, this depends on the *process through which rules are made*—in particular on whether or not the rules are made "under a veil of ignorance". In other words, whether there is insulation between the rule-making process and vested interests. The neo-liberal conception allows for some discretionary policy actions, but there is a very sharp distinction between policy acts, which are transient, and policy rules, which are stable. In reality, however, this neat division between stable policy rules and transient events or policy acts does not hold, for at least three reasons. First, rules simply cannot cover all possible contingencies, nor can they be always enforced due to problems of information asymmetry, and must remain sufficiently general. This vagueness allows room for manipulation by interested participants, and has the potential to gradually lead to the breakdown of rules. Second, quite often the rule making process is not insulated from interests, and is embedded in the "politics of the time". Thus, they contain biases that reflect the short-term interests of those who have the opportunity of making rules. Third, social norms have an inertia, which prevents the new rules from making a complete break with the past.[29]

If we examine through this lens, the Indian attempt to establish a rule-based policy framework for industry and trade, we can see that each of the above caveats hold true. Hence, its vulnerability becomes immediately apparent. Of particular interest is whether or not the rule making during the reform process has been insulated form interests. Though the evidence available to us is anecdotal and sketchy, it does point to the conclusion that this has not been the case.

i) *Relational Obstacles to Impartial Rule-making*

Consider first the issue of whether the rule-making process under the reforms was actually insulated from pressures of interest groups The plain fact is that this was not the case, and is well recognized

The conditions under which the early reforms were carried out can be gauged from the observations recorded by one of the key participants in the process [30] According to Desai, the government at the time was besieged by pressure groups seeking to influence policy. The pressures emanating from parliament were "only the tip of the iceberg". There was in addition, "a seething mass of communication aimed at the government" from the press, parties, lobbies, industry organizations, trade unions, public interest groups and "other busy bodies".

It is very interesting to note, in this context, the enhanced prominence and glamour of the apex industry associations after 1991. At the very time in which the reforms, under FM Manmohan Singh's stewardship, were seeking to change the industrial policy regime, the CII and FICCI in particular as well as ASSOCHAM began to play a more pro-active role in policy making. [31] Realizing that the new economic policies were drastically changing the competitive environment, these associations strove to have a say in the shaping of the emerging business environment. Leading industrialists began devoting much time and effort to work with their industry associations. The prevailing conditions at the time may be gauged from the role and style adopted by the Confederation of Indian Industry. The CEO of an important company in his capacity as the president of CII would "criss-cross the country, attending important seminars and workshops, finalizing details of the engineering trade fair... *meeting senior delegates from international agencies, hobnobbing with politicians and bureaucrats in Delhi...*"[32] The CII has followed a new strategy in keeping with the reforms scenario. It has concentrated on providing broad based policy suggestions, rather than lobbying for industrial licenses, import controls and higher tariffs, as they might have done in the pre-reforms era. Instead, by openly supporting the reforms, it has sought to enter more directly the policy making process, and working "in various ways in getting closer to the powers that be"[33] It has projected itself as a provider of information and advisory services, not only to industry, but also to government. The CII has worked on tax and tariff problems, and on recommending to the government various policy and administrative changes It has built up a good track record of getting its recommendations accepted

What seems striking about the CII's new strategy, however, and perhaps a key source of its success, is the forging and strengthening of links with top politicians and bureaucrats This has permitted it to function as a co-ordinating group for bringing together in seminars and workshops on policy questions ministers from state and central governments, political parties and the press For this, Finance Minister Manmohan Singh, as well as his chief consultant Desai publicly complimented it [34] There is no question that the top office bearers of the CII had attained direct access to the designers of the economic reform at the highest level

When pushing for specific policy changes, the CII adopted a strategy of forming informal coalitions with politicians, bureaucrats, individual experts and even particular government agencies. The process began as early as the mid-1980s, and a sophisticated methodology for policy influence was evolved. This consisted of collating information, preparation of work plan detailing demands for policy change, circulating a policy paper within the relevant ministry, and meeting on a one-to-one basis with key bureaucrats.[35] These institutional networking skills, were gradually perfected with time, and served the CII well in the reforms era. Apparently, "its finest hour was when it presented a widely reported agenda for economic reform in April 1991 which anticipated some of what was to come later in July 1991."[36]

Though the CII took the lead in forging government-business links in the early reform years, FICCI as well as others soon practiced this type of lobbying. But this should not obscure the fact that there were a number of influential groups in the private sector, not to mention those within the public sector who remained opposed to liberalization, or were not happy at the speed with which it was implemented. The most prominent of these was the "Bombay Club" of industrialists. They were unable to mount a significant blocking action *as long as the reforms maintained their "momentum"*. This was, as Bhagwati and Srinivasan (op. cit.) noted, the political management strategy of the reform—the so-called "bicycle theory", i.e., you stay in balance and on track by moving ahead continuously, scattering the opposition. This was obviously a substitute for the alternative strategy of achieving a stable majority support, if not consensus, not necessarily with the voters, but with private industry whose economic performance was crucial. This was a risky strategy Clearly, the alternative was deemed to be unattainable in the prevailing political configuration of the time. The reform could be launched because the severity of the economic crisis of 1990-91 created a political space—a pseudo-consensus

Thus, we may sum up the socio-political context as follows:

- Some groups within industry seized the opportunity to form closer policy making linkages the government reformers.
- There was latent opposition from among private industry to the liberalization agenda, who remained temporarily subdued.
- Knowledge of this opposition and the "bicycle strategy" adopted by the reformers, created a strong incentive for reform managers within government to form informal 'policy coalitions' with segments of private industry.
- The economic crisis provided a window of political opportunity for launching the reform, but it was based only a pseudo-consensus and unstable. The

continuation of the consensus thus depended closely on the economic payoff from the reform in terms of high growth and macro-economic stability.

To conclude this section, the inertia of existing institutional relationships gave the reforms process a *distinct relation-based character and reputation from the very start*. The lack of insulation needed to project an image of *unbiased rule making* was never present in the Indian reform process. An inherent inconsistency developed between the ideological appeal to rule-based rationality, and the ground reality of relational coalitions. Thus the process remained extremely vulnerable to lobbying pressures to change the rules of the game. When the stakes became high, this institutional loophole would justify the undermining of the rule-based ideology of reforms. When this evidence is examined, it is not difficult to understand why, with Yashwant Sinha and Budget 98, these institutional tendencies have come to the fore

ii) *Constraints on Institutional Capacity*

Meanwhile, the government's ability to resist such pressures or to impose some form of collective rationality was not strong. It had become "a racketeering government", through which "a large share of national resources were commandeered for granting special favours", and "everything from jobs in international organizations to bank loans was subject to largesse".[37] The atmosphere within which the bureaucracy functioned was one of tensions and dysfunctional competition—"a fierce game of snakes and ladders". The institutional configuration, which characterized the state, in short, was clearly not propitious for impartial rule making.[38]

The growth of corruption in India has become so rampant, that it seems almost old fashioned to mention it But it can hardly be avoided in a discussion of state capacity While for a long time, corruption was the whip with which neo-liberals would beat opponents of liberalization, now it is becoming increasingly obvious that there is a close correspondence between liberalization and the scale of corruption This indeed is now recognized as a global problem [39] Whatever may have been the scale and incidence of corruption in the pre-reform era, most indications are that it has increased subsequently. The "corruption perception index" prepared by Transparency International and Gottingen University on the basis of surveys of persons working in multinational firms and institutions gives us a picture of how India is *perceived*. First, India is in the top 10 of the most corrupt of the countries surveyed. In 1996, it had a score of 2 63 (out of 10) in the "integrity"score, where 10 represents an "entirely clean" country Second, and more striking is the *trend over time* in the index, which supports the idea that perceived integrity in India has been falling in the liberalization period. The scores, with the relevant survey dates in parentheses, are 3 67(1980-85), 2 89(1988-92) and

2.63(1996) [40] Thus, India's corruption level, as perceived by foreigners has been increasing rapidly, and is significantly higher today than it was in the pre-reform era. We can draw the conclusion that the notion that de-control removes corruption is a costly myth. The reason for this is not hard to find, for the configuration is highly conducive to rent generation.

- Liberalization increases the quantum of external investment flows into the country, thus creating greater opportunities for corruption.
- Weak market discipline and lack of independent oversight mechanisms characterize the transition phase. In such circumstances, the *reduction of bureaucratic discretion* with de-control, may be accompanied by an *increase of political discretion* in economic decisions. This may simply shift the locus of corruption.

.The propensity for corruption has a number of detrimental effects on the reform during the transition to a rule-based system. The legitimacy of the entire process is undermined. It slows down drastically the reform of systems and institutions of law, taxation and democratic elections, which are necessary for the long viability of the neo-liberal economic system. Corruption adds to the myopia of private investment decisions, since the commitments and contracts won through corruption are even more vulnerable to political instability. It is not surprising that high growth and corruption have managed to co-exist mainly in stable authoritarian regimes as in East and Southeast Asia. This was due in large part to the fact that that these regimes based their legitimacy on economic performance. However, the growth rate has plummeted in these countries, almost as soon as they have been politically destabilized. In democratic systems with a more diffused distribution of political power, such as that in India, this factor would add a higher degree of uncertainty to the investment climate as a function of political stability. This would tend to lead to lower investment flows in general, with attendant volatility. Thus, political and policy uncertainty in the context of such institutional weakness would impact negatively on growth—threatening this key strategic variable for reform sustainability.

An additional factor that weakened the implementation of the reform agenda was the inadequate level of coordination between the different branches of government. This has been an old feature of Indian government, but its persistence proved a obstacle for the implementation of reforms where inter-ministerial co-ordination was crucial. In the pre-reform period, the poor ability to coordinate economic policy within different branches of government and ministries were frequently blamed for the slowdown of the decision making process. But after 1991, this flaw has had more debilitating consequences. A.V. Desai, in his book already cited, noted the difficulties of coordinating decisions even across the economic ministries—commerce, industry and finance at the political level, given the substantial autonomy of cabinet ministers. To this must be added the problems of coordinating across the bureaucracy, both horizontally and vertically Failure in coordination resulted in serious distortion of policy. Desai cites as an example the capital goods industry, where there was a serious deviation between the policy intended and that which actually was implemented This resulted in causing unintended damage to the capital goods industry, which found that while itself facing competition from imports, while its inputs received protection through "low-level notifications". The institutional weakness can be traced to the absence of an overarching policy coordination structure that was obviously necessary in this phase.

From our foregoing discussion, it is clear that the reform to establish a rule-based governance system for industry and trade was attempted under highly adverse institutional conditions. Whether or not the attempt could succeed depended a great deal on whether it could generate "adequate" positive results. In the next section, we explore the issue of sustainability of policy reform in a simple schematic framework. This would help us in highlighting the interaction between institutional and economic factors in the determination of sustainability.

IV Sustainability of the Rule-based Transition: A Schematic Model

We shall analyze the sustainability of the rule-based reform process by examining two relationships in a diagrammatic model.[41]. We shall focus on two key variables—the growth rate of GDP (g), and the 'degree of liberalization' (L). Here L refers specifically to the *micro-level liberalization,* i.e., those aspects of reform that deal specifically with decontrol, and removal of other discretionary interventions in markets. These precisely are the main elements of neo-liberal rule-setting reform. We shall assume that L can be measured on a continuous scale of 0 to 1, where 0 refers to the pre-reform control regime, and 1 corresponds to the neo-liberal ideal. *Sustainability* of the rule-based transition is defined as the ability to raise the value of L and g, and to maintain them at a higher level. The objective of the reform is to move the economy to a higher configuration of L and g. The GDP growth rate and L, in this model, are bound together by two separate relationships- one of which is determined by political factors, and the other by economic factors These are shown in Figure 1.

A The Political Possibility Curve

The *first relationship* we shall call the *"political possibility curve"*, and this shows the maximum level of L that is politically feasible at each growth rate. The underlying logic is as follows. Political opinion on the degree of liberalization ranges from those who are strongly opposed to those who favour a very degree of liberalization These are ideological positions. We may assume that opinion is *clustered* around three values of L. These values are ($L_\alpha=0$) for opponents of reform, those with a moderate position (L_β), and those, say the foreign investor community, who prefer a very value L_γ (close to 1). Thus, $0= L_\alpha < L_\beta < L_\gamma <1$. The policy makers are aware of these precise ideological positions, and choose the level of L, as a weighted average of L_α, L_β and L_γ. Thus, the actual level of liberalization L is derived from the underlying ideological positions of important groups based on the judgement of the policy makers. These implicit weights reflect, at any time, the policy makers' assessments of political feasibility.[42]

These weights are not invariant, with respect to the state of the economy. It seems reasonable to suppose that these weights will depend on the rate of GDP growth, which is a summary indicator of economic performance. We assume that the weights assigned will vary with the growth rate, according to a specific pattern We shall focus directly here on the relationship between L and g, without explicitly deriving in from the weights mentioned above. We shall assume that there are *3 distinct phases in the pattern*, reflecting qualitatively different states of the economy. The relationship between L and g is different in each of the phases. As explained below, phase 1 is the range of crisis, phase 2 is the range of resistance, and phase 3 is the range of sustainable reform. Thus,

$$
\begin{aligned}
L&=f_1(g), \text{ for } g \text{ in phase } 1\\
L&=f_2(g), \text{ for } g \text{ in phase } 2 \qquad\qquad \text{(R1)}\\
L&=f_3(g), \text{ for } g \text{ in phase } 3
\end{aligned}
$$

- *Phase 1: Range of Crisis*

When the growth rate is very low, and falls below the average pre-reform growth rates, say the so-called "Hindu rate of growth", the economy may be said to be in *crisis* In such a situation, reformist policy makers will tend to attach a low weight to L_α, and L_β sensing that the opinion of opponents and moderates will not be *voiced* strongly in such a situation. At the same time, the weight attached to L_γ, the opinions of the international investor community and the IMF will be high Thus, there will be a range of low growth rates at which the feasible degree of liberalization will be high We may postulate also that the deeper the crisis, the lower the weight attached to reform opponents' opinion, and the higher the weight of the foreign investor community Hence, in this "crisis range" there is an inverse relationship between L and g It should be noted that the values of L and g in this range represent only *temporarily feasible* configurations. By definition, a crisis is viewed by all as an unusual adverse situation, which allows a brief window of political opportunity for reform to be initiated These are not *sustainable* policy configurations

Phase 2: Range of Resistance

When the growth rate is higher and the economy is no longer viewed as being in "crisis", we have a second phase of the political possibility curve. In this phase, the policy makers will feel compelled to attach a very *high* weight to L_α and corresponding low weight to L_β and L_γ. In Phase 2, the economy is performing in a pre-reform average growth range. There is therefore policy inertia, which reflects the pre-reform political equilibrium. Those who fear that they might be hurt by the reforms voice their opposition strongly, and potential gainers are uncertain of the benefits of the rule-based regime. Hence, there is a range of growth rates in which the politically feasible degree of liberalization will be close to L_α.

As we shall see presently, the size of this 'range of resistance' makes a difference to the conclusions we can draw from the model regarding the sustainability of reform. What determines the size of this range? Clearly, *institutional factors* play a crucial role here. Whether or not the policy makers are able to build political acceptance of the rule-based reform will be important. With a higher consensus, it will be possible to put in place a higher level of L, for the same or lower value of g than otherwise. Higher acceptability comes also from the factors mentioned earlier—greater faith in the ability of the government to be fair, impartial and transparent, rather than being seen as being de-facto relation-based. Conversely, the perception of the government as being corrupt would also damage the credibility of the reform, and lengthen the range of resistance.

- *Phase 3: Range of Sustainable Reform*

Once the growth rate is sufficiently high, the economy moves out of the range of resistance. Higher material prosperity weakens political opposition, because the economic insecurity is reduced. Reformist policy makers now feel encouraged to increase L. They therefore attach higher weights to L_β and L_γ in their policy calculations. As the growth rate increases, they feel increasingly able to raise L. In other words, in this phase, there is a positive relationship between L and g. In contrast to Phase 1, here the liberalization levels, at each level of g, are *politically sustainable* in the long run. This stretch of the political possibility curve can, however, be shifted. These shifts are due to changes in the overall degree of consensus attained and the legitimacy that the reform enjoys with the polity. An increase in consensus will result in an upward movement of the political possibility curve, i.e., a higher degree of liberalization will be politically feasible at each growth rate. These shifts are the result of *institutional capacity* of the state. They reflect the capabilities of reform strategists at both the political and bureaucratic levels, and also the strength of consensus-building policy networks, traditions and practices in the society. The latter is part of what Putnam and others call "*social capital*"[43] Social capital must be accumulated over time through democratic processes of civil society. However, it can be frittered away relatively quickly. Policy strategies such as the "bicycle strategy" alluded to earlier (which are ways of trying to bypass consensus), are actually are likely to depreciate social capital, if the reform gamble fails to meet public expectations.

In Figure 1, ABCD is the political possibility curve with all three phases. Here AB is the range of crisis, BC is the range of resistance, and CD is the range of sustainable reform. For simplicity, these phases are represented as linear stretches. As an extreme case, BC is shown as coinciding with the x-axis, implying zero reform. The curve ABC'D' represents an alternative political possibility curve, in which the *institutional conditions* are more favourable for reform. BC' is shorter indicating a smaller range of resistance. Also, C'D' has a higher slope compared to CD, implying that higher liberalization is now feasible for any growth rate.

B. The Growth Impact Curve

We shall now present the *second relationship* binding L and g. Let us call this the *"growth impact curve"*. This is the economic relationship, which shows the effect that liberalization has on growth. Here L is the independent variable, and g the dependent variable. Now, liberalization is undertaken with the objective of boosting the growth rate. It will be useful to separate out two separate components of the determinants of growth. One component reflects the effect on the growth rate that is *induced* by L, and the other component consists of *autonomous* factors. Recall that *L is the indicator of micro-economic reform*—the rule-based transition. Thus, a key effect of such reform is on systemic *efficiency*. The liberalization level affects the growth rate by:

- Reducing deadweight efficiency losses arising from dysfunctional controls and over-regulation.
- Inducing higher levels of private investment spending, both domestic and foreign [44]

Therefore, the growth impact curve has a positive slope. However, we assume that the marginal effect of L on g would at first be relatively high when L is close to 0, when the dysfunctional effect would be most strongly evident. We assume that this impact would then asymptotically taper off.

However, the location of the growth impact curve depends on factors other than L. There are two determinants, which are particularly significant in causing a *shift* in the position of the growth impact curve. The first is the effect of macro-economic policy on the level of *public investment*. The key consideration underlying the volume of public investment has been the fiscal deficit. Macro-stabilization objectives also affect domestic private investment through its effect on liquidity But perhaps more important is the *profit expectations* of private foreign and domestic investors Much of this is beyond the control of domestic policy makers, such as the fallout of global financial instability on business confidence Political factors also play a key role in shaping business confidence and thereby private investment spending. In a recent survey of Indian CEOs, half the respondents expressed the view that "political and policy uncertainty" was the main reason for slowdown of industrial growth. Indian private investment even today is linked to public investment, and changes in public investment therefore have an additional impact on the total level of investment spending in the economy, through its effect on private investment behaviour.[45] To sum up, growth depends on the magnitude of L—a positive association, and also on the autonomous determinants of investment spending, which cause parametric shifts in the growth impact curve. In other words,

$$g=\phi(L;\delta) \qquad \text{(R2)}$$

where δ represents the aggregate shift parameter reflecting business confidence and macro-economic conditions.

Two growth impact curves are shown in Figure 1, drawn assuming different values of δ. These are PQ and P'Q'. Now, a sustainable political-economic equilibrium for the reform process must satisfy both R1 and R2, and will be given by the intersection point of the political possibility curve and the growth impact curve.

We can now use this simple model to analyze the factors that cause success or failure of the rule based transition. Both possibilities are indicated in Figure 1. Let us first consider how the reform transition may fail. Suppose that the political possibility curve relevant to this hypothetical economy is ABCD, and the growth impact curve is PQ. As explained above, AB is the range of crisis, BC is the range of resistance and CD is the range of sustainable reform. This economy is institutionally weak in the sense described above, and consequently BC is relatively wide and also the slope of the stretch CD is relatively flat. In the pre-reform period, the economy normally registers a rate of growth in the range BC, i.e., its rate of growth lies between the magnitudes OB and OC, and of course, L=0.

Now suppose that there is a macroeconomic crisis, and the economy's growth rate slumps to Oa. This creates a political opening for the rule-based economic reform Given the crisis range AB, the policy makers find that they can liberalize the economy to the extent Ok, which is the highest permissible. They choose L=Ok. They have a gradualist view of reform, and are hopeful that they would be able to move the economy over time through a virtuous cycle to a 'high growth-high liberalization equilibrium'. Will this be possible? Figure 1 shows that this reform will *not* be sustainable—in fact the economy will revert to the pre-reform level of liberalization. This will be the case even though the liberalization raises the growth rate to km, as determined by the growth impact curve PQ. However, the economy is now in the range CD of the political possibility curve, which shows that at this growth rate, the level Ok of liberalization will not be politically acceptable. The economy will then spiral downwards, as shown by the downward and leftward pointing arrows emanating from the point m in Figure 1. The economy will eventually stabilize at the point P on the x-axis. Thus L=0, and the growth rate will be OP, very much within the pre-reform parameters—"back to square one", in other words

How can the reform succeed? This can happen in one of two ways, singly or in combination. Either the institutional conditions and political management of consensus must improve, or the growth impact curve should shift rightward sufficiently. The latter can happen if the macro-economic conditions permit high public investment, or if foreign direct investment surges, or if domestic business confidence is higher, leading to higher private domestic investment.

Consider the effect of higher consensus on the equilibrium. Let ABC'D' represent the new political possibility curve. Its shape and position reflect the effect of enhanced political support for reform—the range of resistance is smaller, and the range of sustainable reform has a steeper slope. Now, we find that the same beginning leads to a very different conclusion. The initial liberalization Ok now leads the economy towards the equilibrium point n, as shown in Figure 1 by the rightward and upward arrows which begin from m. At each stage, a higher combination of L and g will be possible. This clearly is the result that gradualist reformers would hope for, but it becomes possible *only through solving the problem of political management of consensus.* The model demonstrates how vital the need to find agreement on the liberalization agenda really is. Underestimating this task can overturn the entire reform process.

The alternative route to success is if the growth impact curve shifts far to the right A similar logic will show that even with the political possibility curve at the old position ABCD, the reform will succeed if the growth impact curve is P'O' rather than PQ. The equilibrium point will now be at n'. But this means that the policy makers must encounter *highly favourable conditions with some of the autonomous determinants of investment by domestic and foreign investors* The Indian experience shows that overconfidence on this front is unwarranted.

It is thus extremely important for Indian policy makers to understand the precise ways in which policy affects private investment. The failure of P.Chidambaram's "dream budget" to lift the level of private investment significantly clearly shows that this process is not adequately understood by them. On foreign direct investment, the level of L that might actually induce a quantum shift in investment is high This poses a high political risk especially of the uncertainty surrounding FDI Finally, the fiscal deficit poses a limit on stepping up public investment

Hence, the prospect of this solution actually working in the Indian situation is problematic This is the basic reason in our view, for why the rule-based transition tried in India has encountered such difficulties, and why the relation-based alternative has proved so tempting to the Vajpayee government. Finally, from a logical standpoint, if political consensus and business confidence were both to improve simultaneously, the prospects of reform success would brighten considerably. The diagrammatic analysis could easily be extended to show that this would permit an even higher configuration compared to n and n'.

V. *Concluding Remarks:*

We summarize briefly the main themes and arguments developed in this paper. The success of economic reforms depends on whether policy makers can overcome both political as well as economic constraints. This paper has focused on a relatively neglected dimension of the Indian economic reform process —the institutional underpinnings of state capacity. It has argued that state capacity is crucial for the sustainability of the reforms. Paradoxically, this is true even for the neo-liberal type of economic reform, which aims at diminishing the role of government. To sharpen the focus of analysis, state capacity is here defined as the capability for political management of the reform process within a democratic system It is implicitly assumed that the state possesses adequately some of the other dimensions of policy capability, such as the technical capacity for making economic decisions.

In Section II, the concept of government style, drawing on the approach of Okuno-Fujiwara, is utilized to characterize the institutional orientation of policy making. A key dichotomy between "rule-based" and "relation-based" government styles is drawn to describe differences in the nature of engagement between the government and economic actors. Examining the 1998 Union Budget, the paper argues that its main significance lies in the attempted change in government style from rule based to relation based The issue in the reform is not so much 'controls versus the market' as it is 'rules versus relation based system of economic governance'. The paper discusses how government style matters, by examining the relative merits of the two styles along six policy effectiveness criteria (ex-post flexibility, dealing with asymmetric information, stability of private sector incentives, collusion dangers, transparency, and adherence to hard budget constraints) Different government styles do have their relative advantages. Ordinarily, the two styles tend to undermine each other in the same policy arena. However, the challenge of institutional reform is to find the most effective combination of rule-based and relation-based styles in the overall policymaking system

The paper turns next in Section III to an examination of why the transition to a rule-based system –the key element of the micro-economic reforms that were adopted in

1991--has faltered, and made way for the relation-based revisionism of Budget 98 It is argued that the rule-based transition was seriously damaged by certain institutional weaknesses Two of these were identified The first had to do with the way in which the new rules were made, which suggested that the rule making process was not adequately insulated from the influence of economic interests The role of industry associations during the period was analyzed to show that the process was "embedded in the politics of the time", and the government could not project an image as having an impartial and arms length relationship with market actors There emerged a conflict between the ideological appeal to rule-based rationality and the obvious ground reality of relational coalitions This, combined with the "bicycle strategy" of political management of the reform process undercut the formation of broad-based consensus. Sustainability became highly dependent on the economic payoff of the reforms Any shortfall in actual and expected returns had a strong negative impact on political sustainability.

The second institutional weakness has to do with the capacity to implement policy. We noted the propensity for corruption and some evidence of its perceived increase over time It is very likely that the very process of liberalization itself has exacerbated this weakness The inability to coordinate policy horizontally and vertically within the government has long been a problem with the Indian policy system This has remained, and indeed has distorted some of the reform policies. These have served to dampen the economic payoff from the reform

Taken together, these institutional flaws have contributed significantly to undercutting the sustainability of the Indian rule-based transition

In Section IV, we presented a diagrammatic model of reform sustainability The main purpose of the model is to highlight the dual and simultaneous dependence of reform sustainability on political and economic factors The model is based on the 'stylized facts' of the Indian reform experience from 1991 up to the Yashwant Sinha budget The model shows

(1) Institutional mechanisms for consensus formation in support of the market reform can play a very pivotal role in the sustainability of reform
(2) Shift factors, most of which are *not* part of the micro-economic reform, are important in determining the level of economic growth Events such as the global business sentiment, and domestic political uncertainty are examples such shift factors, which may influence private investment behaviour It is generally known that in India both domestic private investment as well FDI and FII behaviour have been erratic and generally below policy makers' expectations
(3) For any given level of private investment, a higher degree of institutional capacity permits a higher sustainable degree of liberalization Correspondingly, the model shows that the greater the gap between expected and actual response of domestic and foreign private investment, the higher the role of institutional capacity in assuring reform sustainability

The Indian rule-based reform thus became unsustainable because of the conjuncture of weak institutional capacity, and negative shift factors influencing private profit expectations We would argue that a country such as India cannot afford to neglect the strengthening of institutional capacity, regardless of the government style chosen An even higher level of such capability will be needed for current the relation-based efforts to succeed

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Rohit Saran *Business Today* June 7-21 1998 Cover article on ' Budget 98 Let us for the moment ignore the implied diagnosis of industry's ailment.

[2] Mr. Sinha lists macro-economic stability and control over inflation as one of the objectives of the budget. Observers however have expressed a lack of confidence about the attainability of stated fiscal targets. Macro-stability itself is listed 7^{th} in a list of 9 objectives. Though this listing is not necessarily in order of importance, it is nevertheless suggestive.

[3] This refers to what Masahiro Okuno-Fujiwara calls "government style". See his article, "Government Business Relationship in Japan: A Comparison of Government Styles", University of Tokyo,mimeo, (Paper presented at World Bank Asian Miracle Project Worhshop, Hawaii), 1993.

[4] Yashwant Sinha's budget speech is littered with statements that are suggestive of a made-to-order style of policy making. A few examples are cited below:

(1) " (The software companies) have sought permission to offer stock options schemes to their Indian employees linked to ADR/GDR issues abroad, under which their employees will be eligible for ADR/GDR stock options. In recognition of the the excellent work being done in this sector, and its very special circumstances, the government have decided to formulate a special scheme to allow such options for the software sector..... I also have some fiscal proposals to support rapid development of this crucial sector."(para 37).

(2) "Non-Resident Indians (NRIs) have expressed a sincere desire to contribute meaningfully to the development of India...... NRIs have also complained to me that the procedures governing their participation in our share markets are extremely cumbersome and onerous. I am having these procedures thoroughly reviewed with a view to modifying them to facilitate investment by NRIs in our capital markets." (para 45).

(3) " I also propose several measures in response to demands from business and industry. Certain categories of business reorganisations are proposed to be freed from any additional tax liability or loss of tax benefits keeping in view the necessity of such reorganisation consequent on economic liberalisation. No capital gain would be charged and the benefit of carry-forward of losses and unabsorbed depreciation would be allowed ......" (para 107)

[5] For example, while Rahul Bajaj, a leading spokesman of the "Bombay Club" was highly enthusiastic about the budget, others such as Narayanamurthy (CEO of Infosys, a leading software company) were more cautious, and still others—such as Vijay Crishna (Godrej-GE Appliances) have been highly critical. Further, an impact analysis of the budget on 24 industry categories based on CEO interviews, market perceptions as reflected in equity values and effect on indirect taxes arrived at the following results: Positive impact- 11, Negative impact-8, Neutral impact-4, Not rated-1. R. Dubey," The Boomerang Budget: Corporate India and Budget 98", *Business Today,* June 7-21, 1998

[6] It would perhaps be more accurate to say that these tendencies were not altogether new. They did exist in a dormant form throughout the 90s, particularly since the reform approach of the Congress and UF led governments was gradualist. There was a past history of a pre-reform relationship between government and business (characterized by Ashok V. Desai as a "cosy straight-jacket"). Nevertheless, this latent tendency has been resurrected and takes centre-stage in the present approach. See A.V. Desai, *My Economic Affair,* Wiley Eastern 1993, Ch. 14.

[7] There is a distinction between the ideology and actual practice. The latter can deviate because of political pragmatism. However, ideology is a statement about goals, and is more significant for setting future directions. It should be also added that this neo-liberal ideology which inspired reform since 1991 did not contain any elements that could be called original or distinctly Indian. As philosophy, it was very much in line with the tenets of the prevailing reform movement that originated in Britain and the USA and swept through developed, developing and transitional economies alike. It has been called the "new public management revolution", and its global reach has been by the adoption if its agenda by bilateral and multilateral aid organs. See M.Minogue, C. Polidano and D.Hulme, " Reorganising the State" in *Insights#23,* September1997, Institute of Development Studies, Sussex.

[8] For example, *Business Today* is worried that Sinha " has chosen to resurrect the paradigm of planning and graft it onto a post-liberalisation environment"(*BT,* June 7-21, p34)

[9] Thus the two government styles correspond to the 'stylised form' of the neo-liberal and the East Asian developmental state-types respectively.
[10] Even though their reform design bore little resemblance to East Asian policy and institutions, P.V. Narasimha Rao and Manmohan Singh made numerous laudatory references to East Asian success in the early 90s.
[11] *The East Asian Miracle: Economic Growth and Public Policy*, Oxford University Press, 1993. This study, not surprisingly, proved controversial both within and outside the Bank. It represented an uneasy compomise, and failed to satisfy purists in either the neo-liberal or the "governed market" camps. A special symposium on this book appeared in *World Development.*
[12] *The East Asian Miracle*, op. Cit. Pp 5-6.
[13] Ibid, p 6.
[14] The WDR 1997 is entitled *The State in a Changing World.* A team led by A. Chhibber, under the general direction of J. Stiglitz, L. Squire and M. Bruno prepared the report. The passage quoted is the assessment of Minogue, Polidano and Hulme, *Insights#23*, IDS, Sussex, op cit. Italics are ours. Even more forthright in distancing itself from the 'Washington Consensus' is the view expressed by J.Stiglitz, " More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus", The 1998 WIDER Annual lecture, Helsinki, mimeo.
[15] Okuno-Fujiwara, op. cit. One can understand, in this perspective, why many commentators have taken a dim view of the speed with which Yashwant Sinha withdrew his budget proposal to hike in the price of urea, when the agricultural lobby brought political pressure almost immediately after the budget was announced. Mr. Sinha also rolled back the 'additional non-modvatable levy on imports' from 8% to 4% for similar reasons. Such volatility of policy creates an impression that pressure can influence policy outcomes, and creates an incentive for economic actors to do so.
[16] We draw here on the analytical scheme developed by Okuno-Fujiwara, op cit. However, our judgement regarding the implications for the effectiveness of alternative styles may differ in some respects from Okuno.
[17] It may be useful to recall that the much-heralded Long Term Fiscal Policy announced by the Government of India in 1985 had this as one of its objectives. Among the themes of the 'new fiscal policy' of the Rajiv Gandhi government was " the fostering of a *stable and predictable* tax policy environment". See Shankar Acharya, " India's Fiscal Policy" in *The Indian Economy: Recent Development and Future Prospects*, ed. by R.E.B. Lucas and G.F. Papanek, OUP, 1988.

[18] Institutional weaknesses that permitted the Asian currency and financial crises to occur are at the heart of current reassessments of the region's, and indeed the world's, regulatory systems.
[19] This view of rule-based government style, linked to a notion of justice and fairness of the rules of the game, voluntarily adhered to by individual actors, forms the basis of the 'contractrarian' approach to policy analysis. Rational people are assumed to choose a fair system on the ground that over the long haul, this would best serve the individual's interest in an environment in which the individual's gains or losses in the short run are uncertain. For an exposition, see Avinash K. Dixit, *The Making of Economic Policy*, MIT Press, 1996, Ch.1.
[20] A good example is the continuing debate over US trade between the proponents of liberal multilateralism and supporters of strategic trade policy.
[21] For example, the Japanese industrial policy framework for many years successfully blended relation-based subsidy for particular industry sectors, with fiscal discipline through an institutional mechanism in which the *total subsidy amount would be agreed in advance* between the MITI and Ministry of Japan/Bank of Japan. MITI allocated the subsidies on relation-based principles, while the macro-economic authorities remained rule-based. Political Scientists have used the term "embedded autonomy" to characterize the attributes of an effective state, which is based on a similar notion of balance. The term seeks to capture the tension between the dualities of embeddedness – implying a hands-on, i.e. relation-based style, with autonomy from political pressures. See P. Evans, " The State as Problem and Solution: Predation, Embedded Autonomy, and Structural Change", in

The Politics of Economic Adjustment, ed. by S. Haggard and R. Kaufman, Princeton University Press, 1992.

[22] These included policies relating to industry, trade and exchange rates, taxation, public sector and the financial sector.

[23] For a compact statement of the early reform agenda, see Montek S. Ahluwalia, "India's Quiet Economic Revolution", *Columbia Journal of World Business*, March 22, 1994.

[24] The earlier limit was 40%, with higher limits allowed in exceptional circumstances. Firms that had had foreign holdings in excess of 40% were subject to additional restrictions.

[25] This was due, in part perhaps, to the inherent political difficulties of the task. But we could argue that the reform agenda focused almost exclusively on the economic aspects, and remained generally murky and ambivalent on the institutional aspects of change needed. There appeared to be limited interest in building up state capacity. Most discussions of reform strategy, emanating from official sources, rarely went beyond scolding and cajoling the recalcitrant state functionaries to implement the reforms. See, for example, J. Bhagwati and T.N. Srinivasan, *India's Economic Reforms*, Ministry of Finance, Government of India, July 1993.

[26] Indeed, subsequent developments suggest that a new trend may have set in. The export promotion package announced recently by the Minister of Commerce, Ramakrishna Hegde, appears to contain a number of selective measures targeted at different segments of exporting industries.

[27] An analogy with physical infrastructure will illustrate the point. The lack of observance of traffic rules by vehicle drivers, motivated by the short- term selfish goal of trying to get ahead by unfair means at congested intersections, provokes imitative behaviour by enraged fellow drivers. This leads inevitably to a dysfunctional breakdown of norms of cooperation and competition. This is a rather common occurrence on Indian roads. The individualized competitive response to the situation only worsens matters. A well-known TV commercial by an Indian two-wheeler company recently promoted its product with a more powerful engine by claiming that on city streets "it is a jungle out there". The solution lies in regulation. The analogy between unruly traffic and various types of "hustler capitalism" is not all that far-fetched.

[28] For a wide-ranging discussion of theoretical and philosophical foundations underlying such arguments, see Dixit, *The Making of Economic Policy*, op. cit.

[29] Dixit, op cit., has a detailed exposition and references to the literature.

[30] Ashok V. Desai was chief economic consultant to Finance Minister Manmohan Singh in the early years. He has recorded his experience and observations of the period with characteristic candour in *My Economic Affair*, op cit.

[31] A very informative article detailing the new role of the Confederation of Indian Industry (CII) is by N. Chandramohan, R. Bist and R. Karnani, "Lobby Power", *Business India*, August 30-September 12, 1993.

[32] "Lobby Power", ibid. p.54. Italics mine.

[33] "Lobby Power", ibid.

[34] According to A.V. Desai, " CII is playing a very constructive role. We welcome their inputs for policy making and also appreciate their commitment to making Indian industry internationally competitive." quoted in "Lobby Power", ibid. p.57.

[35] " A good example of this is when the CII, along with the Bureau of Industrial Costs and Prices and academics, put pressure on the Rajiv Gandhi administration to roll back the liberal regime for capital goods imports in the power and fertiliser industry, which had threatened to destroy BHEL and HMT…in 1985-86. N. Chandramohan et al, "Lobby Power", ibid., p.57. The aims and objectives of the organization has changed significantly with time. However, the point to note is the mode of operation.

[36] "Lobby Power", ibid, p.57.

[37] Ibid, p.3.

[38] It should be noted that the situation depicted is quite different from the typical Western media stereotyped view of an ideological struggle between "socialist bureaucrats" and "market reformers".

[39] See the symposium on "Corruption: Constraints and Constraints", in *Annual World Bank Conference on Development Economics 1997*, ed. by B. Plescovic and J.E. Stiglitz, The World Bank, 1998. See in particular the article by Susan Rose-Ackerman.
[40] Source is the www net site of Transparency International, Germany. A similar observation can be found in Ch. VI, "Corruption at Work: Undermining Society", in John Elliot, *India and China—Asia's New Giants*, Rajiv Gandhi Institute of Contemporary Studies, 1995.
[41] The model is briefly sketched here. It is developed more fully in a forthcoming paper, " A Political-Economic Model of Reform Sustainability".
[42] We are assuming that the ideological positions $L\alpha$, $L\beta$ and $L\gamma$ are fixed in the short run, that they are relatively stable. However, over the longer term, they can shift, and in particular they can be shifted by political and institutional processes, such as consensus building activities, and learning from experience.
[43] See Robert D. Putnam, *Making Democracy Work*, Princeton University Press, 1993,Chapter 6. Social capital comprises of "moral resources" such as trust, and social norms and networks. These have 'public good' characteristics, which lubricate cooperative behaviour. Social capital can be created and destroyed. Putnam cites the growing literature on the subject, and quotes K.J. Arrow: " It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence." p 170.
[44] The relationship between liberalization policy and investment behaviour has been analyzed by D.Rodrik in several papers, including " The Limits of Trade Policy Reform in Developing Countries", *Journal of Economic Perspectives*, Winter 1992. Rodrik focuses on the *credibility* of reform as the key determinant of reform success. Our model complements his analysis and emphasizes the role of consensus and political feasibility.
[45] In this same survey carried out by *Business Today*, (November 7-21, 1997), "Why is our Economy not Growing?", 60% of Indian CEOs felt that the increased infrastructural investment spending (by the Government) was essential to spur a revival of growth.

TABLE 1: Selected Indicators of Indian Economic Performance

Year	Percent Change over previous Year			
	Index of Industrial Production	Index of Agricultural Production	Exports (US dollar revenues)	Gross Fiscal Deficit (Per cent of GDP at Market Prices)
1990-91	8.2	3.8	9.2	8.3
1991-92	0.6	-2	-1.5	5.9
1992-93	2.3	4.1	3.8	5.7
1993-94	6.0	3.8	20.0	7.4
1994-95	9.3	5.0	18.4	6.0
1995-96	12.1	-2.7	20.7	5.4
1996-97	7.1	9.3	5.3	5.2
1997-98	4.2	-3.7	1.5	6.1

Source: Economic Survey, 1997-98, GOI
Ministry of Finance, Monthly Economic Report, May 1998
Reserve Bank of India, Annual Report 1997-98

Table 2: Volume of Private Investment Intentions*

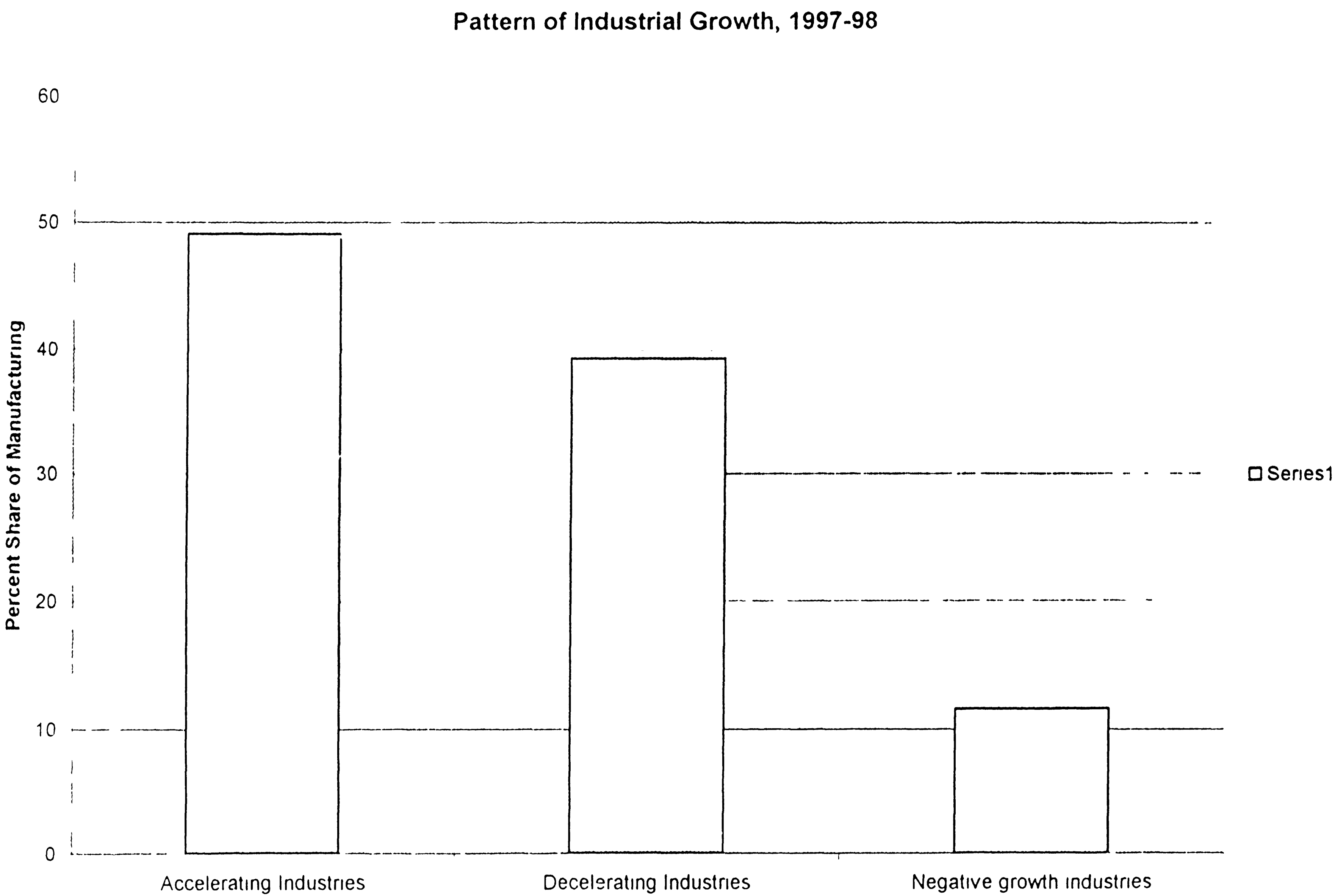
Year	Annual percentage change over previous year
1993	-40.8
1994	38.9
1995	31.0
1996	-26.2
1997	-40.0
1998#	-7.7

*= Calculated from Rupee values of investment intentions as expressed in LOIs and IEMs combined
= Calculated by projecting figures available figures for January-March 1998
Source: Economic Survey 1997-98. GOI, p 101

Table 3: Non-debt Creating Foreign Capital Inflows
(Millions of US $)

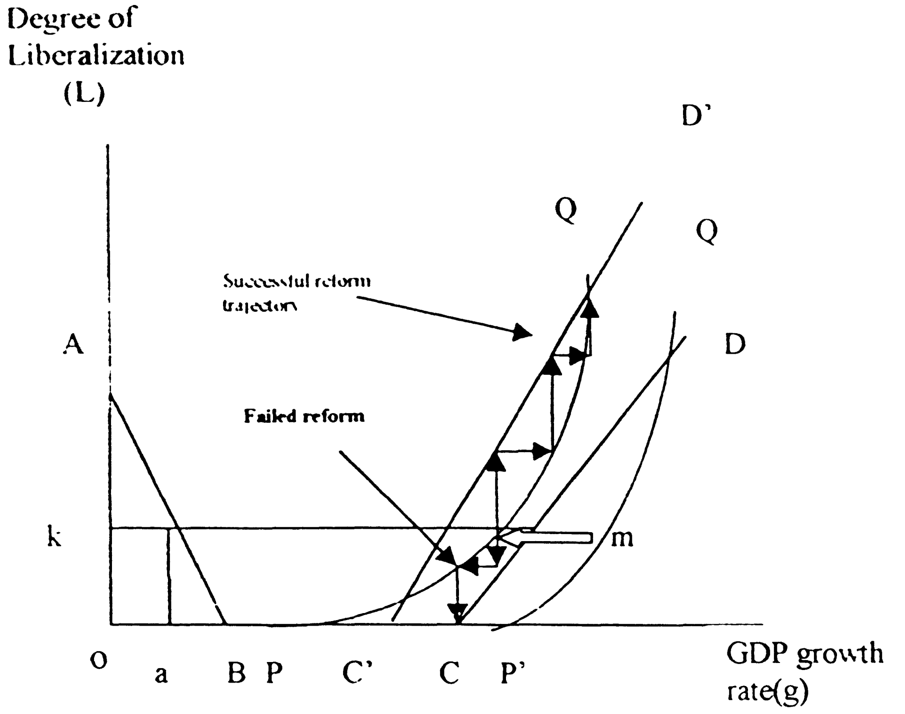
Year	Foreign Direct Investment	Portfolio Investment
1990-91	93.4	7.1
1991-92	132.2	3.8
1992-93	237.8	182.0
1993-94	581.7	3645.3
1994-95	1266.9	3580.0
1995-96	1960.0	2736.6
1996-97	2528 3	3307 1
1997-98	3119.5	1790.4

Source Calculated from data provided in Reserve Bank of India, Annual Report 1997-98



Pattern of Industrial Growth, 1997-98
60
50
40
30
20
10
0
Percent Share of Manufacturing
Series1
Accelerating Industries
Decelerating Industries
Negative growth industries

Figure 1


Degree of
Liberalization
(L)
D'
Q
Q
Successful reform
trajectory
A
D
Failed reform
k
m
o
a
B
P
C'
C
P'
GDP growth
rate(g)