Law, Finance, and Politics: The Case of India

Law Working Paper N° 107/2008

April 2008

John Armour
University of Oxford and ECGI

Priya Lele
Ashurst LLP and University of Cambridge

ECGI Working Paper Series in Law

Law, Finance, and Politics: The Case of India

Working Paper N° 107/2008
April 2008

John Armour
Priya Lele

This research was funded by a grant from the ESRC's World Economy and Finance programme. We are most grateful to our interviewees in India. We also owe particular thanks to Mr P B Kulkarni and to Arun and Siddharth Bhatnagar for their assistance. This paper has benefited from comments following presentations at the Bank of England, Birmingham University, Columbia Law School, CLEF, and the LSE. We thank Thankom Arun, Sumon Bhaumik, Bob Cooter, Simon Deakin, Panicos Demetriades, Joshua Getzler, Curtis Milhaupt, Richard Nolan, Katharina Pistor, Prabirjit Sarkar, Mitra Sharafi, Mathias Siems, and Ajit Singh for helpful comments and discussions. Views expressed are those of the authors alone and our interviewees and commentators bear no responsibility.

Abstract

The liberalization of India's economy since 1991 has brought with it considerable development of its financial markets and supporting legal institutions. An influential body of economic scholarship asserts that a country's 'legal origin'—as a civilian or common law jurisdiction—plays an important part in determining the development of its investor protection regulations, and consequently its financial development. An alternative theory claims that the determinants of investor protection are political, rather than legal. We use the case of India to test these theories. We find little support for the idea that India's legal heritage as a common law country has been influential in speeding the path of regulatory reforms and financial development. Rather, we suggest there are complementarities between (i) India's relative success in services and software, (ii) the relative strength of its financial markets for outside equity, as opposed to outside debt, and (iii) the relative success of stock market regulation, as opposed to reforms of creditor rights. We conclude that political economy explanations have more traction in explaining the case of India than do theories based on 'legal origins'.

Keywords: India, Law and Finance, Investor Protection, Economic structure and financial structure, Legal origins, politics and finance

JEL Classifications: G28, G38, K22, K40, O16, P37

John Armour*
Professor of Law and Finance
University of Oxford, Faculty of Law
St. Cross Building, St. Cross Road
Oxford OX1 3UL, United Kingdom
phone: +44 1865 281 616
e-mail: john.armour@law.ox.ac.uk

Priya Lele
Research Fellow
University of Cambridge, Centre for Business Research
Trumpington Street
Cambridge CB2 1AG, United Kingdom
e-mail: p.lele@cbr.cam.ac.uk

*Corresponding Author

Law, Finance, and Politics: The Case of India

John Armour [*] *and Priya Lele* [**]

Abstract

The liberalization of India's economy since 1991 has brought with it considerable development of its financial markets and supporting legal institutions. An influential body of economic scholarship asserts that a country's 'legal origin'—as a civilian or common law jurisdiction—plays an important part in determining the development of its investor protection regulations, and consequently its financial development. An alternative theory claims that the determinants of investor protection are political, rather than legal. We use the case of India to test these theories. We find little support for the idea that India's legal heritage as a common law country has been influential in speeding the path of regulatory reforms and financial development. Rather, we suggest there are complementarities between (i) India's relative success in services and software, (ii) the relative strength of its financial markets for outside equity, as opposed to outside debt, and (iii) the relative success of stock market regulation, as opposed to reforms of creditor rights. We conclude that political economy explanations have more traction in explaining the case of India than do theories based on 'legal origins'.

Keywords: India, Law and Finance, Investor Protection, Economic structure and financial structure, Legal origins, politics and finance.

JEL Codes: G28, G38, K22, K40, O16, P37

Acknowledgements

This research was funded by a grant from the ESRC's World Economy and Finance programme. We are most grateful to our interviewees in India. We also owe particular thanks to Mr P B Kulkarni and to Arun and Siddharth Bhatnagar for their assistance. This paper has benefited from comments following presentations at the Bank of England, Birmingham University, Columbia Law School, CLEF, and the LSE. We thank Thankom Arun, Sumon Bhaumik, Bob Cooter, Simon Deakin, Panicos Demetriades, Joshua Getzler, Curtis Milhaupt, Richard Nolan, Katharina Pistor, Prabirjit Sarkar, Mitra Sharafi, Mathias Siems, and Ajit Singh for helpful comments and discussions. Views expressed are those of the authors alone and our interviewees and commentators bear no responsibility.

[*] Faculty of Law and Oxford-Man Institute for Quantitative Finance, University of Oxford; European Corporate Governance Institute.

[**] Ashurst LLP; Centre for Business Research, University of Cambridge.

1. Introduction

A growing literature emphasises the importance of legal institutions for economic development. Within this tradition, an influential claim is that a country's 'legal origin' significantly affects the evolution of its legal rules, in particular as they relate to finance. An alternative claim asserts that the development of legal rules is more closely influenced by national political choices and interest group lobbying. This paper uses the case of India, one of the world's most significant developing economies, as a case study for exploring the applicability of these theories.

The Indian economy, subject to central planning from independence in 1947, liberalised dramatically in 1991. Since then, there have been rapid and far-reaching law reforms intended to ensure that legal institutions keep pace with the needs of the growing economy. To shed light on the mechanisms by which these legal changes were brought about, and their relationship with the needs of investors, we conducted interviews with a range of Indian lawyers, policymakers, regulators, judges, businesspeople and investors. We focus our enquiries on changes to the legal protection of outside investors: that is, shareholders and creditors. These yield interesting findings both as regards the modalities of legal change and its relationship with development.

As regards the modalities of law reform, the most effective institutions for producing improved legal rules have been regulatory agencies to which rule-making power for specific sectors have been delegated: for example, the Securities and Exchange Board of India (SEBI) and, to a lesser extent, the Reserve Bank of India (RBI). In contrast, statutory changes have been implemented more slowly: coalition politics and very activist judicial review mean that legislation can be an erratic process. Moreover, in contradiction of the 'legal origins' claim, the Indian judiciary has not played a significant role in 'adapting' the substantive law to the changed needs of an open economy. Very long delays in Indian civil procedure mean that courts have simply been too slow to play a significant role in updating law.

There is a correlation between effective legal protection of investors and the development of markets for outside finance in India. Laws protecting equity investors have been dramatically improved, and equity markets are flourishing; much less has been achieved in the way of legal protection for creditors and markets for corporate bonds are much weaker. This complements sectoral trends in Indian industry: 'new economy' sectors for which equity finance is more complementary (e.g. software, pharmaceuticals and high-tech manufacturing) have been relatively successful, whereas 'old economy' sectors such as heavy manufacturing, traditionally more reliant on debt finance, have seen rather more limited growth. Whilst this implies a link between the quality of legal institutions and the real economy, we find little evidence that differences in legal rules have caused these sectoral differences in economic development. Rather, both appear to have been influenced by the legacy of political choices taken during the era of central planning. In industries that were subject to planning, the dominant interest groups lobby for redistributive rules to maintain their protected status. By contrast, in sectors that were never subject to central planning, the dominant interest groups seek rules that allow markets to function more effectively. In short, the quality of investor protection and sectoral development have both co-evolved on paths that have been to a large degree determined by past political choices. This supports the 'political' view that financial development stimulates law reform, rather than vice versa.

The rest of this paper is structured as follows. Section 2 reviews principal theoretical claims concerning the relationship between legal institutions and financial development. Section 3 outlines and problematizes the case of India, and explains our methodology. In Section 4, we explore whether, and to what extent, the development of India's financial market laws is a function of the country's common law legal heritage, focusing in particular on the role of the judiciary and judge-made law. Section 5 examines the role of politics in India's legal and financial development. Section 6 concludes.

2.The role of law in financial development

2.1 Law and finance

Whilst scholarly interest in the role of law and legal institutions in economic development may be traced back to Weber (1978), the subject received relatively little attention from economists until recently. The economic literature began with the pioneering work of North (1990), and has since then flourished with the emergence of systematic comparative research into the links between micro-level legal institutions and the real economy. Highly influential in this scholarship has been work of La Porta, Lopez-de-Silanes, Shleifer and Vishny (La Porta et al., 1997, 1998, 2008), which makes two important claims.

The first claim, which may be termed 'quality of law', is that the greater the protection afforded to outside investors by a country's legal institutions, the more readily firms in that jurisdiction will be able to obtain external financing. This claim, which echoes Weber's espousal of the importance of a properly functioning legal system to economic development, was tested by reference to quantitative indices representing the extent to which legal systems protect different constituencies in business enterprise (Weber, 1978; La Porta et al, 1997, 1998, 2008; Djankov et al, 2002, 2006, 2008; Botero et al., 2004). Whilst the results showed correlation between 'good quality' legal rules and financial development, there are ambiguities over the interpretation of causation. This is because legal rules may be 'endogenous' to financial development: that is, greater investment itself creates demand for legal norms (Cheffins, 2001; Coffee, 2001).[1]

[1] Other criticisms point to biases in the selection of legal variables (Lele and Siems, 2007) and inaccuracies in their coding (Spamann, 2006).

A second claim asserts that the quality of legal institutions varies systematically with a jurisdiction's 'legal origin'—that is, whether it falls into the Anglo-American 'common law', or Napoleonic, German or Scandinavian 'civil law' systems. This emerges empirically from correlations between legal origins and the quality of law scores. As legal origin is, for most countries in the world, exogenous—deriving from historical contingencies such as the identity of colonial invaders—it is argued that this supports the view that law drives financial development, rather than *vice versa* (La Porta *et al*, 2008).[2]

It is of course well-known to comparative lawyers that such classifications are really no more than ideal types, and that attempts to map these onto real-world systems will suffer from arbitrariness (Dam, 2006; Siems, 2007). Clearly, 'legal origins' proxy for a congeries of structural features of legal systems, and classification would be improved by focusing solely on those features thought to influence the quality and effectiveness of legal rules. This requires an account of the channels through which such influence is transmitted. Whilst the literature suffers from a degree of under-theorization on this point, at least two (complementary) working hypotheses have been articulated.

First, the 'adaptability' or 'flexibility' hypothesis concerns the way in which new rules are produced (Beck et al, 2003; La Porta et al, 2008). Common law rules develop through incremental change from judicial precedents, whereas civilian systems rely on large-scale statutory codification. It is argued that case-by-case evolution may therefore promote flexibility and adaptation to changes in the real economy, leading presumably to more rapid emergence of better-quality legal rules. Second, the 'judicial independence' hypothesis posits that common law judiciary enjoy greater independence (including appointment, selection and tenure) from the other branches of government, and consequently may do better at protecting

[2] It is with this claim that the 'new comparative economics' parts company with the earlier work of Weber, who acknowledged causal relationships running in both directions between law and the economy (Weber, 1978).

property rights from state rent-seeking (Hayek, 1978; Mahoney, 2001; Claessens and Laeven, 2003; La Porta et al, 2008).

2.2 Political economy and finance

'Political' explanations assert that the structure of corporate and commercial law is better explained by political economy than by legal origins (Roe, 2003; Rajan and Zingales, 2003; Gourevich and Shinn, 2005; Milhaupt and Pistor, 2008). One class of such theories focuses on 'macro' politics: that is, the way in which domestic political preferences shape the economy. For example, in relation to developed economies, Roe (2003) argues that social democratic governments enact laws favouring labor. Strong labor groups prompt concentrated share ownership as a means ensuring shareholders are able to coordinate in bargaining with employees over corporate rents.

Another class of 'political economy' theories of legal institutions focuses at a more 'micro' level on the role played by particular interest groups (Rajan and Zingales, 2003). As the outcome of the legislative process will affect the returns captured by interest groups, such theories commonly predict a two-way, or 'rolling', relationship between legal change and financial development (Milhaupt and Pistor, 2008; see also Weber, 1978).

A related claim discerns a link between economic organisation and prevalent financial structures (Hall and Soskice, 2001; Carlin and Mayer, 2002). Certain forms of financial contract complement more effectively particular types of industry: debt is suited to manufacturing, where there are hard assets to pledge as collateral; whereas equity is more appropriate for high-growth sectors where assets are less tangible. Allen *et al* (2006a) present results from cross-country regressions indicating that bank (debt) finance is more prevalent in countries dominated by physical-asset intensive industries. This literature might readily be linked with the 'political' account canvassed above, in that dominant industrial structures are likely to be reflected in powerful interest groups who may be expected to influence the course of law reform. Industrial structure, therefore, may be expected to be an input to law reform.

2.3 Motivation

The theoretical debate on the links between law and the development of financial markets benefits from a surfeit of cross-country regression results, but suffers from and a lack of case study evidence shedding light on the mechanisms by which legal changes provoke, or are provoked by, changes in the real economy. In particular, little work has examined the operation of the posited channels by which 'legal origins' are said to affect the efficacy of the legal environment for finance. In order to explore this, we conduct a case study of the processes by which legal change occurred in India, a very significant developing economy, during the past 20 years.

3. The Indian pattern of corporate governance and finance

In this section, we give an overview of our case study, outlining developments in India's industrial structure, corporate finance, and legal protection.

3.1 Industrial development

India is, compared to similarly-situated developing countries, said to be relatively weak in labour-intensive manufacturing, strong in skill-intensive manufacturing, and strong in services and high-tech sectors (Topalova, 2004; Kochhar et al, 2006). To a large extent, this is thought to flow from policies adopted during the socialist era of central planning, following independence in 1947 until the early 1980s. In particular, planners pursued policies seeking (i) to develop self-sufficiency through import substitution and restrictions on capital flows; (ii) to channel scarce domestic capital into large-scale, capital-intensive 'national champion' firms; (iii) to deter the formation of other large-scale private sector firms—which might compete for such capital—by discriminating in favour of small-scale private enterprise; and (iv) to foster the development of home-grown human capital through investment in education. Under this regime, manufacturing firms were subject to a plethora of regulatory controls over their operations which were nicknamed the 'licence Raj' on account of their similarity to the arbitrary power formerly wielded by the British.

For many years, the Indian economy languished under what was referred to disparagingly as the 'Hindu rate of growth', averaging around 3% per annum until the early 1980s (Panagariya, 2008). However, liberalization beginning in the mid-1980s and intensifying with a general opening to trade and capital flows in 1991 have been associated with a dramatic increase in growth, which has averaged over 6% per annum since then.[3]

Kochhar et al (2006) argue that the distinctive pre-liberalization policy mix resulted in a relative underdevelopment of private sector large-scale manufacturing industry in India by the early 1980s, and a comparatively high degree of specialisation in private-sector services, which required less capital investment. As the manufacturing sector struggled to develop, the heavy state investments in tertiary education had produced by the 1980s many more qualified engineers than there were jobs (Athreye, 2005). At the same time, however, services and software firms were starting to grow rapidly. The licence Raj extended only to firms manufacturing tangible assets, leaving services firms and software manufacturers outside its ambit (Khanna and Papelu, 2005; Athreye, 2005) and giving them greater freedom to innovate. When constraints on the private sector were relaxed from the early 1990s onwards (Bala, 2006), there were therefore relatively many highly-skilled workers and an emerging

[3] The causes of this growth transformation are contested. For example, Panagariya (2008) argues that the market liberalizations of 1991 were the crucial turning point for increased growth, whereas Rodrik and Subramanian (2008) argue that an 'attitudinal shift' in government's relations with business during the 1980s provided the most important spark to growth.

specialisation in services. Seemingly as a result, India's subsequent pattern of development has seen dramatic growth fuelled by the services sector and skill-intensive manufacturing, whilst the country still remains relatively under-developed—as compared with other countries at a similar stage of development—in terms of labour-intensive manufacturing.

3.2 Financial markets

By developed country standards, Indian firms tend to be highly reliant on retained earnings and informal networks of family and friends as sources of finance. Yet, relative to similarly situated *developing* countries, India's equity markets are highly developed. As regards debt finance, overall private lending is slightly below the level in comparable developing countries, and markets for publicly-traded corporate debt (bonds) are virtually non-existent.

Table 1 lists certain key indicators for stock markets in various countries around the world. As can be seen, the 'depth' of India's equity markets—as measured by the ratio of market capitalisation to GDP—is higher than that for comparable developing countries such as China, or indeed for many developed countries, including Germany.

[Table 1 about here]

In a similar vein, Table 2 presents data on the evolution of stock market capitalisation to GDP, comparing India with averages for high, middle and lower income countries around the world. As can be seen, India's equity markets grew rapidly during the 1990s, moving from having only a slightly higher market capitalization ratio than low income countries at the start of the period to exceeding that of middle income countries.

[Table 2 about here]

Figure 1 plots the relationship between outside equity and outside debt markets for selected Asian countries in 2004. Whilst India's equity markets are comparable with the stronger economies in the region, its corporate bond markets are relatively underdeveloped.

[Figure 1 about here]

In line with the relative success of India's equity markets, as compared to corporate bond markets, both aggregate and firm-level debt-to-equity levels in India's corporate sector have decreased during the period since liberalisation (Shirai, 2004; Topalova, 2004; Thomas, 2006). Figure 2 shows the liabilities (historic cost) of Indian firms during the period 1990-2001. As can be seen, the proportion represented by equity funds has grown during this period, with a corresponding decline in bank loans and bonds.

[Figure 2 about here]

Moreover, the use of outside equity by riskier firms (as proxied by age and size) is reported to have increased significantly since 1990, implying that developments in the stock markets have assisted such firms in raising finance (Pal, 2001; Shirai, 2002; Allen et al, 2006b, cf. Sarkar, 2006). A similar pattern of development has not, however, been present in credit markets. Whilst banks have become more willing to extend credit, this appears to have been across the spectrum of borrower types (Shirai, 2002), with the result that access to credit by the more risky firms has not proportionately increased (Love and Peria, 2005).

It is interesting to note that the relative strengths of India's financial markets complement the areas of comparative advantage in industry. Debt finance is not well suited to high-tech manufacturing or services firms, in which much of the value is likely to be tied up in growth opportunities (Armour and Cumming, 2006). Firms developing new technologies or client bases commonly do not generate steady cash flows that can be used to make interest payments, and lack liquid assets that could be used as collateral. Instead, the value (if any) of such a firm will inhere in the ideas and 'human capital' of the entrepreneur and opportunities for growth. This makes such firms unsuitable candidates for debt investment (Berger and Udell, 1998). Empirical findings confirm that equity financing, and not debt, predominates in privately-held firms in technology-intensive industries (Freear and Wetzel, 1990; Carpenter and Petersen, 2002).[4]

3.3 Development of India's legal institutions for corporate finance

Although India has a 'common law' legal system, inherited from the British, many of its laws were in fact codified during British rule.[5] This foundation was overlaid with extensive further legislation when the post-independence government implemented a socialist reform agenda encompassing all areas of commercial activity, including corporate finance. However, the dramatic recent development of the economy has been accompanied by equally dramatic legal changes, with the wholesale scrapping of legislation facilitating government intervention in markets and the introduction of more market-facilitative legal infrastructure.

Table 3 identifies the principal legislation in the sphere of company law and investor protection prior to India's liberalisation in 1991, which established a tightly-regulated regime as respects corporate management and finance. In particular, there were controls on the extent

[4] Whilst in the US, such outside equity would initially at least take the form of venture capital, many Indian firms simply go directly to the stock markets, as is evidenced by the extraordinarily high number of listed companies in India (see Table 1).

[5] See, e.g., Indian Penal Code 1860; Indian Contract Act 1872; Indian Evidence Act 1872; Criminal Procedure Code 1873; Negotiable Instruments Act 1881; Indian Trusts Act 1882; General Clauses Act 1897; Code of Civil Procedure 1901.

and pricing of equity issues by private firms. Debt finance was controlled through legislation requiring banks (the majority of which were state-owned) to lend at subsidised interest rates to ‘national champion’ industries.

[Table 3 about here]

In an environment in which banks were used as a means of channelling subsidies to firms favoured by central planning policies, debt does not impose a hard budget constraint on borrower firms. It is therefore not surprising that effective enforcement mechanisms for debt contracts were lacking prior to liberalization. For the recovery of unpaid debts, and even the enforcement of security interests, there were few options other than filing a suit before the courts. However, the very long delays typical in the Indian courts significantly undermined the legal protection of creditors. Moreover, India’s insolvency laws were also notoriously weak, with winding-ups typically taking more than ten years to complete, and in some cases upwards of 50 years (Goswami, 2002; Batra, 2003). The Sick Industrial Companies Act (SICA) was enacted in 1985, ostensibly to provide an improved means for the reconstruction of distressed industrial firms. It placed control of distressed firms in the hands of a new quasi-judicial agency, the Board for Industrial Financial Reconstruction (‘BIFR’). However, this appears to have achieved little more than to keep failed firms in operation to mask unemployment.[6]

Following a currency crisis in 1991, the Indian government implemented a dramatic reconfiguration of the economy (Joshi and Little, 1996). The motivating idea was to move decisively away from state control by granting a significant role to the private sector,

[6] BIFR records show that from 1987 to 2005, 5327 firms entered the SICA regime. Of these, only 504 have been successfully revived (http://bifr.nic.in/geninfo.htm).

encouraging competition, developing market-oriented mechanisms and limiting government intervention (Bhagwati, 1993; Panagariya, 2008). Widespread legal reforms were associated with this shift, encompassing investor protection alongside industrial policy, foreign investment, and trade and exchange rate policy (Joshi and Little, 1996; Ahluwalia, 2002; Mohan, 2007).

As regards corporate finance, many of the restrictions imposed by the legislation set out in Table 3 were removed during the 1990s. Of these five pieces of legislation, two (CICA and SICA) have been repealed outright,[7] another (FERA) was entirely replaced by a more liberal statutory regime (the Foreign Exchange Management Act 1999 or 'FEMA'), and two others (SCRA, MRTP), have been amended with a view to reducing governmental control of the activities on the securities markets and increasing competition. Whilst the Companies Act 1956 remains the primary legislation governing the establishment, operation and management of companies and also winding up or liquidation, several changes have also been made to this Act, mostly with a view to relaxing government controls and giving more freedom to companies to manage their own affairs. Moreover, it is anticipated that the entire regime will be replaced by the Companies Bill 2008, although this may take several years to come into force. In addition, a range of new measures were introduced. We consider these by reference to equity and debt finance in turn. Table 4 summarizes the timing of the liberalizing repeals and these new measures.

[Table 4 about here]

3.3.1 Reforms relating to equity finance

[7] The repeal of SICA has not at the time of writing been brought into force.

Rapid and wide-ranging legislative efforts were made after liberalisation to foster the development of Indian securities markets (Shah and Thomas, 1999; Thomas, 2006). Principal amongst these was the replacement of central government control over stock exchanges with an SEC-style independent regulator, the Securities and Exchange Board of India ('SEBI'). Initially established in 1988 as an advisory body, SEBI was granted statutory authority as a unified securities regulator in 1992, including—crucially—the power to produce binding regulations by way of delegated legislation. It proceeded to establish a regulatory framework to ensure transparency of trading practices, speedy settlement procedures, enforcement of prudential norms and full disclosure for investor protection, rather than the prior emphasis Government intervention and control (Ahluwalia, 1995). Specific regulations included rules governing merchant (investment) banks,[8] disclosure requirements,[9] substantive corporate governance rules (the so-called "Clause 49" of the Listing Agreement), a takeover law,[10] and the prohibition of insider trading.[11]

The inauguration of SEBI was soon followed by the establishment of a new securities exchange, the National Stock Exchange ('NSE') in 1992,[12] the first clearing corporation—the National Securities Clearing Corporation Ltd ('NSCCL')—in 1995, and an independent depository called the National Securities Depository Limited ('NSDL') in 1996. These new and independent institutions provided necessary infrastructure for the now fast-growing Indian stock markets. Moreover, the advent of competition between stock exchanges lead to

[8] SEBI (Merchant Bankers) Regulations 1992.

[9] SEBI (Disclosure and Investor Protection) Guidelines 2000, as amended from tiem to time, and replacing earlier guidelines on the issuance of shares dating from 1992.

[10] SEBI (Substantial Acquisition of Shares) Regulation 1994, replaced by new regulations in 1997 and subsequently amended from time to time.

[11] SEBI (Prohibition of Insider Trading) Regulation 1992, as amended from time to time.

[12] The NSE started trading bonds in June 1994, and shares in November 1994 (see: http://www.nseindia.com/content/us/fact2006_sec1.pdf).

the rapid adoption of a number of innovative technologies, such as fully automated screen-based trading (Shah and Thomas, 1996, 1999; Bhattacharya and Patel, 2005).

Another important development has been the increase in market participants. Following liberalisation, Indian stock markets have been opened to investment by foreign institutional investors ('FIIs'), Overseas Corporate Bodies ('OCBs') and non-resident Indians ('NRIs'), who have been allowed to invest extensively in Indian companies.

The limited body of empirical research which has to date examined the relationship between these equity-oriented reforms and market performance suggests that they have had a positive impact. Black and Khanna (2007) report empirical findings that the introduction of Clause 49 has been associated with a positive impact on firm performance, although this appears to have been greatest following the introduction of effective enforcement, which began in 2004 (Dharmapala and Khanna, 2008).

3.3.2 Reforms relating to debt finance

A range of banking reforms initiated in 1992 were designed to liberalize the sector, enhance banks' financial stability, and to increase banking competition—which up to that point had been subject to a near-monopoly from the public sector (Khatkhate, 2002; Ahluwalia, 2002; Mohan, 2007). To be sure, these reforms have resulted in some increase in the number of market participants, with associated competition from private and foreign banks now permitted to operate in India, which has in turn prompted increased operating efficiency at the remaining publicly-owned banks (Bhaumik and Dimova, 2004). However, the pre-liberalization legal framework for credit agreements, which made it difficult for creditors to enforce their claims and prioritized the interests of distressed companies over those of their creditors, has not changed with anything like the speed, or to the extent, that has occurred in relation to the legal institutions underpinning equity markets (Ahluwalia, 2002).

The first step to improve the situation was the passage of the Recovery of Debts Due to Banks and Financial Institutions Act 1993 (the 'RDDB Act'). Under this legislation, dedicated Debt Recovery Tribunals ('DRTs') were established for the recovery of debts of more than Rs1m due to banks or financial institutions, in a bid to bypass the long delays associated with enforcement through Indian courts. But the RDDB legislation was subject to constitutional challenge, with the result that the DRTs were stayed from operating until 1996, and it was not until 2002 that the Act was finally approved in a form compatible with the Court's requirements. Visaria (2006) finds that the introduction of the RDDB Act has been associated with improvements in bank credit markets, including lower borrower delinquency and lower interest rates offered to borrowers.

A second major enhancement for creditor rights was the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act 2002 ('SARFAESI'). Again aiming to bypass delays associated with court proceedings, this legislation empowered banks and financial institutions to enforce security interests extra-judicially. In a pattern that echoed the experience with the RDDB Act, certain aspects of SARFAESI's enforcement regime were challenged on constitutional grounds, staying its operation until 2004, when the Supreme Court generally upheld the Act's validity.[13] Vig (2007) finds that the introduction of SARFAESI serves to reduce use of secured credit by Indian firms, consistently with the intuition that enhanced creditor enforcement rights renders this form of credit more costly for borrowers.

SARFAESI also established a regime regulating the securitisation and reconstruction of financial assets. This has given lenders an alternative exit route from distressed loans—sale to an investment entity specialising in distressed debt, as opposed to enforcement. In July 2005, the RBI authorised the sale or purchase of non-performing assets by banks and other

[13] *Mardia Chemicals Ltd Etc. v. Union of India and others*, JT 2004 (4) SC 308.

financial institutions in return for cash consideration. From November 2005, it also paved way for foreign investment in such assets by allowing foreign direct investment to comprise up to 49% of the equity capital of asset reconstruction companies or securitisation companies set up to purchase non-performing loans from banks. These have enabled such companies to finance the acquisition distressed debt, affording a clean exit to the sellers.

The RDDB Act and SARFAESI represent significant steps forward as regards debt enforcement. However, these provisions apply only to debts due to banks and financial institutions, and are not available to ordinary creditors, who still have no option but to pursue the debtor before ordinary civil courts, with the associated long delays. Consistently with this observation, it is worth noting that aggregate bank credit in the Indian economy has more than quadrupled since 2001 (when the time series in Figure 2 ends), whereas bond issues actually fell over the same period (Reserve Bank of India, 2008).[14]

Little progress has to date been made with Indian insolvency law, which, according to World Bank measures, continues to be amongst the least effective in the world (World Bank, 2007).[15] Following the recommendations of an expert committee (Eradi, 2000), the government passed the Companies (Second Amendment) Act 2002 (the 'Second Amendment'). Amongst other things, this sought to introduce new corporate reorganization provisions to the Companies Act 1956, which it is intended will replace the SICA regime (Batra, 2003).

The new reorganization provisions will transfer the powers exercised by the BFIR under SICA to a new tribunal called the National Company Law Tribunal ('NCLT'). The

---

[14] In 2001, aggregate Indian bank credit was Rs 2,188 bn rising to Rs 8,719 bn in 2008; private sector debenture issuance was Rs 30.7 bn in 2000-01, falling to Rs 13.1 bn in 2007-08 (Reserve Bank of India, 2008: Tables 49 and 81).

[15] According to the World Bank survey, the completion of a corporate bankruptcy in India typically takes 10 years—a tie with Chad for the longest time in the world.

new scheme seeks to avoid a number of the problems of SICA, in particular the much abused statutory moratorium, and the NCLTs will be constituted of qualified people to preside over rehabilitation and liquidation matters. However, implementation of the Second Amendment has also been held up by constitutional challenges. The Madras High Court ruled some of the provisions of the Second Amendment to be unconstitutional in 2004, staying its operation until suitable changes were made.[16] Pending suitable amendments, the NCLT tribunals have not yet been established and the BIFR is still operating.[17] Moreover, it has been doubted whether the reorganization provisions of the Second Amendment are sufficiently different to SICA to make a major impact on corporate debt markets (Batra, 2003; World Bank, 2007).

3.4 Research questions and methodology

As emerges from the foregoing discussion, India has made more progress in implementing new legal institutions as respects equity finance than as respects debt. The early establishment of a new independent securities regulator, SEBI, with power to pass delegated legislation, has seen a rapid and responsive development of a regulatory regime for shareholder protection. In contrast, however, the reform strategy for creditor rights has depended largely upon primary legislation, which has seen lengthy delays owing to constitutional challenges before the courts.

As we have seen, there are complementarities between the pattern of India's industrial development; the pattern of financing for Indian firms, and the development of legal institutions supporting external finance. Stronger legal institutions for equity investors are associated with, by comparison with similarly situated countries, relatively high levels of

[16] *Thiru. R. Gandhi President v. Union of India (UOI)* [2004] 120 Comp Cas 510 (Mad).

[17] As of March 2008, the future of NCLT still seemed uncertain and the BIFR was still operational. See, e.g., *Economic Times,* 'No Easy Cure for Industrial Sickness', 2 January 2008, available at: http://economictimes.indiatimes.com/Policy/No_easy_cure_for_industrial_sickness/articleshow/2667172.cms.

equity investment; this in turn complements a pattern of industrial development specialising in services, software and high-tech manufacturing, sectors naturally complemented by equity, rather than debt, finance. Empirical studies report that developments in the legal infrastructure supporting finance are associated with improvements in financial market performance. increased performance of both equity (Black and Khanna, 2007; Dharmapala and Khanna, 2008) and debt markets (Visaria, 2006; Vig, 2007; Deakin, Demetriades, and James, 2008). However, what is less clear is what drove the development of legal institutions. Was this influenced by India's legal origin, or by political economy?

The complementarities we have outlined are consistent with both the 'legal origins' and the 'political economy' views outlined in section 2. Both theories predict that increased legal protection of investors is associated with enhanced financial development. How they differ is in the extent to which they contemplate a 'reverse channel' by which financial development provokes legal change, rather than *vice versa*. On the legal origins view, reforms of investor protection laws are determined (exogenously to financial development) by the structure of the country's legal system, and in turn lead to financial development. On the political economy view, the relationship between law and finance is entirely endogenous: financial development strengthens the calls of investors pressing for enhanced legal investor protection, which in turn spurs further financial development; the two evolving in a mutually-reinforcing dynamic.

To test which account better explains the case of India, we therefore need to look at the mechanisms by which legal change occurs. To this end, we focus in this study on the processes by which India's investor protection laws were transformed during the past 20 years. The theories reviewed in section 2 yield quite different predictions. The legal origins view predicts that developments in the quality of India's legal protection of investors should have been driven by the characteristic status and role of common law judges. This could take effect through either or both of the postulated channels. In particular, the 'adaptability' channel implies an important role for judicial law-making in generating positive enhancements of the legal regime; and the 'judicial independence' channel implies a role for the judiciary in preventing its subversion by state rent-seeking. In contrast, the 'political economy' theory predicts that legal change will be provoked in particular by interest group pressure for reform, and that the resources enjoyed by particular constituencies (and hence their ability to exert pressure for reform) will be influenced by previous rounds of legal interventions.

In order to explore the extent to which these theories explain the reforms of investor protection in India, we searched for 'process data' supporting the predictions made by these theories. In addition to surveying judicial decisions, legislative history and official reports, newspaper cuttings and the secondary literature, we conducted 21 interviews with actual or potential participants in the Indian law reform process, in order to build up a narrative account of the law reform process which can then be tested. Our strategy was to include representatives from as wide a range as possible of different constituencies—including judges, practising lawyers, policymakers (civil servants responsible for preparing relevant legislation), regulators, investment and commercial bankers, venture capitalists, and representatives of industry associations. Consequently interviewees were not selected at random but rather by their membership of these constituencies and their willingness to speak with us.[18]

4. What role did India's 'legal origin' play?

[18] Details of our interviewees are given in an Appendix. The interviews were structured around a list of questions sent to interviewees in advance, but with sufficient flexibility to pursue additional relevant issues that came up in discussion. The majority of interviews were conducted by both authors. Interviews were recorded with subjects' permission, which was given in most cases.

As discussed in section 2, the 'legal origins' view asserts that the historically-determined structure of a country's legal system—into one of the civil or common law 'legal origins'—is a determinant of the quality of micro-level legal institutions that facilitate corporate finance. Common law legal origins are thought to lead to superior legal institutions through two particular channels: first, the relative adaptability of judge-made, as opposed to codified, law; and secondly, the relative independence of common law judges from the legislature, resulting in a reduced tendency towards rent-seeking by the state. We now examine whether, and to what extent, India's status as a common law country affected matters through each of these two channels.

4.1 Judicial law-making and 'adaptability'

The 'adaptability' channel asserts that common law systems derive a comparative advantage in innovating legal rules (to respond to changed environmental or technological circumstances) through the use of judge-made, as opposed to codified, laws. Judicial law-making results in an emergent, rather than a planned, system of rules, in which one aspect may change at a time without implications for the coherence of the body of rules as a whole. If this were an accurate account, we would expect to see rapid development of judicial rules following significant environmental or technological changes. Post-liberalization India therefore makes a good test case, as the relaxation of government controls on finance from 1991 onwards created scope for significant financial innovation.

The defining feature of the Indian court system is the staggering delays involved in resolving a case by trial, which typically would take up to 20 years (Debroy, 2000).[19] As of

[19] As a consequence, the World Bank's *Doing Business* survey reports that commercial disputes before courts in India are among the most lengthy, costly and complex in the world. It takes 1,420 days to enforce a contract in India, compared with 969 days on average in South Asia, 351 days on average in OECD countries, 450 days in Malaysia and only 292 days in China (World Bank, 2007).

February 2007, there were over 41,000 cases pending before the Supreme Court,[20] and as of August 2006, nearly 4 million before all the High Courts, and approximately 25.5 million before all the District Courts.[21] Table 5 gives figures for pendency of cases before High Courts of the various states. With a backlog of this magnitude, it is simply not possible for India's judges, even if they are activist and willing to update the legal rules in response to changes in the real economy, to act as agents of legal change in a way that responds anything like quickly enough to keep up with the galloping pace of economic change.

[Table 5 about here]

It appears that the incidence of new litigation has not increased significantly in the past 30 years—and indeed has decreased over the past century. Delays have lengthened rather owing to the legal system's increasing inability to resolve existing cases (Debroy, 2000; Krishnan, 2003; Hazra and Micevska, 2004; Galanter, 2006). There are several contributing factors. First, India has relatively few judges per capita, as illustrated by Table 6. Second, procedural laws in India—particularly with respect to civil litigation–facilitate delays and are often abused to frustrate litigants. For instance, they readily allow a variety of 'interim applications', 'ad-interim applications' and adjournments, which permit a party wishing to prolong the proceedings to do so almost indefinitely (Debroy, 2000; Krishnan, 2003).[22] Furthermore, they create several layers of rights to appeals and revision—another major

[20] According to the monthly statement of pending cases for the month of February, 2007, see http://www.supremecourtofindia.nic.in/new_s/pendingstat.htm

[21] Figures as of 7.8.2006, Ministry of Home Affairs, Department of Justice, available at http://mha.nic.in/rtijustice1.pdf and http://mha.nic.in/rtijustice2.pdf.

[22] Amendments to the Indian Civil Procedure Code 1908 ('CPC') in 1999 and in 2002 attempted to improve things by imposing a maximum of three adjournments, and abolishing the right of second appeal for small claims (<Rs. 25,000) (Ministry of Law, Justice and Company Affairs, 2002).

cause of delay.[23] As one of our interviewees observed—'it's a Defendant's court'. Third, these procedural laws generate negative synergies with the fee structure of litigation lawyers, who are paid by appearance, and so have an incentive to prolong the duration of cases for as long as possible. Long delays and low settlement rates are the result.

[Table 6 about here]

With a typical delay of 10 years or more until a lawsuit is resolved, it seems hardly likely that judicial innovation in lawmaking through the civil courts can have been a significant channel through which India's substantive laws regarding investor protection were developed in the post-liberalization era. These findings appear to challenge the notion that common law systems' alleged advantages in terms of the adaptability of judge-made law give them an inherent advantage for economic development. Where courts are chronically overworked (or worse still, corrupt)—as is likely to be the case in many developing countries—then it is hard to see that they can be motors of legal reform.

In contrast, the most successful mechanism for producing new laws in India has been delegation to regulators with quasi-legislative power. Passing the mantle to technocratic committees has deflected political attention which would have been received had the rules been promulgated by primary legislation. The real engines for development of the legal

[23] Under the Civil Procedure Code 1908 ('CPC'), a first appeal in a civil matter may be made on point of fact or of law to the District Courts (s 96), then a second appeal to the High Courts is possible only on a point of law (s 100). If the second appeal is heard by a single judge, the appellant can pray for an additional appeal, known as a 'letters patent' appeal, to a Division Bench of the High Court. Upon certificate by the High Court, a further appeal can be made on a substantial question of law to the Supreme Court (Article 133 of the constitution). What is more, under CPC s 115, 'revision applications' may be filed with High Courts under certain circumstances even when an appeal is not possible.

framework of corporate finance in India have rather been specialist regulatory bodies such as SEBI, and, to a lesser extent, the Reserve Bank of India (RBI).

SEBI in particular has promulgated a wide range of delegated legislation. The enforcement of these rules is also carried out by the same agency, with a right of appeal to a specialist tribunal, the SEBI Appeals Tribunal ('SAT').[24] The SAT consists of three members: two law members who must be experts in securities and a chair drawn from the senior Judiciary. Thus the SEBI dispute-resolution structure bypasses of the backlog in India's courts by setting up *de novo* a specialist adjudication mechanism.

It can be seen that the long backlogs in the Indian courts rule out judicial adaptation as a source of legal development. Rather, the most important source of legal innovation in relation to financial markets has been specialist regulators, with accompanying specialist tribunals to adjudicate disputes. There are no *a priori* reasons for thinking that delegation of rule-making power to regulatory agencies is associated with any particular class of legal origin. Hence the Indian case casts considerable doubt on the idea of an 'adaptability channel' through which a country's legal origin influences the content of its legal rules.

4.2 Judicial independence and the protection of property rights

Judicial independence is a second channel through which a country's legal origin is said to influence the development of its laws. Common law systems, it is asserted, grant greater political independence to their judiciary than do civilian systems, which better positions common law judges to protect property rights from encroachment by the state.

India's constitutional scheme designates the Supreme Court as protector of constitutionally-guaranteed 'fundamental rights',[25] and makes efforts to maintain the Court's

[24] Securities and Exchange Board of India Act 1992, Chs VIA-VIB.

[25] Constitution of India, Part III (Arts 12-35).

political independence.[26] The Court has extensive powers of judicial review of legislative and executive actions, and has been, by international standards, exceptionally activist in exercising them (Allen, 2000). Of particular interest for present purposes is the vigor with which the Court has, over the years, sought to protect private property rights against encroachment by the state.

The Constitution of India, as originally drafted following independence in 1947, provided for the protection of individual property as a fundamental right. However, the newly independent government of India was keen to carry out drastic land reforms and redistribution of property in order to further social justice. This quickly led to tension between the government and the judiciary over the extent to which the legislature had power to engage in such redistribution of property rights.

The saga began with the 1951 case of *Kameshwar Singh v. State of Bihar*,[27] in which the Patna High Court held that legislation providing for the abolition of an age-old hierarchical system of 'zamindari' rights was unconstitutional.[28] The legislature's response was to pre-empt the Supreme Court by introducing the First Amendment to the Constitution,

---

[26] A Supreme Court judge may be appointed by the President, but only after consultation with the Chief Justice of India (Constitution of India, proviso to Art 124(2)). Once appointed, Supreme Court judge can be removed from office only by impeachment in Parliament by a two-thirds majority (Art 124 (4)). Moreover, the Court has recently developed a system of collegia by judges which operates, in effect, to rule out any executive interference over appointments: *Supreme Court Advocates-on-Record Association v Union of India* 1994 SC 268; Desai and Muralidhar (2000).

[27] AIR 1951 Patna 91.

[28] Established since the Mughal era, the system of zamindari rights granted the 'zamindars', or intermediaries, special powers over land in return for an obligation to collect and pay fixed amount of land revenue to the rulers. By the time of the British Raj, the zamindars were treated as landlords of the lands for which they collected taxes and the farmers that worked the land for crops became their tenants.

providing that certain laws listed in a new (and now notorious) Schedule IX were to be beyond challenge on the ground of interference with fundamental rights.[29]

The next point of contest followed a 1954 Supreme Court decision that it had power to review the adequacy of compensation payable following the exercise of state compulsory acquisition powers.[30] The legislature responded with another constitutional amendment, expressly rendering this issue non-justiciable.[31] Despite this and further amendments,[32] the Supreme Court subsequently came up with further ingenious ways to protect private property from public takings. For instance, in *Vajravelu*,[33] the Court held that whilst the *adequacy* of compensation was not justiciable, laws could still be declared invalid if they made *no* provision for compensation, or if the compensation was *illusory*.

This constitutional back-and-forth continued into the 1970s, with further constitutional amendment by the legislature being met by correspondingly expansive interpretation of the remaining provisions by the Supreme Court. An endgame appeared to have been reached during the Emergency period of 1975-77, which was the height of the arrogation of executive power. During this period, which also witnessed executive interference with judicial appointments, the Court acceded to the government's wish to suspend entirely the constitutional protection of fundamental rights. When the Emergency suspension ended in 1978, the legislature amended the constitution so as to remove entirely the 'right to property' from the category of fundamental rights.[34]

---

[29] Constitution (First Amendment) Act 1951.

[30] *State of West Bengal v. Bela Banerjee*, AIR 1954 SC 170.

[31] Constitution (Fourth Amendment) Act 1955.

[32] Constitution (Seventeenth Amendment) Act 1964.

[33] *Vajravelu v Special Deputy Collector* AIR 1965 SC 1017; *Union of India v the Medical Corporation of India* AIR 1967 SC 637 (overruled in *State of Gujarat v Shantilal* AIR 1969 SC 64).

[34] Constitution (Forty-fourth Amendment) Act 1978, repealing Art 31 of the Constitution of India.

Whilst the legislature ultimately succeeded in putting the protection of property rights beyond justiciability, the Supreme Court became, if anything, even *more* activist in its interpretation of the Constitution of India following the end of the Emergency. An extraordinary innovation was to relax standing requirements so as to permit any citizen to challenge an alleged breach of fundamental rights, even where the breach does not affect the plaintiff personally (Desai and Muralidhar, 2000; Thiruvengadam, 2006).[35] As might be expected, actions of this type—now known as 'public interest litigation' ('PIL')—have engendered a great deal of litigation (Cunningham, 2003).

Thus it seems likely that India's independent judiciary has played a meaningful role in protecting property rights in the years since independence. Despite the problems of backlog, the Supreme Court has been willing to go to great lengths to ensure that cases involving issues of expropriation or other violation of fundamental rights are heard. That said, it is unclear to what extent this is a function of India's *common law*, as opposed to its *constitutional*, status. In the UK, where the 'common law' approach to lawmaking originated, there was until very recently no constitutional protection for fundamental rights,[36] and the judiciary would have no legal basis for objecting to encroachments on property rights of the variety disputed in India during the pre-liberalization period.[37]

Moreover, the extent of judicial activism also illustrates a significant tension between the desiderata reflected in the 'adaptability' and 'judicial independence' accounts. Adaptability involves rapid change to accommodate developments in the real economy;

[35] The 'Judge's case' or *S.P. Gupta v Union of India*, AIR 1982 SC 149, is commonly regarded as the beginning of PIL in India (Jain, 2000).

[36] The Human Rights Act 1998 (UK) marked a significant departure, but even this does not give the judiciary power to strike down primary legislation as unconstitutional: merely to request that Parliament reconsider.

[37] To be sure, one should not push this point too far, as a characteristic feature of the Indian judiciary's intervention has been an expansionist interpretation of what legal bases were open to them under the constitution for checking executive power.

judicial independence on the other hand implies conservatism in respecting property rights. To the extent that the reforms required for adaptation to changed circumstances are those affecting property rights, a strong judiciary will act as a check on efficiency-enhancing, as well as rent-seeking, reforms. The delays following challenges to the implementation of credit market reforms such as the Debt Recovery Tribunals, SARFAESI and the reform of insolvency law flowed in part from the activism of India's judiciary. To some extent, therefore, the retardation of credit market reforms—as compared with stock market reforms—may be a consequence of their greater impact on property rights.

We have seen that two aspects of the 'legal origins' claim at best only partly explain the pattern which the development of India's investor protection has followed since liberalisation. And to the extent that it does—through the 'judicial independence' channel—the implications are at least partly contrary to the manner predicted by the theorists: India illustrates that an independent judiciary may not only be a check on rent-seeking, but also on beneficial adaptation.

5. The political economy of India's pattern of legal and industrial development

We now turn to consider the extent to which the patterns of change in Indian laws relating to corporate finance can be explained by reference to 'political economy' theories.

5.1 Demand side: interest groups and financial law reform

We asked our interviewees a series of questions about the role of interest groups in Indian financial law reform, in particular seeking to identify points of input to law-making processes and relative importance of different groups. We discussed both the drafting of primary legislation by government Ministries (namely, the Ministries of Company Affairs, Finance, and Law and Justice) and of secondary legislation by regulators (namely the SEBI and RBI).

The involvement of interest groups, and the extent to which the government and regulators are willing to interact with them, has increased significantly over the past 20 years. Prior to liberalisation, consultation with industry participants was limited to discussions over proposed provisions in the budget. Our interviewees spoke of a marked difference in the attitude of the government following the onset of liberalisation.

Although the relevant Ministries traditionally viewed drafting legislation as a purely internal exercise, it appears that public consultation and involvement of interest groups has become much more common. This often includes the setting up of committees of experts with representatives including businesspeople, bankers, professional bodies, regulators, and corporate lawyers. For example, when the Ministry of Company Affairs was considering a comprehensive reform of company law, it established an expert committee chaired by J.J. Irani, a director of Tata Steel, in 2004.

The SEBI and RBI also make use of committees comprised of experts from relevant fields, including industry and the legal profession, to consider reforms. The SEBI committees are usually chaired by well-known business persons and involve consultation with a larger number of interest groups.[38] RBI committees, on the other hand, are typically chaired by officials from the RBI or from other government bodies or public financial institutions, rather than industrialists.[39]

The nature of the involvement depends on the type of interest groups. For instance, corporate lawyers are involved at all stages of legal or regulatory change, including participation in consultation, sitting on expert committees and more direct involvement in

[38] E.g., the corporate governance rules adopted in the form of Clause 49 were the result of SEBI committee headed by well-known businessman Kumar Mangalam Birla and amended as a result of recommendations by a committee chaired by the software tycoon Narayan Murthy.

[39] E.g., the High Level Expert Committee on Corporate Bonds and Securitization was headed by R.H. Patil, Chairman of the Unit Trust of India. M. Narasimham, a former Governor of the RBI, headed the highly influential Narasimham Committee, which recommended a number of significant reforms in the banking sector.

assisting the ministries or regulators (mostly the SEBI) in the drafting of legislation or subordinate legislation (on a *pro bono* basis).[40]

Indian industry, represented by various interest groups, appears to be an important constituency influencing the law reform agenda at both ministerial and regulatory levels. Publicly-traded firms in India typically have controlling interests concentrated in the hands of family blockholders (Khanna and Palepu, 2005). The powerful networks and high concentration of wealth of leading business families enables them to act as an effective interest group in seeking regulatory reform. Indian industry exerts influence through well-established and organized channels of trade and industry associations. We were told that umbrella organizations like the Federation of Indian Chambers of Commerce of Industry ('FICCI') and the Confederation of Indian Industry ('CII') are amongst the most active, followed by the several local chambers of commerce and a range of industry-specific associations.

We were told that these industry bodies have become involved in agenda-setting by organizing seminars, roundtables and workshops to provide a platform for discussion and consensus-building on topical issues by involving representatives of government, regulators, and industry. The CII, operating through this process, has initiated several reforms relating to equity markets, including the corporate governance norms introduced in the form of Clause 49 of the Listing Agreement and the voluntary code for 'Desirable Corporate Governance'.

As far as commercial banks are concerned, the Indian Banks Association ('IBA') provides a formal channel for the exchange of ideas and policy influence.[41] There is a concern that the RBI, which itself holds stakes in a number of the public banks, may be

[40] Examples range from SEBI's Takeover Regulations to, more recently, a bill to introduce a limited liability partnership business form, which corporate law firms were involved in drafting.

[41] The IBA's membership includes both public and private sector domestic banks, foreign banks with offices in India, and other non-bank financial institutions: see http://www.iba.org.in/brief_background.asp.

subject to conflicts leading it to focus on the interests of public rather than private concerns (Thomas, 2006). That said, the increase in competition in the banking sector has engendered new interest groups representing private banks and foreign banks, which have been able to exert some influence at the ministry level in the reforms agenda. For instance, we were informed by some of our interviewees that a significant part of the impetus for SARFAESI came from the lobbying efforts of large private banks.

Labour unions, we were told, do not tend to get directly involved in shaping the reform agenda with regard to investor protection, especially as regards regulations introduced by the SEBI or RBI. However, unions were involved in lobbying regarding corporate insolvency law, seeking to deflect reforms that might diminish the pro-employee features of the current procedures (Umerji, 2004). Moreover, labour unions and groups representing small businesses have been amongst those that have used the wide standing rules available for public interest litigation to challenge the introduction of legislative reforms such as the Second Amendment to the Companies Act 1956.

The general picture that emerges may be summed up by three observations. First, reforms that have taken the form of delegated legislation promulgated by technocratic regulators such as the SEBI and the RBI have proceeded more quickly, and with less political hold-up, than have reforms that have depended on the passage of primary legislation. Secondly, as between SEBI and the RBI, the former has been more effective in implementing reforms and developing new institutions, perhaps in part because of its absence of ties with interest groups aligned with the pre-liberalisation era. Thirdly, the needs of businesses, as opposed to investors and employees, appear to have been heard most loudly by those responsible for reform, and by SEBI in particular.

These points suggest a possible explanation for several aspects of the pattern of Indian law and finance set out in Section 3. For firms in the industrial sectors in which India is disproportionately successful—software, hi-tech manufacturing and services—equity is likely to be a more significant form of outside finance than debt.[42] In a consultation framework in which the voice of industry is influential, one might expect the needs of successful industrial sectors to be well catered-for.[43] In short, we conjecture that industrial structure not only influences firms' financial structure, but may also have influenced the political economy of India's financial law reforms.

This 'demand-side' political economy account becomes more plausible the greater the differential in the success between India's service and manufacturing sectors. As such, it may help to explain recent rounds of reforms, but seems less convincing in relation to important earlier steps, such as the establishment of the SEBI's legislative powers in 1992, at a point when the pro-tertiary sector bias in India's industry was less pronounced.

To develop a more complete explanation, it may be instructive to consider whether earlier political preferences, reflected in pre-liberalization legislation, may have created path dependencies in favour of a particular type(s) of reform.

5.2 Supply side: the legacy of social planning

As it happens, many of the key features of India's pattern of legal and financial development since liberalisation may have been influenced by the legacy of legislative choices made during the era of central planning.

During India's socialist period from 1947 until 1991, a series of plans were instituted for the development of India's industry (Rothermund, 1988; Lal, 2005; Kochhar et al, 2006).

---

[42] This is because they tend to lack hard assets that can be pledged to creditors, as discussed in section 3.2, *supra*.

[43] Whilst merchant banks (as investment banks are known in India) have a stake in bond market development, they have also profited from equity market development, and so their preferences are likely to have been neutral as between the two, although going forwards this may change as equity markets mature.

These focused on developing capital-intensive infrastructure projects and 'prestige' industries, through subsidised lending from state-owned banks. Firms in such industries lacked hard budget constraints. The result of these policies, when coupled with import substitution, was that capital and product markets exerted only weak discipline on firms operating in these sectors. As a result, many Indian firms (mostly public sector) were inefficient. Indeed, the chronic overstaffing of many large (public) firms was recognised by the government as a means of disguising unemployment. Powerful labour protection under labour laws (Tendulkar, 2004), coupled with protection of employment in the public sector,[44] made these consequences difficult to reverse. The small but significant private sector, although more productively efficient, worked subject to a range of restrictions, including lack of access to finance, licensing requirements, extensive labour regulations, import restrictions, and heavy taxation.

Central planning of industry was complemented by state intervention in the financial sector (Thomas, 2006). Following the nationalization of the Reserve Bank of India in 1949, and the major private banks in 1969,[45] the state established a near-monopoly in the banking sector. Entry barriers existed for private banks, and foreign banks were prohibited from operating in India. The Banking Regulation Act 1949 invested the RBI with extensive supervisory and licensing powers in relation to banks, along with control of interest rates and thereby financial transactions. Both the state-owned banks and remaining private-sector banks were encouraged to lend at preferential interest rates to 'national champion' industries, being the state-sponsored heavy manufacturing. Consequently, these industries sought little outside equity finance, and Indian stock markets remained limited in size.

[44] Art 311 of the Constitution of India provides for special rules in relation to 'dismissal, removal or reduction in rank' of public sector employees, thereby creating a sort of tenure for incumbents.

[45] In 1969, the government nationalized 14 of the largest private banks operating at the time. A further 6 were nationalized in 1980.

These complementary aspects of the central planning regime had important, and probably unintended, legacies. Kochhar et al (2006) chart the influence of state intervention in manufacturing on the rise of technology-oriented firms from the '80s onwards. Service sector and high-tech firms operated outside the central planning framework applicable to manufacturing firms. Without either subsidies or the interference imposed by the 'licence Raj', they were forced to be efficient. These firms also benefited from another central tenet of post-independence policy, namely investment in higher education. The restrictions on the manufacturing sector meant that the pool of well-qualified individuals produced by India's higher education institutions had limited opportunities in that sector. As a consequence, service and high-technology firms were able to recruit well-qualified labour at relatively low wage costs. India's software, telecoms and high-tech manufacturing industries have grown dramatically since the early '80s.

There was also a legacy to the financial sector. Credit markets had an existing regulatory infrastructure, with the RBI at the apex, which was adapted to the financing needs of centrally planned firms. The underdeveloped equity markets, on the other hand, had little regulatory infrastructure. This meant that, after liberalisation, reformers had a blank slate on which to create new institutions from scratch for equity markets. The reform of credit markets, however, required modification to the existing institutions, which lead to inertia, because the RBI's personnel and culture have been influenced by its former role.

6. Conclusion

In recent years, India has undergone spectacular economic and financial development. This makes it an interesting and important case study for the investigation of claims asserting links between legal institutions, corporate finance, and—more tentatively—economic development. India's economy is heavily biased, relative to comparable developing nations, towards services. This is complemented by a relatively high use of equity finance and—again in relative terms—less use of debt finance, especially bonds. We show that these complementarities are, further, associated with a particular pattern of legal institutions: an effective regulator, and much new regulation, for equity markets; conversely reforms which might stimulate debt markets have been slower in their promulgation and implementation.

We investigated the extent to which these links between law, finance, and the economy in India may have flowed from the nature of India's legal system, in particular its 'regulatory style' as a common law country. One mechanism sometimes said to underpin such a link is the idea that judge-made law is more readily 'adapted' to changes in circumstances. We do not find evidence that this mechanism played a role in transforming India's investor protection laws since liberalization in 1991. Judge-made law, in the form of precedents, can only emerge at the speed at which judgments are in fact given. Indian courts are typically overwhelmed by delays—a typical dispute taking 10 years to resolve—and so it seems implausible that the judiciary acted as an important agent of legal change.

We find some evidence to support an alternative claim, that common law systems derive an advantage over their civil law counterparts through greater judicial independence, which can act as a constraint on rent-extraction by the state. India's independent judiciary did play a meaningful role in protecting property rights from state expropriation during the era of central planning. However, the Indian experience with judicial review being used to delay the passage of creditor-oriented reforms in recent years suggests that an independent judiciary may also act as a brake on beneficial legal change.

To be sure, case study evidence cannot 'disprove' the statistically significant links reported in the literature between legal origins, the quality of law, and financial development. Case study evidence is, however, well-suited for understanding mechanisms at work in social systems. Our finding that there is at best weak evidence for the operation of the mechanisms posited in the literature as driving the relationship between legal 'origins' and discrete legal rules therefore calls into question whether these mechanisms are in fact correctly specified. If they are not, then the challenge for future research is to specify more precisely the mechanisms through which legal origins does operate.

In contrast, we find more convincing support for the claim that economic structure is a determinant of financial structure. Moreover, this in turn appears to have been influential in the relative success of reforms fostering equity markets, as opposed to bond markets. Indian industry provides significant interest groups influencing the reform process, and so it is perhaps not surprising that the regulation of equity markets should fare better than debt. The pattern of India's (relatively) service-oriented economy appears to be an unintended consequence of the policies pursued during the pre-liberalization period. These too have also had an independent influence on legal reform, as the development credit markets appears to have been delayed by the need to re-orient regulators and institutions from their former role in industrial policy to simply imposing a hard budget constraint. It seems that it may be easier to create new institutions from scratch (SEBI) than to reorient the culture and interest groups associated with an existing institution designed for a different purpose (RBI).

All in all, then, we conclude that legal origins played at best a supporting role in bringing about India's characteristic pattern of legal, financial and economic development. Political theories, and in particular those focusing on the identity and influence of interest groups associated with industry, allow us to explain a greater part of the links observed between service-oriented economy, equity-oriented finance, rapid regulatory developments for equity markets and lack of legal change in relation to credit markets.

References:

Ahluwalia, MS. (1995), 'India's Economic Reforms', in Robert Cassen and Vijay Joshi (eds.) *India: The Future of Economic Reforms* (New Delhi: Oxford University Press).

Ahluwalia, M.S. (2002), 'Economic Reforms in India since 1991: Has Gradualism Worked?', 16 *Journal of Economic Perspectives* 67-88.

Allen, F., Bartiloro, L., and Kowalewski, O. (2006a), 'Does Economic Structure Determine Financial Structure?', working paper, Wharton School, University of Pennsylvania.

Allen, F., Chakrabarti, R., De, Sankar, Qian, J., and Qian, M. (2006b), 'Financing Firms in India', World Bank Policy Research Working Paper 3975.

Allen, T.R.S. (2000), *The Right to Property in Commonwealth Constitutions* (Cambridge: Cambridge University Press).

Armour, J., and Cumming, D.J. (2006), 'The Legislative Road to Silicon Valley' 58 *Oxford Economic Papers* 596-635.

Athreye, S.S. (2005), 'The Indian Software Industry', in A. Arora and A. Gambardella (eds.), *From Underdogs to Tigers: The Rise and Growth of the Software Industry in Brazil, China, India, Ireland, and Israel* (Oxford: Oxford University Press), 7-40.

Bala, M. (2006), 'Economic Policy and State Owned Enterprises: Evolution Towards Privatisation in India', working paper, Indira Gandhi National Open University, available at http://ssrn.com/abstract=944423.

Batra, S. (2003), 'The Asian Recovery: Progress and Pitfalls : The Position of India', paper prepared for World Bank Global Forum on Insolvency Risk Management (Washington DC, 2003), available at: http://siteresources.worldbank.org/GILD/ConferenceMaterial/20157508/Batra%20-%20India%20-%20FINAL.pdf

Beck, T., Demirgüc-Kunt A. and Levine R. (2003) 'Law and finance: why does legal origin matter?' 31 *Journal of Comparative Economics* 653-675.

Berger, A.N. and Udell, G.F. (1998) 'The economics of small business finance: the roles of private equity and debt markets in the financial growth cycles' 22 *Journal of Banking and Finance* 613-673.

Bhagwati, J. (1993), *India in Transition* (Oxford, Clarendon Press).

Bhattacharya, S. and Patel, U.R. (2005), 'New Regulatory Institutions in India: White Knights or Trojan Horses?', in D. Kapur and P.B. Mehta (eds.), *Public Institutions in India: Performance and Design*(New Delhi, New York: Oxford University Press), 406-456.

Bhaumik, S.K. and Dimova, R. (2004), 'How Important is Ownership in a Market with a Level Playing Field: The Indian banking sector revisited.' 32(1) *Journal of Comparative Economics* 165–180.

Black, B.S., and Khanna, V.S. (2007), 'Can Corporate Governance Reforms Increase Firm Market Values? Event Study Evidence from India', 4 *Journal of Empirical Legal Studies* 749-796.

Botero J., Djankov S., La Porta R., Lopez-de-Silanes F. and Shleifer A. (2004) 'The regulation of labour' 119 *Quarterly Journal of Economics* 1340-1382.

Carlin, W. And Mayer, C. (2002), 'How Do Financial Systems Affect Economic Performance', in J.A. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog (eds.), *Corporate Governance Regimes: Convergence and Diversity* (Oxford: Oxford University Press), 325-342.

Carpenter, R.E. and Petersen, B.C. (2002) 'Capital market imperfections, high-tech investment, and new equity financing' 112 *Economic Journal* F54-F72.

Cheffins, B.R. (2001), 'Does Law Matter? The Separation of Ownership and Control in the United Kingdom', 30 *Journal of Legal Studies* 459.

Coffee, J.C., Jr. (2001), 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control', 111 *Yale Law Journal* 1.

Claessens, S. and Laeven, L. (2003), 'Financial Development, Property Rights, and Growth' 58(6) *Journal of Finance* 2401-2436.

Cunningham, C.D. (2003), 'The World's Most Powerful Court: Finding the Roots of India's Public Interest Litigation Revolution in the Hussainara Khatoon Prisoners Case', in S.P. Sathe and S. Narayan (eds.), *Liberty, Equality and Justice: Struggles for a New Social Order* (Lucknow, Eastern Book Company), 83-96.

Dam, K. (2006), *The Law-Growth Nexus* (Washington, DC: Brookings Press).

Deakin, S., Demetriades, P., and James, G. (2008), 'Creditor Protection and Banking System Development in India', working paper, University of Leicester Department of Economics Working Paper No 08/25.

Debroy, B. (2000), 'Some Issues in Law Reform in India', in J.-J. Dethier (ed.), *Governance, Decentralization, and Reform in China, India and Russia* in (London: Kluwer Academic Publishers), 339–368.

Desai, A.H. and Muralidhar, S. (2000), 'Public Interest Litigation: Potential and Problems', in B.N. Kirpal *et al* (eds.), *Supreme But Not Infallible: Essays in Honor of the Supreme Court of India* (New Delhi, Oxford University Press), 159, also available at http://www.ielrc.org/content/a0003.pdf.

Dharmapala, D., and Khanna, V. (2008), ‘Corporate Governance, Enforcement, and Firm Value: Evidence from India’, University of Michigan Law & Economics Olin Working Paper No 08-005.

Djankov, S., La Porta, R., Lopes-de-Silanes, F., and Shleifer, A. (2002), ‘The Regulation of Entry’ 117 *Quarterly Journal of Economics* 1-37.

Djankov, S., Hart, O., McLeish, C., and Shleifer, A. (2006), ‘Debt Enforcement Around the World’ NBER Working Paper W12807.

Djankov S., La Porta R., Lopez-de-Silanes F. and Shleifer A. (2008), ‘The Law and Economics of Self-Dealing’ 88 *Journal of Financial Economics* 430-465.

Eradi, Justice V.B. (2000), *Eradi Committee Report on Law Relating to Insolvency of Companies,* (Delhi: Department of Company Affairs).

Farrell, D., Lund, S., and Puri, L. (2006), ‘India’s Financial System: More Market, Less Government’, *McKinsey Quarterly* August 2006.

Freear, J. and Wetzel, W.E., Jr. (1990), ‘Who bankrolls high-tech entrepreneurs?’ 5 *Journal of Business Venturing* 77-89.

Galanter, M. and Krishna J.K. (2003), ‘Debased Informalism: Lok Adalats and Legal Rights in Modern India’, in E.G. Jensen and T.C. Heller (eds.), *Beyond Common Knowledge: Empirical Approaches to the Rule of Law* (Stanford: Stanford University Press), 96-141.

Galanter, M. (2006), [title], paper presented at ESRC Centre for Business Research Seminar, Cambridge University.

Goswami, O. (2003) ‘India: the Tide Gradually Rises’, in C. Oman (ed.) *Corporate Governance in Development* (Paris, OECD), 105-160.

Gourevitch, P.A. and Shinn, J.J. (2005), *Political Power and Corporate Control: The New Global Politics of Corporate Governance* (Princeton, NJ: Princeton University Press).

Hall, P.A. and Soskice, D. (2001), ‘An Introduction to Varieties of Capitalism’, in P.A. Hall and D. Soskice (eds.), *Varieties of Capitalism* (Oxford: Oxford University Press).

Hayek, F.A. (1978), *Law, Legislation and Liberty Vol 1: Rules and Order* (Chicago, IL: University of Chicago Press).

Hazra, A.K. and Micevska, M.B. (2004), ‘The Problem of Court Congestion: Evidence From Indian Lower Courts’, Royal Economic Society Annual Conference 2004 2, Royal Economic Society, available at http://repec.org/res2004/MicevskaHazra.pdf

Jain, M.P. (2000), ‘The Supreme Court and Fundamental Rights’, in S.K. Verma and K. Kumar (eds.), *Fifty Years of The Supreme Court of India: Its grasp and Reach* (New Delhi: Oxford University Press), 1-100.

Joshi, V. and Little, I.M.D. (1996), *India's Economic Reforms 1991-2001* (Oxford: Clarendon Press).

Khanna, T. and Palepu, K.G. (2005), 'The Evolution of Concentrated Ownership in India: Broad Patterns and a History of the Indian Software Industry', in R.K. Morck (ed.), *A History of Corporate Governance Around the World* (Chicago, IL: NBER), 283-324.

Khatkhate, D. (2002), 'India: Evaluating Bank Assistance for Financial Sector Development: A Country Assistance Evaluation', World Bank Operations Evaluation Department, available at http://wbln0018.worldbank.org/oed/oeddoclib.nsf/24cc3bb1f94ae11c85256808006a0046/42f0fb4efefd548e85256b26005d5798/$FILE/Finance.pdf

Kochhar, K., Kumar, U., Rajan, R., Subramanian, A., and Tokatlidis, I. (2006), 'India's Pattern of Development: What Happened, What Follows?', 53 *Journal of Monetary Economics* 981-1019.

Krishnan, J. (2003), 'Social Policy Advocacy and the Role of the Courts in India', 21 *American Asian Review* 91-124.

La Porta R., Lopez-de-Silanes F., Shleifer A. and Vishny R. (1997) 'Legal determinants of external finance' 52 *Journal of Finance* 1131-1150.

La Porta R., Lopez-de-Silanes F., Shleifer A. and Vishny R. (1998) 'Law and finance' 106 *Journal of Political Economy* 1113-1155.

La Porta R., Lopez-de-Silanes F., and Shleifer, A. (2006) 'What Works in Securities Laws?' 61(1) *Journal of Finance* 1-32.

La Porta R., Lopez-de-Silanes F., and Shleifer A. (2008) 'The Economic Consequences of Legal Origins', 46:2 *Journal of Economic Literature* 285-332.

Lal, D. (2005), *The Hindu Equilibrium* (Oxford: Oxford University Press).

Lele, P. and Siems. M. (2007), 'Shareholder Protection: A Leximetric Approach' 7 *Journal of Corporate Law Studies* 17-50.

Love, I. and Peria, M.S.M. (2005), 'Firm Financing in India: Recent Trends and Patterns', Technical Report WPS 3476, World Bank Working Paper Series 3476.

Mahoney, P.G. (2001), 'The Common Law and Economic Growth: Hayek Might be Right', 30 *Journal of Legal Studies* 503-525.

Milhaupt, C., and Pistor, K. (2008), *Law and Capitalism: What Corporate Crises Reveal About Legal Systems and Economic Development Around the World* (Chicago: University of Chicago Press).

Ministry of Law, Justice and Company Affairs (India) (2002), 'Civil Procedure Code as Amended Enforced from Today', Press Release, 1 July 2002, available at: http://pib.nic.in/archieve/lreleng/lyr2002/rjul2002/01072002/r010720022.html.

Mohan, R. (2007), 'Capital Account Liberalisation and Conduct of Monetary Policy: The Indian Experience' *RBI Monthly Bulletin,* July, 1129-1154.

North, Douglass C. (1990), *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press).

NSE (National Stock Exchange of India) (2006), *Indian Securities Market: A Review* (Mumbai, NSE), Vol III available at: http://www.nseindia.com.

Pal, P. (2001), 'Stock Market Development and its Impact on the Financing of the Indian Corporate Sector' National Stock Exchange of India (NSE) Research Initiative, Working Paper No. 4.

Panagariya, A. (2008), *India: The Emerging Giant* (Oxford: OUP).

Rajan, R. and Zingales, L. (2003), 'The Great Reversals: The Politics of Financial Development in the Twentieth Century' 69 *Journal of Financial Economics* 5-50.

Reserve Bank of India (2008), *Handbook of Statistics on Indian Economy* (Reserve Bank of India: Mumbai), available at http://www.rbi.org.in/scripts/AnnualPublications.aspx?head=Handbook%20of%20Statistics%20on%20Indian%20Economy.

Roe, M.J. (2003), *Political Determinants of Corporate Governance* (Oxford: Oxford University Press).

Rodrik, D. and Subramanian, A. (2008), 'From "Hindu Growth" to Productivity Surge: The Mystery of the Indian Growth Transition', in A. Subramanian, *India's Turn: Understanding the Economic Transformation* (Oxford: OUP), 3-49.

Rothermund, D. (1988), *An Economic History of India* (London: Croom Helm).

Sarkar, P. (2006), 'Stock Market Development, Capital Accumulation and Growth in India Since 1950', working paper, available at http://ssrn.com/abstract=952153

Shah, A and Thomas, S. (1996),'How automation and competition have changed the BSE', Technical report, Centre for Monitoring Indian Economy.

Shah, A and Thomas, S. (1999), 'Developing the Indian capital market', in J.A. Hanson and S. Kathuria (eds.), *India: A Financial Sector for the Twenty-First Century* (Oxford: Oxford University Press), 205–265.

Shirai, S. (2002), 'Banking Sector Reforms in India and China: Does India's Experience Offer Lessons for China's Future Reform Agenda?', Japan Bank for International Cooperation Institute Discussion Paper No. 2, available at https://www.jbic.go.jp/english/research/report/discussion/pdf/dp02_e.pdf.

Shirai, S. (2004), 'Assessing the Impact of Financial and Capital Market Reforms on Firms' Corporate Financing Patterns in India', 5(2) *South Asia Economic Journal* 189-208.

Siems, M. (2007), 'Reconciling Law & Finance and Comparative Law' 52 *McGill Law Journal* 55-81.

Spamann, H. (2006), 'On the Insignificance and/or Endogeneity of La Porta et al.'s "Anti-Director Rights Index" Under Consistent Coding', ECGI Law Working Paper No 67/2006.

Tendulkar, S.D. (2004), 'Organised Labour Market in India: Pre and Post Reform', working paper presented at the conference on Anti Poverty and Social Policy in India organised by the Mac Arthur Research Network on Inequality and Economic Performance at the Neemrana Fort Palace, Alwar, Rajasthan, January 2-4, 2004, available at http://globetrotter.berkeley.edu/macarthur/inequality/papers/TendulkarLabor.pdf.

Thiruvengadam, A.K. (2006), 'In Pursuit of 'the Common Illumination of our House': Trans-Judicial Influence and the origins of PIL jurisprudence in India, Pakistan and Bangladesh', working paper presented at Conference on South Asian Constitutionalism, SOAS, 2006.

Thomas, S. (2006), 'How the financial sector in India was reformed', in S. Narayan (ed.). *Documenting Reforms: Case Studies from India* (New Delhi, Macmillan India).

Topalova, P (2004), 'Overview of the Indian corporate sector: 1989–2002', IMF Technical Report WP/04/64.

Umarji, M.R. (2004), 'Trends and Developments in Insolvency Systems and Risk Management: The Experience of India', paper presented at Forum on Asian Insolvency Reform, Insolvency Systems and Risk Management in Asia, New Delhi, India, 3-5 November 2004, available at http://www.oecd.org/dataoecd/51/5/33933730.pdf

Vig, V. (2007), 'Access to Collateral and Corporate Debt Structure: Evidence from a Natural Experiment', working paper, Columbia University Business School.

Visaria, S. (2006),' Legal Reform and Loan Repayment: The Microeconomic Impact of Debt Recovery Tribunals in India', working paper, Boston University Department of Economics DP 157http://www.bu.edu/econ/, available at: http://www.bu.edu/econ/ied/dp/papers/dp157-Visaria.pdf

Weber, M. (1978), *Economy and Society* (Berkeley, CA: University of California Press).

World Bank (2007), *Doing Business in South Asia in 2007*, country profile of India, available at: http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/Publications/448813-1171300070514/india.pdf

Appendix: Details of Interviewees

	Date	Name	Organisation	Background	Location
1.	15.08.09*	Mr NV Deshpande	Former Principal Legal Adviser and Executive Director, Reserve Bank of India	Lawyer/Regulator	n/a
2.	12.09.06	Mr Umesh Kudalkar Mr Ajay Limaye	CEO, SICOM Capital Management Ltd SICOM Capital Management Ltd	VC Investor	Pune
3.	12.09.06	Mr P B Kulkarni Mr V C Joshi	Ex-CMD Bank of Maharashtra and former Executive Director of Reserve Bank of India Formerly with Bank of India; thereafter Director of National Insurance Academy	Banker/Academic	Pune
4.	13.09.06	Mr Ravi Pandit Mr Bansal	President of Chamber of Commerce, Pune Chapter and CEO of KPIT Cummins Infosystems Ltd Company Secretary, KPIT Cummins Infosystems Ltd	Business	Pune
5.	14.09.06	Mr Mahesh Parasuraman	Senior Associate, Carlyle	VC Investor	Mumbai
6.	14.09.06	Mr Sunderaman	Vice President, National Stock Exchange of India	Exchange/Regulator	Mumbai
7.	15.09.06	Mr Anurag Goel	Secretary, Ministry of Company Affairs, Government of India	Policymaker	Delhi
8.	15.09.06	Dr Adarsh Kishore	Secretary, Ministry of Finance, Government of India	Policymaker	Delhi
9.	16.09.06	Ms R V Anuradha Mr Piyush Joshi Ms Gunjan Shah	Partners, Amarchand Mangaldas	Corporate Lawyers	Delhi
10.	18.09.06	Mr TK Viswanathan	Secretary, Department of Legal Affairs, Ministry of law and Justice, Government of India	Policymaker	Delhi
11.	18.06.09	Ms Abha Seth Mr Sumant Batra Mr Sandeep Parekh Mr Satvik Varma	Deputy Director, Confderation of Indian Industry Partner, Kesar Dass B. & Associates P.H. Parekh & Co	Business Bankruptcy Lawyer Corporate Lawyer Corporate Lawyer	Delhi
12.	19.09.06	Justice YV Chandrachund	Former Chief Justice, Indian Supreme Court	Judge	Mumbai

13.	19.09.06	Mr Suhas Tuljapurkar Mr Ajay Walimbe	DSK Legal Legasis Services	Corporate Lawyer Legal BPO	Mumbai
14.	19.09.06	Mr SR Kolarkar	Principal Legal Adviser and Executive Legal Director, Reserve Bank of India	Lawyer/Regulator	Mumbai
15.	19.09.06	Justice DG Karnik	Judge, Bombay High Court	Judge	Mumbai
16.	20.09.06	Dr MY Khan	Former Economic Adviser to SEBI and Reserve Bank of India	Economist	Mumbai
17.	19.09.06	Ms Zia Mody	Founding Partner, AZB and Partners	M&A Lawyer	Mumbai
18.	20.09.06	Justice VG Palshikar	Acting Chief Justice, Bombay High Court	Judge	Mumbai
19.	25.09.06	Mr Vidu Shekhar	Vice President, National Stock Exchange	Exchange/Regulator	Mumbai
20	15.12.06*	Dr Nachiket Mor	Deputy Managing Director, ICICI Bank	Banker	n/a
21.	03.01.07*	Ms Lalita Gupte	Former Joint Managing Director, ICICI Bank	Banker	n/a

* Telephone interview

The views expressed in this paper are those of the authors alone and should not be taken as reflecting the views of any individual interviewee(s) or their organisation(s).

Table 1: Selected stock market indicators, 2005

	US	**UK**	**Japan**	**Germany**	**Singapore**	**Hong Kong**	**China**	**India**
Listed companies	5,143	2,759	3,279	648	557	1,126	1,387	4,763
Market capitalisation ($bn)	16,998	3,058	4,737	1,221	208	1,006	781	553
Market capitalisation ratio (%)	139.7	151.9	100.0	48.2	198.4	548.3	40.3	82.2
Turnover ($bn)	21,510	4,167	4,997	1,763	120	460	586	443
Turnover ratio (%)	129.1	141.9	118.8	146.0	63.1	49.3	82.5	94.2

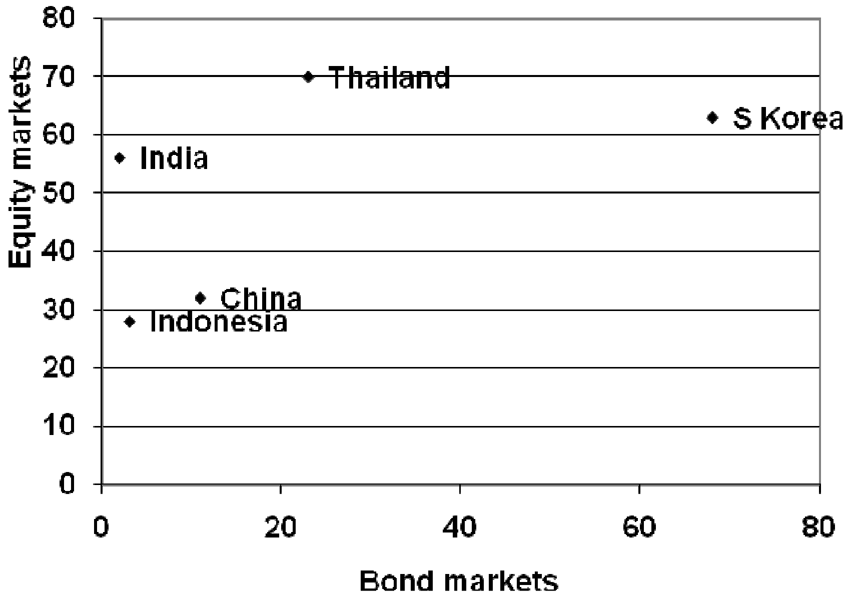
Source: National Stock Exchange of India (2006).

Table 2: Market capitalisation ratio of world stock markets, 1990-2005

Markets	**Market capitalisation/ % GDP**					
	1990	**2000**	**2002**	**2003**	**2004**	**2005**
High income	51.6	120.6	83.4	100.1	108.9	112.9
Middle income	19.4	41.2	35.3	44.5	43.7	49.5
Low & Middle income	18.8	38.7	33.3	43.5	43.8	50.1
Low income	9.8	23.6	22.6	37.3	44.5	54.2
India	12.2	32.4	25.7	46.5	56.1	68.6
World	48.0	105.1	74.6	89.7	96.3	99.6

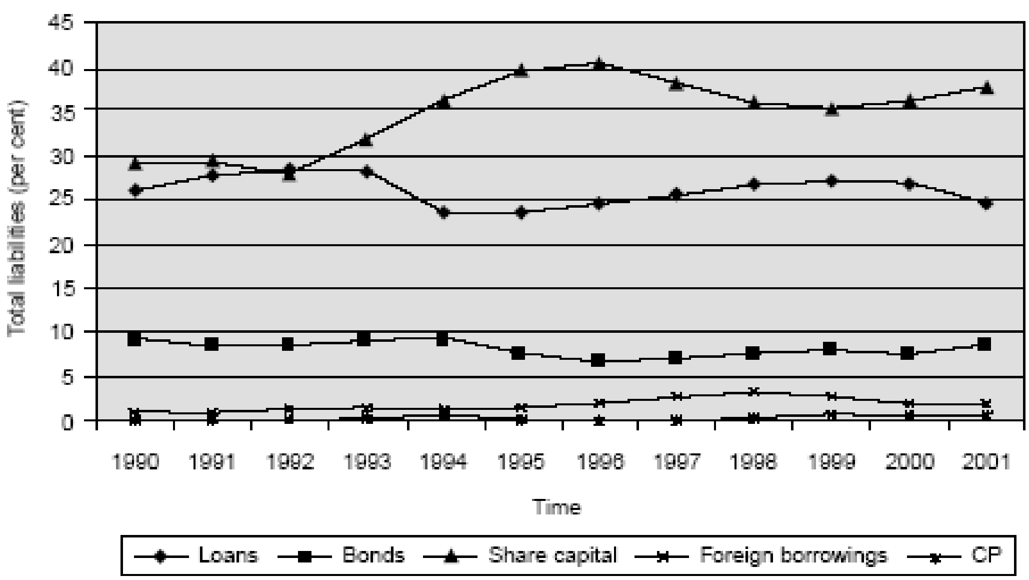
Source: World Bank, World Development Indicators (2006).

Figure 1: Debt and Equity Market capitalisation (% GDP), 2004



Source: Farrell *et al*, (2006)

Figure 2: Balance Sheet Liabilities of Indian Firms, 1990-2001



Source: Prowess database, Centre for Monitoring the Indian Economy.

Source: Shirai (2004)

Table 3: Principal Components of the Regulatory Framework for Indian Corporations Prior to Liberalisation

Capital Issues Control Act 1947 (‘CICA’)	Requirement of Government permission, and price regulation, for new issues of equity by private companies.
Companies Act 1956 (‘CA 1956’)	Conferred a variety of powers on the central government (exercised through the Department of Companies Affairs via the Company Law Board or the Registrar of Companies) and the judicial system (the High Courts) to monitor and regulate companies.
Securities Contract (Regulation) Act 1956 (‘SCRA’)	Government control of securities trading, including operation of stock exchanges. Exchanges can frame their own listing regulations provided they meet minimum criteria set out in the rules.
Monopolies and Restrictive Trade Practices Act 1969 (‘MRTP’)	Antitrust/competition rules, to prohibit monopolistic and restrictive trade practices. Said to act as a barrier to Indian (private) companies realising economies of scale.
Foreign Exchange Regulation Act 1973 (‘FERA’)	Regulated foreign exchange transactions, with severe criminal penalties for breach.
Sick Industrial Companies Act 1985 (‘SICA’)	State agency (BIFR) takes control of industrial firms with negative net assets; stay of creditors’ claims.

Table 4: Timeline of Legal Reforms

Year	Removal of statutory restrictions	Legal institutions facilitating equity finance	Legal institutions facilitating debt finance
1991	MRTP relaxed; SICA amended.		
1992	CICA repealed; SCRA amended.	Statutory authority conferred on SEBI; NSE established; SEBI (Prohibition of Insider Trading) Regulation 1992. Initial guidelines on issuance of shares.	Banking sector reforms.
1993			Recovery of Debts Due to Banks and Financial Institutions Act 1993 ('RDDB').
1994		Substantial Acquisitions of Shares Regulations 1994 (takeovers).	
1995		National Securities Clearing Corporation established.	
1996	CA amended.	Depositaries Act 1996 National Securities Depositary Ltd established.	
1997		Takeover Code amended.	
1998			
1999	FERA repealed; CA amended.		
2000	CA amended.	Disclosure requirements; 'Clause 49' corporate governance rules.	
2001	CA amended.		
2002	CA amended.		RDDB 1993 in force; SARFAESI 2002 passed; CA amendment to improve insolvency laws (not yet in force).
2003			SICA Repeal Act 2003 (not yet in force).
2004			
2005			SARFAESI 2002 in force.
2006			
2007			
2008			
2009			Reform of insolvency law anticipated.

Table 5: Pendency in High Courts

SI. No.	Name of the High Court	As on	Civil cases	Criminal cases	Total
1	Allahabad	30.6.06	584499	207651	792150
2	A.P.	30.6.06	216433	21239	237672
3	Bombay	31.5.06	320840	37191	358031
4	Calcutta	30.6.06	227485	37887	265372
5	Delhi	30.5.06	95589	30923	126512
6	Gujarat	31.12.05	100488	30897	131385
7	Gauhati	30.6.06	52418	6900	59318
8	H.P.	30.6.06	10934	5993	25027
9	Jammu & Kashmir	31.12.05	39529	2444	41973
10	Karnataka	30.6.06	77697	13732	91429
11	Kerala	30.6.06	101374	24677	126051
12	Madras	30.6.06	339157	31754	370911
13	M.P.	31.12.05	130259	55759	186018
14	Orissa	30.6.06	193186	17254	210440
15	Patna	31.12.05	66549	25033	91582
16	Punjab & Haryana	31.12.05	201151	42320	243471
17	Rajasthan	31.12.05	158318	47867	206185
18	Sikkim	30.6.06	47	11	58
19	Uttaranchal	30.6.06	31518	7422	38940
20	Chattisgarh	30.6.06	52355	24038	76393
21	Jharkhand	30.6.06	47066	231032	278098
	Total		**3054992**	**902024**	**3957016**

Source: Ministry of Home Affairs, Department of Justice, available at http://mha.nic.in/rtijustice1.pdf (as of 7 August 2006).

Table 6: International Variation in Judges per Capita

	Year	Judges	Judges per 100,000 capita
Common Law Countries			
USA	1998	28049	10.4
England & Wales	2001	3518	6.6
Canada	1991	1817	6.5
Malaysia	1990	274	1.6
India	1995	9564	1.0
Civil Law Countries			
Germany	1995	22134	27.1
Denmark	1997	653	12.4
France	1997	6287	10.7
Taiwan	1995	1252	5.7
S. Korea	1995	1212	2.7
Japan	1999	2949	2.3

Source: Galanter and Krishnan (2003).

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.global/content/working-papers) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html