Law, Finance, and Politics: The Case of India

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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 (1) India's relative success in services and software; (2) the relative strength of its financial markets for outside equity, as opposed to outside debt; and (3) 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."

A growing literature emphasizes 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 article 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.

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The Indian economy, subject to central planning from independence in 1947, liberalized 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, policy makers, regulators, judges, businesspeople, and investors. We focused our enquiries on changes to the legal protection of outside investors: that is, shareholders and creditors. These yielded interesting findings as regards both 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). By 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 found 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 article is structured as follows. The second section reviews principal theoretical claims concerning the relationship between legal institutions and financial development. The third section outlines and problematizes the case of India and explains our methodology. In the fourth section, 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. The fifth section examines the role of politics in India's legal and financial development. The final section concludes.

The Role of Law in Financial Development

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 the work of La Porta and colleagues (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 indexes representing the extent to which legal systems protect different constituencies in business enterprises (Weber 1978; La Porta et al. 1997, 1998, 2008; Djankov et al. 2002, 2008a, 2008b; Botero et al. 2004). Whilst the results showed correlation between "good quality" legal rules and financial development, there were 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 & 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 undertheorization 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 members enjoy greater independence (including appointment, selection, and tenure) from the other branches of government and consequently may do better at protecting property rights from state rent-seeking (Hayek 1978; Mahoney 2001; Claessens & Laeven 2003; La Porta et al. 2008).

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 & Zingales 2003; Gourevitch & Shinn 2005; Milhaupt & 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 favoring labor. Strong labor groups prompt concen-

[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).

trated share ownership as a means to ensure that shareholders can 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 & 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 & Pistor 2008; see also Weber 1978).

A related claim discerns a link between economic organization and prevalent financial structures (Hall & Soskice 2001; Carlin & 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. F. 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 that may be expected to influence the course of law reform. Industrial structure, therefore, may be expected to be an input to law reform.

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 it suffers from 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 conducted a case study of the processes by which legal change has occurred in India, a very significant developing economy, during the past 20 years. Unlike many developing countries, many of the liberalizing reforms implemented in India in the 1990s had domestic origins, rather than being imposed by international financial organizations (Ghosh 2006; Panagariya 2008:95–6).[3] This makes India a particularly useful case study against which to explore the two theories outlined above.

[3] Whilst the International Monetary Fund did provide structural adjustment finance to India following the balance of payments crisis in 1991, many of the adjustments involved had been proposed domestically already (Ghosh 2006; Panagariya 2008).

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.

Industrial Development

India is, compared to similarly-situated developing countries, said to be relatively weak in labor-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 (1) to develop self-sufficiency through import substitution and restrictions on capital flows; (2) to channel scarce domestic capital into large-scale, capital-intensive "national champion" firms; (3) to deter the formation of other large-scale private sector firms—which might compete for such capital—by discriminating in favor of small-scale private enterprise; and (4) 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 that 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 percent 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 has been associated with a dramatic increase in growth, which has averaged more than 6 percent per annum since then.[4]

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 specialization 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

[4] 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.

rapidly. The licence Raj extended only to firms manufacturing tangible assets, leaving services firms and software manufacturers outside its ambit (Khanna & Palepu 2005; Athreye 2005) and giving them greater freedom to innovate. When constraints on the private sector were relaxed from the early 1990s onward (Bala 2006), there were therefore relatively many highly skilled workers and an emerging specialization in services. Seemingly as a result, India's subsequent pattern of development has seen dramatic growth fueled by the services sector and skill-intensive manufacturing, whilst the country still remains relatively underdeveloped —as compared with other countries at a similar stage of development—in terms of labor-intensive manufacturing.

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 nonexistent.

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 capitalization to GDP—is higher than that for comparable developing countries such as China, or indeed for many developed countries, including Germany.

In a similar vein, Table 2 presents data on the evolution of stock market capitalization 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.

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

Table 1. Selected Stock Market Indicators, 2005

	U.S.	U.K.	Japan	Germany	Singapore	Hong Kong	China	India
Listed companies	5,143	2,759	3,279	648	557	1,126	1,387	4,763
Market capitalization ($bn)	16,998	3,058	4,737	1,221	208	1,006	781	553
Market capitalization ratio (%)	139.7	151.9	100.0	48.2	198.4	548.3	40.3	82.2
Turnover ($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 Capitalization Ratio of World Stock Markets, 1990–2005

	Market capitalization/% GDP					
Markets	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 (2006).

in the region, its corporate bond markets are relatively underdeveloped.

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 liberalization (Shirai 2004; Topalova 2004; Thomas 2006). Figure 2 shows the liabilities (historic cost) of Indian firms during the period of 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.

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; F. Allen et al. 2006b; compare 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),

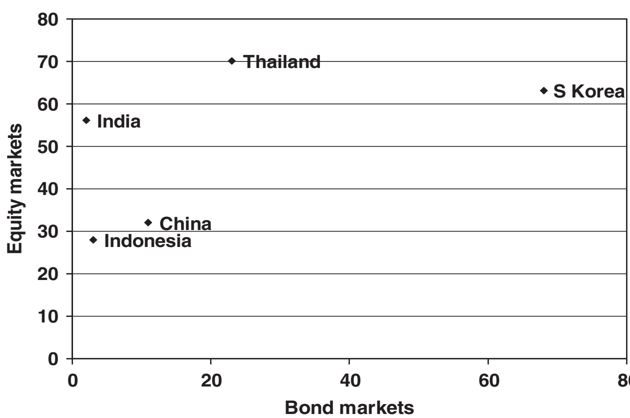

Figure 1. Debt and Equity Market Capitalization (% GDP), 2004
Source: Farrell et al. (2006).

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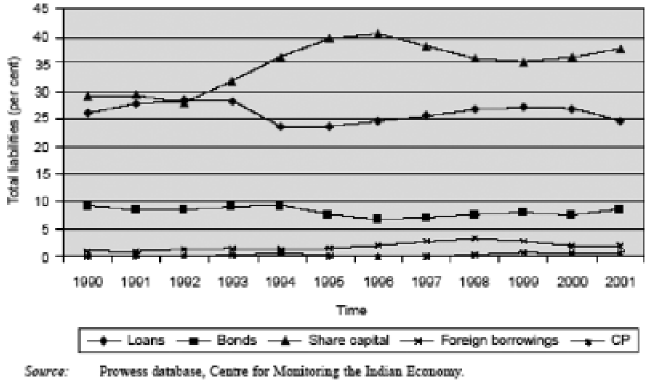

Figure 2. Balance Sheet Liabilities of Indian Firms, 1990–2001
Source: Shirai (2004).

with the result that access to credit by the more risky firms has not proportionately increased (Love & 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 & 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 they 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 & Udell 1998). Empirical findings confirm that equity financing, and not debt, predominates in privately held firms in technology-intensive industries (Freear & Wetzel 1990; Carpenter & Petersen 2002).[5]

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.[6] This foundation was overlaid with extensive further legislation when the post-independence government implemented a socialist reform agenda encompassing all areas of commercial activity,

[5] Whilst in the United States, 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).

[6] 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); Indian Civil Procedure Code (1908).

Table 3. Principal Components of the Regulatory Framework for Indian Corporations Prior to Liberalization

Capital Issues Control Act (CICA) 1947	Requirement of government permission, and price regulation, for new issues of equity by private companies.
Companies Act (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 (SCRA) 1956	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 (MRTP) 1969	Antitrust/competition rules, to prohibit monopolistic and restrictive trade practices. Said to act as a barrier to Indian (private) companies realizing economies of scale.
Foreign Exchange Regulation Act (FERA) 1973	Regulated foreign exchange transactions, with severe criminal penalties for breach.
Sick Industrial Companies Act (SICA) 1985	State agency (BIFR) takes control of industrial firms with negative net assets; stay of creditors' claims.

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 a more market-facilitative legal infrastructure.

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

In an environment in which banks were used as a means of channeling subsidies to firms favored by central planning policies, debt did 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 10 years to complete, and in some cases upwards of 50 years (Goswami 2003; Batra 2003). The Sick Industrial Companies Act (SICA; 1985) was enacted 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.[7]

Following a currency crisis in 1991, the Indian government implemented a dramatic reconfiguration of the economy (Joshi & Little 1996). The motivating idea was to move decisively away from state control by granting a significant role to the private sector, 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 & 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 (Capital Issues Control Act 1947 and SICA) have been repealed outright,[8] another (Foreign Exchange Regulation Act 1973) was entirely replaced by a more liberal statutory regime (the Foreign Exchange Management Act 1999, or FEMA), and two others (Securities Contract [Regulation] Act 1956 and Monopolies and Restrictive Trade Practices Act 1969) 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 enactment of the Companies Bill (2008), although this may take several years to come into force. In addition, a range of new measures were introduced during the 1990s. 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.

Reforms Relating to Equity Finance

Rapid and wide-ranging legislative efforts were made after liberalization to foster the development of Indian securities markets (Shah & Thomas 1999; Thomas 2006). Principal amongst these

[7] BIFR records show that from 1987 to 2005, 5,327 firms entered the SICA regime. Of these, only 504 have been successfully revived (http://bifr.nic.in/geninfo.htm, accessed 20 March 2009).

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

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; National Stock Exchange of India (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 (RDDB) 1993
1994		SEBI (Substantial Acquisition 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

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 on government intervention and control (Ahluwalia 1995). Specific regulations included rules governing merchant (investment) banks,[9] disclosure requirements,[10] substantive corporate governance rules (the so-called Clause 49 of the Listing Agreement), a takeover law,[11] and the prohibition of insider trading.[12]

The inauguration of SEBI was soon followed by the establishment of a new securities exchange, the National Stock Exchange (NSE), in 1992,[13] 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 led to the rapid adoption of a number of innovative technologies, such as fully automated screen-based trading (Shah & Thomas 1996, 1999; Bhattacharya & Patel 2005).

Another important development has been the increase in market participants. Following liberalization, Indian stock markets have been opened to investment by foreign institutional investors, overseas corporate bodies, and nonresident Indians, who have been allowed to invest extensively in Indian companies.

The limited body of empirical research that 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 & Khanna 2008).

Reforms Relating to Debt Finance

A range of banking reforms initiated in 1992 were designed to liberalize the sector, enhance banks' financial stability, and 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

[9] SEBI (Merchant Bankers) Regulations (1992).

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

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

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

[13] The NSE started trading bonds in June 1994, and shares in November 1994 (see http://www.nseindia.com/content/us/fact2006_sec1.pdf, accessed 20 March 2009).

operate in India, which has in turn prompted increased operating efficiency at the remaining publicly owned banks (Bhaumik & 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 (SARFAESI; 2002). Again aiming to bypass delays associated with court proceedings, this legislation empowered banks and financial institutions to enforce security interests extrajudicially. 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.[14] Vig (2007) finds that the introduction of SARFAESI has served to reduce the 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 securitization and reconstruction of financial assets. This has given lenders an alternative exit route from distressed loans—sale to an investment entity specializing in distressed debt, as opposed to enforcement. In July 2005, the RBI authorized the sale or purchase of nonperforming assets by banks and other financial institutions in return for cash consideration. Beginning in November 2005, it also paved the way for foreign investment in such assets by allowing foreign direct investment to comprise up to 49 percent of the equity capital of asset reconstruction companies or securitization companies set

[14] *Mardia Chemicals Ltd v. Union of India* (2004).

up to purchase nonperforming loans from banks. These actions have enabled such companies to finance the acquisition of 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).[15]

Little progress has been made to date with Indian insolvency law, which, according to World Bank measures, continues to be amongst the least effective in the world (World Bank 2007).[16] Following the recommendations of an expert committee (Eradi 2000), the government passed the Companies (Second Amendment) Act in 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 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.[17] Pending suitable amendments, the NCLT tribunals have not yet been established and the BIFR is still operating.[18] Moreover, it has been doubted whether the reorganization provisions of the Second Amendment are sufficiently different

[15] 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 2000–2001, falling to Rs 13.1 bn in 2007–2008 (Reserve Bank of India 2008: tables 49 and 81).

[16] 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.

[17] *Thiru. R. Gandhi President v. Union of India* (2004).

[18] As of March 2008, the future of NCLT still seemed uncertain and the BIFR was still operational ("No Easy Cure for Industrial Sickness," *Economic Times*, 2 January 2008, http://economictimes.indiatimes.com/Policy/No_easy_cure_for_industrial_sickness/articleshow/2667172.cms [accessed 20 March 2009]).

than SICA to make a major impact on corporate debt markets (Batra 2003; World Bank 2007).

Research Questions and Methodology

As emerges from the foregoing discussion, India has made more progress in implementing new legal institutions regarding equity finance than regarding 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 discussed, 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 equity investment; this in turn complements a pattern of industrial development specializing 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 the performance of both equity (Black & Khanna 2007; Dharmapala & Khanna 2008) and debt markets (Visaria 2006; Vig 2007; Deakin et al. 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 the second section. 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 the second section 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 lawmaking 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. By 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 that could then be tested. Our strategy was to include representatives from as wide a range as possible of different constituencies—including judges, practicing lawyers, policy makers (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.[19]

What Role Did India's Legal Origin Play?

As discussed in the second section, 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

[19] Details of our interviewees are given in the 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. We undertook not to attribute any statements to interviewees and consequently do not quote interviews directly in the text.

to lead to superior legal institutions through two particular channels: first, the relative adaptability of judge-made, as opposed to codified, law; and second, the relative independence of common law judges from the legislature, resulting in a reduced tendency toward rent-seeking by the state. We now examine whether, and to what extent, India's status as a common law country has affected matters through each of these two channels.

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, one 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 onward 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 could typically take up to 20 years (Debroy 2000:343).[20] As of February 2007, there were more than 41,000 cases pending before the Supreme Court,[21] and as of August 2006, nearly 4 million before all the High Courts, and approximately 25.5 million before all the District Courts.[22] Table 5 gives figures for the 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.

It appears that the incidence of new litigation has not increased significantly in the past 30 years—and indeed has decreased over

[20] 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 (Organisation for Economic Co-operation and Development) countries, 450 days in Malaysia, and only 292 days in China (World Bank 2007).

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

[22] Ministry of Home Affairs, Department of Justice; http://mha.nic.in/rtijustice1.pdf, and http://mha.nic.in/rtijustice2.pdf (accessed 7 Aug. 2006).

Table 5. Pendency in High Courts

SI. No.	Name of the High Court	As of	Civil cases	Criminal cases	Total
1	Allahabad	30.6.06	584,499	207,651	792,150
2	A. P.	30.6.06	216,433	21,239	237,672
3	Bombay	31.5.06	320,840	37,191	358,031
4	Calcutta	30.6.06	227,485	37,887	265,372
5	Delhi	30.5.06	95,589	30,923	126,512
6	Gujarat	31.12.05	100,488	30,897	131,385
7	Gauhati	30.6.06	52,418	6,900	59,318
8	H. P.	30.6.06	10,934	5,993	25,027
9	Jammu & Kashmir	31.12.05	39,529	2,444	41,973
10	Karnataka	30.6.06	77,697	13,732	91,429
11	Kerala	30.6.06	101,374	24,677	126,051
12	Madras	30.6.06	339,157	31,754	370,911
13	M.P.	31.12.05	130,259	55,759	186,018
14	Orissa	30.6.06	193,186	17,254	210,440
15	Patna	31.12.05	66,549	25,033	91,582
16	Punjab & Haryana	31.12.05	201,151	42,320	243,471
17	Rajasthan	31.12.05	158,318	47,867	206,185
18	Sikkim	30.6.06	47	11	58
19	Uttaranchal	30.6.06	31,518	7,422	38,940
20	Chattisgarh	30.6.06	52,355	24,038	76,393
21	Jharkhand	30.6.06	47,066	231,032	278,098
	Total		**3,054,992**	**902,024**	**3,957,016**

Source: Ministry of Home Affairs, Department of Justice: http://mha.nic.in/rtijustice1.pdf (accessed 7 Aug. 2006).

the past century. Delays have lengthened rather owing to the legal system's increasing inability to resolve existing cases (Debroy 2000; Krishnan 2003; Galanter & Krishnan 2003; Hazra & Micevska 2004). 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).[23] Furthermore, they create several layers of rights to appeals and revision—another major cause of delay.[24] As one of our interviewees observed, "It's a defendant's court." Third, these procedural laws generate negative synergies

[23] 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 (for amounts less than Rs. 25,000) (Ministry of Law, Justice and Company Affairs 2002).

[24] Under the CPC (1908), a first appeal in a civil matter may be made on point of fact or of law to the District Courts (§96), then a second appeal to the High Courts is possible only on a point of law (§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 §115, revision applications may be filed with High Courts under certain circumstances even when an appeal is not possible.

Table 6. International Variation in Judges Per Capita

	Year	Judges per 100,000 capita
Common Law Countries		
U.S.A.	2001	10.9
England and Wales	2005	7.1
Canada	2003	6.5
Malaysia	2006	0.9
India	2003	1.3
Civil Law Countries		
France	2000	11.5
Germany	2006	17.8
Italy	2006	11.0
Japan	2006	2.6
S. Korea	2004	3.5
Thailand	2006	6.0

Sources: Ministry of Home Affairs (2003); United Nations Office on Drugs and Crime, Surveys on Crime Trends and the Operation of Criminal Justice Systems (CTS), http://www.unodc.org/unodc/en/data-and-analysis/United-Nations-Surveys-on-Crime-Trends-and-the-Operations-of-Criminal-Justice-Systems.html (accessed 20 March 2009).

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.

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.

By 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 that would have been received had the rules been promulgated by primary legislation. The real engines for development of the legal 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).[25] The SAT consists of three members: two law members who must be experts in securities, and a chair drawn

[25] Securities and Exchange Board of India Act (1992), Chapters VIA–VIB.

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from the senior judiciary. Thus the SEBI dispute-resolution structure bypasses 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 the delegation of rulemaking 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.

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 position common law judges to protect property rights from encroachment by the state.

India's constitutional scheme designates the Supreme Court as the protector of constitutionally guaranteed "fundamental rights,"[26] and it makes efforts to maintain the Court's political independence.[27] The Court has extensive powers of judicial review of legislative and executive actions and has been, by international standards, exceptionally activist in exercising them (T. 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 a redistribution of property rights.

[26] Constitution of India, Part III (Articles 12–35), 2008.

[27] 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 Article 124(2)). Once appointed, a Supreme Court judge can be removed from office only by impeachment in Parliament by a two-thirds majority (Article 124 (4)). Moreover, the Court has recently developed a system of collegia by judges that operates, in effect, to rule out any executive interference over appointments: *Supreme Court Advocates-on-Record Association v. Union of India* (1994); Desai and Muralidhar (2000).

The saga began with *Kameshwar Singh v. State of Bihar* (1951), 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, 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 v. Special Deputy Collector* (1965),[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 amendments by the legislature being met by correspondingly expansive interpretations of the remaining provisions by the Supreme Court. An endgame appeared to have been reached during the Emergency period of 1975–1977, 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]

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[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 a 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 who worked the land for crops became their tenants.

[29] Constitution (First Amendment) Act (1951).

[30] *State of West Bengal v. Bela Banerjee* (1954).

[31] Constitution (Fourth Amendment) Act (1955).

[32] Constitution (Seventeenth Amendment) Act (1964).

[33] See also *Union of India v. the Medical Corporation of India* (1967), overruled in *State of Gujarat v. Shantilal* (1969).

[34] Constitution (Forty-fourth Amendment) Act (1978), repealing Article 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 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 & 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 violations 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 United Kingdom, 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; 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.

[35] The "Judge's case," or *S. P. Gupta v. Union of India* (1982), is commonly regarded as the beginning of public interest litigation 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.

We have discussed how aspects of the legal origins claim at best only partly explain the pattern that the development of India's investor protection has followed since liberalization. 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.

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.

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 lawmaking processes and the 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 the 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 liberalization, 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 liberalization.

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 comprising experts from relevant fields, including industry and the legal profession, to consider reforms. The SEBI committees are usually chaired by well-known businesspeople and involve consultation

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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 group. 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 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 the ministerial and regulatory levels. Publicly traded firms in India typically have controlling interests concentrated in the hands of family blockholders (Khanna & Palepu 2005). The powerful networks and high concentration of wealth of the 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 such as the Federation of Indian Chambers of Commerce of Industry (FICCI) and the Confederation of Indian Industry (CII) are amongst the most active, followed by 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

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

[39] For example, 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.

[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.

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 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.

Labor 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 have been involved in lobbying regarding corporate insolvency law, seeking to deflect reforms that might diminish the pro-employee features of the current procedures (Umarji 2004). Moreover, labor 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. Second, 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-liberalization era. Third, 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 the third section of this article. For firms in the industrial sectors in which India is disproportionately successful—software, high-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

[41] The IBA's membership includes both public and private sector domestic banks, foreign banks with offices in India, and other nonbank financial institutions; see http://www.iba.org.in/brief_background.asp, accessed 20 March 2009.

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

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 explain recent rounds of reforms, but it 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 preliberalization legislation, may have created path dependencies in favor of a particular type(s) of reform.

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 liberalization 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 was instituted for the development of India's industry (Rothermund 1988; Lal 2005; Kochhar et al. 2006). These focused on developing capital-intensive infrastructure projects and "prestige" industries, through subsidized 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 government recognized the chronic overstaffing of many large (public) firms as a means of disguising unemployment. Powerful labor protection under labor 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

[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 forward this may change as equity markets mature.

[44] Article 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.

lack of access to finance, licensing requirements, extensive labor 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 RBI 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, namely the state-sponsored heavy manufacturing. Consequently, these industries sought little outside equity finance, and Indian stock markets remained limited in size.

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 1980s onward. 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: 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 labor at relatively low wage costs. India's software, telecommunications, and high-tech manufacturing industries have grown dramatically since the early 1980s.

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 liberalization, 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 led to inertia, because the RBI's personnel and culture have been influenced by its former role.

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

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, toward 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 have shown 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 that might stimulate debt markets have been slower in their promulgation and implementation.

We have 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 did 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 has acted as an important agent of legal change.

We found 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 do operate.

By contrast, we found 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 appear to have been delayed by the need to reorient 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 have 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.

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Table A1. Appendix: Details of Interviewees

	Date	Name	Organization	Background	Location
1.	15.08.09*	Mr. N.V. 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. T. K. 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, Confederation 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 Y. V. 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. S. R. Kolarkar	Principal Legal Adviser and Executive Legal Director, Reserve Bank of India	Lawyer/Regulator	Mumbai
15.	19.09.06	Justice D. G. Karnik	Judge, Bombay High Court	Judge	Mumbai
16.	20.09.06	Dr. M. Y. 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 V. G. 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 article are those of the authors alone and should not be taken as reflecting the views of any individual interviewee(s) or their organization(s).

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