

POLITICAL RISK ANALYSIS AND ECONOMIC
REFORM: INVESTING IN THE INDIAN
ELECTRICITY SECTOR

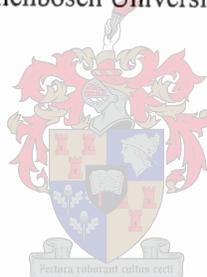
by

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the requirements for the degree of

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DECLARATION

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously, in its entirety or in part, submitted it to any university for the purposes of obtaining a degree.

Signature:

Date:

ABSTRACT

The definition of political risk and the methodology of its assessment have changed since the inception of the discipline midway through the last century. This assignment assesses the usefulness of a new quantitative technique that uses political constraints and the policy preferences of political actors to construct a measure of political risk. Integrating the findings of the resulting Political Constraints Index with an analysis of the political economy of the Indian Electricity Sector, the assignment demonstrates that, contrary to the original interpretations of the index, high levels of political constraints and political competition may propagate a disabling policy regime and be detrimental to the investor, despite the stated commitment of the incumbent government to policy reform. The implication of these findings is that, to avoid incorrect interpretation, the Political Constraint Index should be augmented by a comprehensive qualitative assessment of the industry in question.

OPSOMMING

Die definisie van politieke risiko en die metodologie om dit te ontleed, het verander sedert die ontstaan van hierdie dissipline gedurende die middel van die laaste eeu. Hierdie opdrag ontleed die nuttigheid van 'n nuwe kwantitatiewe tegniek wat die politieke beperkings en beleidsvoorkeure van politieke rolspelers gebruik om 'n maatstaf van politieke risiko te verskaf. Die opdrag se integrasie van die bevindinge van die resulterende Politieke Beperkings Indeks met 'n analise van die politieke ekonomie van die Indiese Elektrisiteits Sektor bewys dat, teenstrydig met oorspronklike interpretasies van die indeks, hoë vlakke van politieke beperkings en politieke kompetisie 'n deaktiveringsbeleid regime kan kweek wat nadelig is vir die belegger, ten spyte van die huidige regering se verklaarde toegewydheid tot beleidshervorming. Die implikasie van hierdie bevindinge is dat, om foutiewe interpretasie te vermy, die Politieke Beperkings Indeks verbeter moet word deur 'n omvattende kwalitatiewe ontleding van die verlangde industrie.

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Lee Kuan Yew

Senior Minister and former Prime Minister of Singapore
addressing a Fortune 500 Forum
Boston, Mass, November 1997

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1 INTRODUCTION

1.1 Introduction

“When I took over as Minister of Power in October last year, I realised that the Power Sector was at the crossroads and if the trend of the nineties were to continue, power supply would deteriorate further and have adverse impact on the economy and citizens. I have been sharing my anxiety with opinion makers and emphasizing that unless we take urgent measures ... it would be difficult to avert the impending crisis. Reform cannot be delayed any further.” – Suresh Prabhu, Minister of Power, August 14, 2001.

The words of the Indian Power Minister emphasise the dire straits the Indian Electricity Sector finds itself in at the beginning of the 21st century. The country’s inability to provide access to reliable power at reasonable cost is significantly hindering much needed economic growth.

Conservatively, the shortfall in electricity India-wide is estimated at 11 per cent for regular and 18 per cent for peak hour demand (World Bank 2002:6). This lack of power infrastructure elevates the cost of doing business in India; a World Bank survey showed that 69 per cent of Indian firms ran their own generators, compared to 30 per cent in neighbouring China (World Bank 2002:6). As the electricity industry is characterised by large economies of scale, private, small-scale electricity generation is highly cost-inefficient. Operating a generator can consume as much as one-sixth of a small- to medium-sized company’s capital. The result of this is that energy costs in certain industries in India are sometimes double those of competing industries in Indonesia, the Philippines and Thailand.

A central reason for the poor performance of the electricity sector is the country’s history of state control over the generation and distribution of power. Prior to the 1990’s, electricity

production was monopolised by government owned enterprises acting under the auspices of State Electricity Boards (SEBs). These Boards followed deliberate policies of cross-subsidising the electricity costs of powerful voting groups like households and farms at the expense of business. Such strategies were only partly successful and losses were borne by the Boards themselves. This, combined with the inability of the SEBs to collect bills and prevent theft of power, led to a severe shortage of capital for reinvestment and, consequently, a serious underinvestment in maintenance and capacity.

In 1991, the Indian government began the process of opening the Indian economy to market principles. During this phase it was decided to liberalise the electricity sector in the hope of attracting foreign producers to make up the shortfall in capacity. Such efforts have had limited success, partly because of the absence of a regulatory framework in which potential investors have confidence (World Bank 2002:7).

As the comments of the Minister indicate, Indian leadership has recognised the need to take strong steps to rebuild the sector. This has not been easy. The history of state intervention in the sector, the complexities of the Indian federal system and the large number of vocal and influential stakeholders in the electricity game have made essential changes difficult to implement. Despite this, the Indian government professes a commitment to the sustained reform of the sector in accordance with market principles. Most recently, the much vaunted and hotly debated Electricity Bill was passed with the intent to instil investor confidence by consolidating a slew of previously instituted reforms.

Previous abortive reform attempts and the past experiences of foreign investors have set a bad precedent for investment in the sector that continues to scare multinational corporations (MNCs) away from a large and potentially lucrative market. India is seen as an unreliable destination for investment because changes of government at national or state level have often precipitated attempts to renegotiate agreements with investors (Rufin *et al* 2003:654).

In 1992, for example, Enron, a large US-based company, was invited to bid for a power project to be established in the Indian state of Maharashtra. A power purchase agreement was concluded between the Houston giant and the state government amidst a shroud of secrecy and allegations of under-handed dealings. Shortly after the project's inception, elections in Maharashtra brought to power a new government that sought to scrap the

agreement without compensation and at huge cost to the foreign investor. Enron officials reportedly mobilised senior US-government officials to apply pressure to the Indian central government to force a more equitable resolution. Since then other infrastructure investors such as Cogentrix and Electricité de France have announced plans to withdraw from the country (Ruffin *et al* 2003:654). Defaults on power payments are spreading (Economist Intelligence Unit 2003:3).

Assessment of risk is a crucial component of any investigation into a potential investment opportunity. Political and regulatory risks, in particular, may have significant influence on the value of the firm (Ellestrand *et al* 2002:771). As Enron discovered, these risks are harder to quantify and therefore more difficult to measure than other forms of investment risk, yet can have equally far-reaching consequences.

A large body of literature has developed surrounding the topic of political risk and various methods of assessing risk have been suggested and debated¹. Henisz (2000, 2002) has recently devised a new tool to be used for political risk assessment, the Political Constraints Index (PCI), contending that it can be used as a measure of policy stability within a country².

According to Henisz, countries that rank relatively high on the index should have policy regimes that are less susceptible to change and therefore should present lower levels of political risk. Such countries should be preferred destinations for foreign investment. This conclusion, while possibly true under certain circumstances, relies on the implicit assumption that the initial policy regime is beneficial to the investor. When initial policies are not favourable to the investor (as can be argued for the example of the Indian Electricity Sector), it seems intuitive that high political constraints index may propagate a disabling policy regime that will be detrimental to the MNC's return on investment.

This intuition leads the assignment to suggest an alternate interpretation of the Political Constraints Index. When the reform of economic institutions, particularly politically sensitive ones, is required, a high level of political constraints may tend to work against

¹ A number of these will be discussed below.

² So far the tool has only been used for high-level, cross-country risk analysis – appropriate for theoretical studies, but less useful to the investor.

change. By limiting the opportunity for positive policy reform, relatively high political constraints may, in contrast to the interpretation offered by Henisz, indicate riskier investments. This, if true, has important implications for the use of the PCI in the assessment of political risk. Firstly, the index cannot be used in a simplistic fashion, as doing so may deliver spurious results. Secondly, the PCI may demonstrate a policy stability that will hinder or even derail attempts at policy reform. Thirdly, the PCI, to be useful as an investor's tool, may need to be augmented with a comprehensive understanding of the political economy of the country and, specifically, the sector under investigation. This alternative interpretation must be investigated and the impact of these implications assessed.

This assignment will revisit the literature on political risk assessment to point out and discuss shortcomings in existing methodologies in the field. It will critically evaluate the Political Constraints Index, assess where and how it overcomes the limitations of other methodologies and discuss some of its weaknesses. The assignment will consider the political economy of the Indian Electricity Sector and its recent reform history, evaluate the predictions of the PCI against occurrences in the Indian Electricity Sector and, for comparison purposes, those of China and Brazil, and suggest how the Index can and should be augmented and interpreted to become a useful assessment tool for the investor³. Lastly, new areas to be researched will be identified.

In summary, the assignment has four main goals:

- To provide insight into the literature in the field of political risk;
- To critically discuss reforms in the Indian Electricity sector and provide commentary relevant to investors;
- To evaluate the PCI in the context of economic reform in India and in the Indian Electricity Sector in particular; and
- To suggest how the PCI can be augmented to become more useful to the investor.

³ The Indian Electricity Sector is an ideal backdrop for an evaluation of the PCI because of the recent attempts that have been made to reform it and because of its susceptibility to political influence. While the Indian Electricity Sector will remain the focus of this assignment, it is useful, in the interests of evaluating the PCI, to compare India's experiences with those of China and Brazil, as all three countries have been exposed to similar challenges. This will be elaborated below.

1.2 Structure

The content of the assignment can be grouped into four chapters:

- Chapter 1, *Introduction*, provides a rationale for the assignment in the context of the Indian Electricity Sector and the structure that the argument will follow. It continues to explore salient definitions in political risk assessment that have been used in both the academic literature and in the private sector and discusses how these definitions can be categorised. This provides the definitional foundation upon which the rest of the argument will be constructed.
- Chapter 2, *The Theory of Political Risk Assessment*, begins by exploring the possible causes of political risk for the MNC, discussing how risk can be seen to derive from the changing relationship between the host government and the investor. This understanding of the causes of risk is required before a useful discussion of the methods of assessing risk can be pursued. With possible causes established, the chapter continues to categorise and evaluate various methodologies that have been used to assess political risk, dividing them into two primary groupings, subjective and objective methods. The use of cross-national data to determine the efficacy of various political risk methodologies is briefly considered. Finally, the chapter introduces and evaluates a new approach to political risk assessment, the Political Constraints Index, indicating how this technique can be placed within the context of the other methodologies and suggesting how to augment the index so that it can be used as a useful adjunct during the investment decision.
- Chapter 3, *The Political Economy of the Indian Electricity Sector*, returns the argument to its Indian backdrop, beginning with an overview of the current political structure of the country and the important political actors and groupings in the Indian political arena. The chapter charts the progress of the Indian reform process and critically discusses how this process has been both hindered and helped by internal and external economic and political considerations. The argument is then narrowed to the power sector, tracing its recent history, its inefficiencies and crises,

and the reform attempts that have thus far failed to address the root causes of its problems. The discussion emphasises the impact of political interference in the sector, the extent to which lobby groups and patronage can influence decision-making and the need for sustainable SEB reform. The chapter concludes by introducing and critically evaluating the newly passed Electricity Bill 2001.

- Chapter 4, *Analysis of the PCI and Concluding Remarks*, derives the index for India and, using the previous discourse on economic reform in the country and the electricity sector in particular as a foundation, discusses the predictions of the index and implications for its use in assessing risk. The argument is supported by examples taken from the reform experiences of China and Brazil which, because of the similar development challenges that these countries have faced, are able to assist in the assessment of the PCI. The chapter and the assignment conclude with a brief summation of the arguments presented and some suggestions for possible areas for further research into the use of the constraints index for the purposes of the MNC.

1.3 Definitions in Political Risk Assessment

The assignment begins with an overview of the existing definitions of political risk, categorising them and appraising some of their strengths and weaknesses and, by so doing, creating a necessary link to the existing literature. This is an important step because, as scholars such as Clark and Tunaru (2003:126), Moran (1999:3), Sethi and Luther (1986:58), Kobrin (1979:67) and Robock (1971:7) point out, there is no single universally accepted definition of political risk. Without a thoroughly grounded argument there exists the danger of confusion. This section brings together some leading thoughts in the political risk field in an attempt to show what political risk is.

1.3.1 The Need for Definition

Perhaps a possible reason for this lack of definitional conformity can be derived from the diverse uses that political risk assessments have been put to in the past and the great variance in the backgrounds of those who are active in the field. The political risk

discipline is not solely the province of the academic – political risk assessments are a crucial and integral part of the business operations of multinational firms, and the great demand for accurate risk predictions has resulted in a vast private industry of risk assessment services. While the academics struggled with the problems of defining political risk, the industry proceeded to develop its own definitions that suited its markets and its business needs.

The academia was not as pressed for a pragmatic interpretation of risk as the business world and continued to debate the issue, developing a series of definitions with their own distinctions. That disagreement should arise within academia itself is hardly surprising, given the varied backgrounds of the students of political risk. Economists, business management students and political scientists have each approached the subject differently, emphasizing certain aspects and simplifying others⁴.

Those who practice the art of political risk analysis tend to overlook the need for a consistent and accurate definition, leading to a lack of agreement that has complicated the comparison of different assessment approaches and resulted in a number of discrepancies on methodological issues. Poorly defined arguments have greatly weakened the dialogue surrounding the study of political risk, and the tendency of both professional analysts and scholars alike to proceed without a sound definitional underpinning has led to the incorrect selection of data, the use of inappropriate analytical tools and the misinterpretation of findings.

Sethi and Luther warn that the dangers of such disparities in definition are an overestimation of the usefulness of the results of a study, and the real possibility that an assessment could deliver the wrong answers (1986:59). Even though the authors were writing in the mid-eighties, these problems and their effects can still be seen and felt today.

1.3.2 A Framework for Definitions of Political Risk

Before exploring a topic in political risk, it is necessary to understand these different definitions, how they relate to each other, how they have evolved, and how they are

⁴ For examples of economists in the field see Schiffer and Weder (2000), Harms (2002a), Harms (2002b) and Feils and Sabac (2000). Business management articles include Ellstrand *et al* (2002), Howell and Chaddick (1994), Howell (1996) and Green (1972). An often quoted and widely published political scientist is Stephen Kobrin.

relevant to some situations and not to others. Once that understanding has been achieved, a useful and applicable definition of political risk can be developed and defended and an appropriate methodology for risk assessment constructed.

Narrow definitions of political risk have surfaced through the years. These are usually adopted by MNCs and are not well suited to academic discourse on the topic. Consider, for example, Shell Oil's definition of political risk as the "probability of not maintaining an oil contract during a period of 10 years in the face of changing economic and political circumstances" (Chermak 1992:168). Clearly, such definitions and the analyses that are based upon them do not lend themselves usefully to comparison with other studies in political risk. Their strength is that they allow the firm in question to focus explicitly on its own issues of strategic concern.

Other definitions of political risk are more ambitious in scope and a definitional framework becomes a useful tool to put them in perspective. This assignment suggests a simple three category framework to organise the definitions, differentiating categories according to the transmission mechanism through which government influences the firm⁵.

The decision was taken to group definitions according to how they view the interaction between government and investor because doing so provides a strong base for weighing their strengths and determining which can best support the objectives of the eventual political risk assessment⁶. At the simplest level, all members of the three categories include the concept that the presence of political risk will have an impact on the profitability of the investing company.

1.3.2.1 Category One

Definitions that fall into the first category consider the **direct** actions that governments take to influence the operations of a particular firm or those of firms in a particular industry. Typically implicit in these definitions is the assumption that government action will

⁵ The framework described here is loosely based on the four category framework that Fitzpatrick (1983) developed.

⁶ Not all definitions will fit comfortably into the categories described. The diverse nature of the discipline makes it debatable whether a perfectly accurate framework could be created with fewer categories than the sum total of definitions in the field. Broad definitions may also be too broad for this framework and it becomes necessary to consider the way in which the definition is used before assigning it to a category. This implies some level of interpretation.

necessarily lead to negative outcomes for the investor and that government inaction does not constitute a source of risk to the MNC.

Risk analysis in the 1960s and 1970s tended to be concerned with one particular event that was directly initiated by government – the expropriation or confiscation of foreign owned assets by host governments. This is illustrated by Truitt’s definition in 1974 of political risk as the “propensity to expropriate” (Chermak 1992:168)⁷. Definitions that allow the assessment of risks related to expropriation, so-called “creeping” expropriation, discriminatory taxation, public sector competition and the explicit breach of investment agreements would be accounted for by this category⁸.

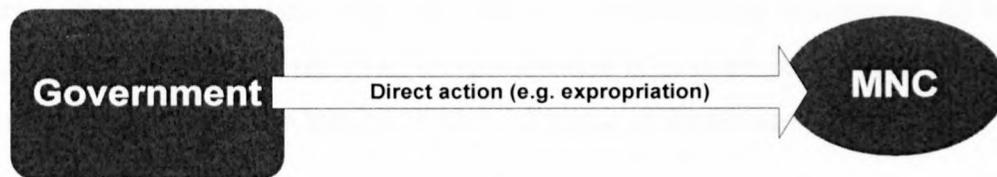


Figure 1: Category One Relationships

Figure 1 illustrates the simple relationship that exists between the government and the firm for definitions in category one.

1.3.2.2 Category Two

The second category builds on the first by identifying political risk in terms of occurrences of a political nature, usually political events, as well as constraints imposed at the specific industry or firm level. These events are typically changes in government or heads of state and politically motivated violence. In this grouping, both direct and **indirect** actions and

⁷ Early studies of political risk, such as Truitt’s, concentrated on the act of expropriation (the confiscation of privately owned assets by the host government). It is interesting to note that the incidence of such acts fell from 336 between 1970 and 1975 to 15 between 1980 and 1985 to only one between 1986 and 1992 (Minor 1994). From this it stems that definitions that limit themselves to expropriation are no longer useful to the investor.

⁸ Weston and Sorge’s definition provides a good example: “[P]olitical risks arise from the actions of national governments which interfere with or prevent business transactions, or change the terms of agreements, or cause the confiscation of wholly or partially foreign owned business property” (1972:60). See also Schmidt (1986) who defines political risk to be “the application of host government policies that constrain the business operations of a given foreign investment”. He subdivides risk into three main categories “transfer risk”, concerning risk to capital payments; “operational risk”, with threats over local source or content; and “ownership control risk”, high-lighting possibilities of expropriation or confiscation. Further examples are Wang *et al* (1999), and Nehrt (1972).

inaction by government can result in risk to the investment – rioting or similar politically motivated violence, for example, being the possible indirect outcome of sovereign action or inaction⁹.

It is often business that considers political risk in terms congruent with this category because it is convenient to do so for the purposes of purchasing insurance cover. The US government’s Overseas Private Investment Corporation (OPIC) insures US businesses against loss resulting from expropriation, inconvertibility, war damage, civil strife damage, and breach of contract (Howell 1994:7). For the damage to be considered “political”, the contract must be repudiated in such a way that the loss of revenue can be described as resulting from government decision making.

Figure 2 illustrates the relationships that category two definitions encompass. As well as having direct influence on the firm, the government affects the body politic through its actions or inactions which in turn could have influence on the investor.

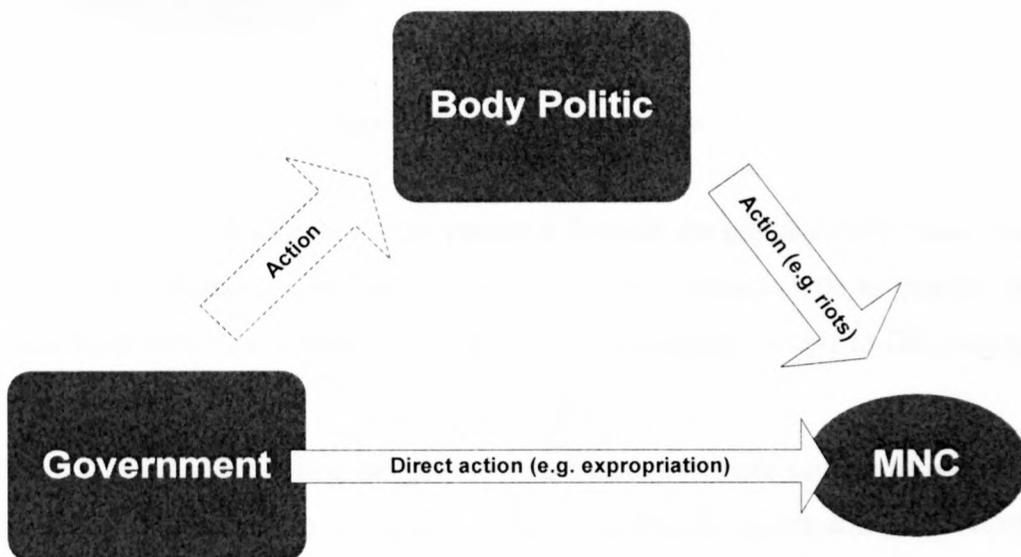


Figure 2: Category Two Relationships

⁹ Butler and Joaquin speak of political risk in terms of a sovereign host government changing the “rules of the game” under which investors operate (1998:599). According to them, this has a profound impact on the MNC because instability in a host government or in monetary or fiscal policies results in more uncertain investment outcomes. Their approach is event focused. See also El-Tabtabai & Alex (2000), Green (1972), Wells (1995) and Moran (1999).

1.3.2.3 Category Three

The third category concentrates on the political **environment**, rather than the actions of players in isolation. The typical definition in this category focuses on the discontinuities in the business environment that arise from political change, which pose a risk if they are able to affect the profit or other goals of a particular enterprise. From this it follows that fluctuations in the political environment that do not change the business environment should not be considered as a source of political risk for international business¹⁰.

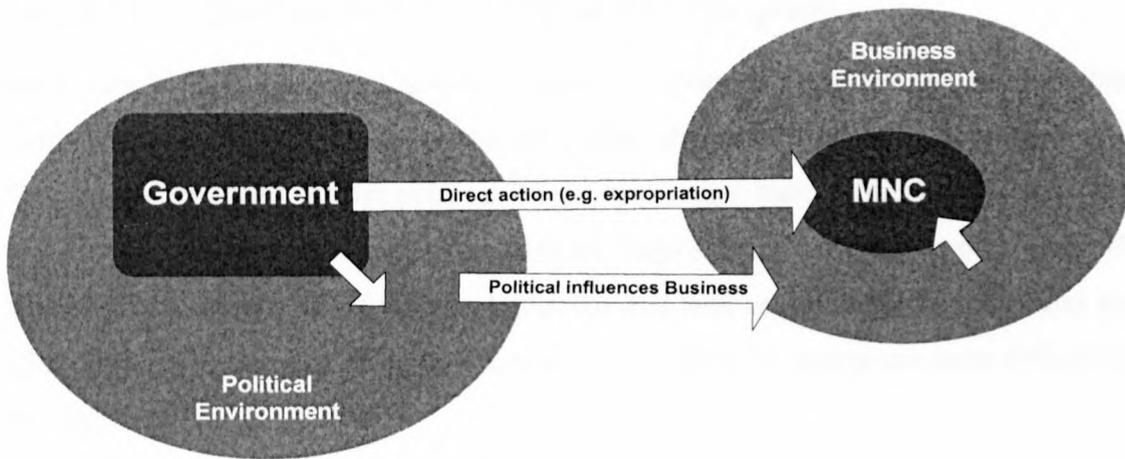


Figure 3: Category Three Relationships

Figure 3 illustrates this category. Government influences the political environment, which impacts on the business environment in turn. The firm is susceptible to changes in the business environment, so changes to the political environment are able to filter through to affect the firm's profitability.

Definitions in each succeeding category tend to encompass more sources of political risk than those in the one before. The first two deal with specific events and the level of risk associated with that event. Deeper than the first category of definitions, the second encompasses both direct actions from governments and other political activity over which the government has indirect and limited control, such as violence and regime change. The

¹⁰ Consider Howell and Chaddick's definition of political risk as the "possibility that political decisions, events, or conditions in a country [...] will affect the business environment such that investors lose money or have a reduced profit margin" (1994:71). Note that the assumption is that political risk will have a negative impact on the firm. Other authors whose explicit or implicit definitions can be put in this category are Clark & Tunaru (2003:127), Harms (2002a), Harms (2002b), Robock (1971:7), Simon (1982:68), Howell (1996:7), and Alon & Martin (1998:12).

third category considers the political environment, how it is shaped and influenced by political events, and how it in turn impacts on the business environment.

The framework illustrates a significant weakness associated with some past and current definitions of political risk. By concentrating either on the actions of government or on how the political environment influences business, the interdependent nature of the various spheres is overlooked. Environmental changes can prompt government actions as much as government activity can provoke environmental developments (Sethi and Luther 1986:59). This simple yet significant two-way causality should not be ignored.

Definitions in these categories tend to ignore the ongoing political process and its subtle forms of change, concentrating instead on sudden changes in the political environment. This means that they predict political **event** risk, rather than political risk itself. The popularity of such approaches can be explained: large shifts in government policy and the general political environment are easy to discern, and their causal links to political risk are relatively easy to describe, whereas the cumulative effects of change are more difficult to anticipate.

If, as Fitzpatrick postulates, the nature of politics is a “continuous process rather than a discrete series of events” (1983:250), a risk analysis that focuses solely on events will lose a great deal of its predictive capability. The assessment of political risk, then, must involve process variables as well as event variables, an issue which remains relevant to a discussion of definitions, but which will become more central when the question of methodology is raised.

1.3.3 A Working Definition

Chermak, in 1992, develops a useful definition of political risk that incorporates many of the concerns raised above and which will be used throughout the argument presented here. He adds a probability element to Jodice’s definition of 1985 so that political risk becomes the **probability** of:

*“[C]hanges in the operating conditions of foreign enterprises that arise out of **political process**, either directly through war, insurrection, or political violence, or through changes in government policies that affect the ownership and behaviour of the firm. Political risk can be conceptualized as events, or a series of events, in the **national and international environments** that can affect the physical assets, personnel and operations of the firm” (1985 in Chermak 1992. *Emphasis added*).*

This definition implicitly allows for the analysis of two-way causalities between political actors (firms, governments and environments), explicitly encompasses both political processes and the events that result from them, considers the impact of factors beyond the domestic political environment and acknowledges that risk is the probability that the political environment will affect the firm’s ownership and bottom-line.

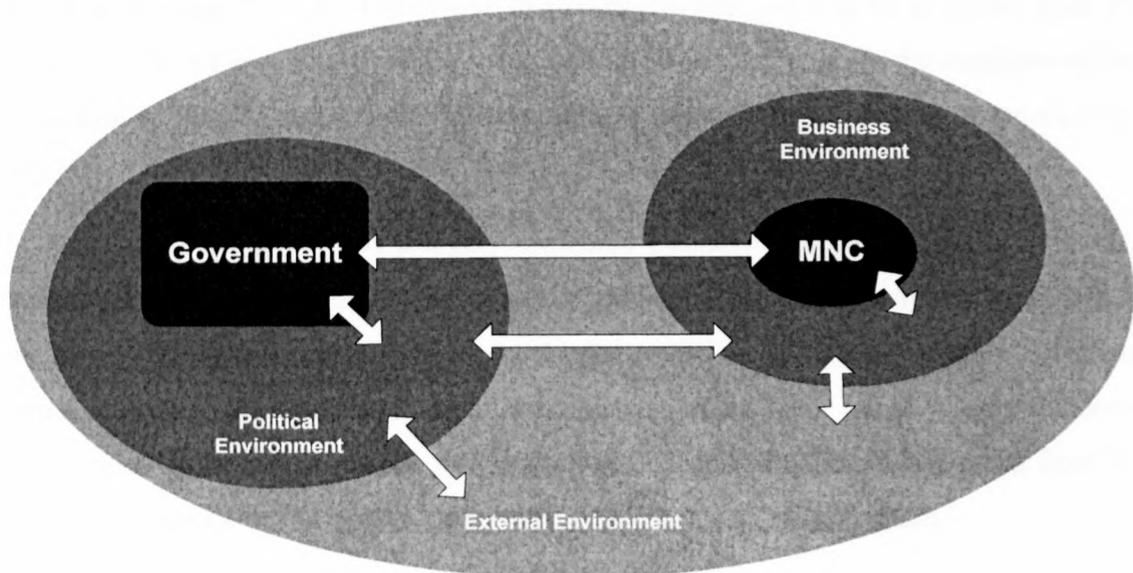


Figure 4: Relationships in the Definition

Figure 4 shows the relationships that are catered for by this definition. By including more sources of risk, a more complete picture of the political risk environment can be achieved and a more accurate risk assessment performed.

Further, it is important to note that this definition does not limit risk to changes inimical to the business. The possibility of both favourable and unfavourable change is included. This will become important later on in the discussion when it becomes apparent that, in the context of the Indian electricity sector and this argument, it is the lack of positive change that is more dangerous to the investor than the possibility of negative change. The nature of the Indian electricity sector, the incentives for investment offered by government and the promises made to continue needed reforms in the industry make this so.

1.3.4 Macro and Micro Risk

A short detour must briefly distinguish between two important concepts in political risk analysis: macro and micro risks. The first type is defined by Kobrin to be “environmental events which affect all foreign firms in a country”, as opposed to the second, which are “risks specific to an industry, a firm, or even a project” (1982:35).

Frei and Ruloff believe that micro risk is far more important than macro risk in the context of a risk analysis (1987:4). They argue that an assessment, for it to be of worth, must be conducted from the perspective of a specific business project, and use the examples of oil extraction in Angola and asbestos cement shingle production in Germany to prove their point.

In Angola, oil extraction was a highly profitable business venture during the civil war, despite the fact that the country was ravaged by violence. From the macro risk perspective, the country was a disaster area, and a very dangerous and unprofitable investment. In micro terms, however, the characteristics of the industry would have led to a very different assessment: protection by Cuban troops allowed Gulf Oil to maintain and profit from its operations, despite the turmoil in the country. Micro risk was at a minimum.

In the second example, the early eighties’ business climate in Germany was conducive to the production of asbestos shingles. A few years later, a small clause in a certain law shifted the burden of proof regarding the toxicity of asbestos products away from the plaintiff and onto the producers. The industry was effectively destroyed. In this case, although macro risk virtually did not exist, the micro risk proved devastating.

1.4 Conclusion

This chapter has shown how the field of political risk assessment, with its varied actors and objectives, has suffered from a lack of definitional clarity. To put the assignment's argument on a firm footing, it has created a simple framework to show how definitions can be differentiated according to the way that they allow for the interaction of government and investor.

Using the framework, the chapter has elucidated some weaknesses in existing definitions and has suggested a useful definition that overcomes most of them, highlighting the need to consider the influences that the external and internal political environments have on the government and *vice versa*. The definition also includes political processes, the events that result from these processes and does not assume that change necessarily has unwanted impact on the MNC.

2 THE THEORY OF POLITICAL RISK ASSESSMENT

2.1 Introduction

Since the nineties, developing countries have often been eager to act as hosts for the operations of multinationals. Foreign investment brings with it production technology, skills, innovative capacity and new organizational and managerial practices, while adding to the stock of domestic resources and increasing capital formation (Blanchard 2000:470). Desiring these benefits, governments seek to attract foreign capital by devising incentive schemes that make investment potentially lucrative for the multinational corporation. These schemes are typically formalised through contractual agreement between the host and the MNC.

Host governments, however, do not necessarily honour such agreements throughout the lifetime of the contract, possibly leading to considerable loss of revenue for the investor.

This chapter considers the trends in foreign participation in infrastructure projects in the developing world and important issues in the contemporary era that suggest on-going sources of threat to the MNC. It presents a theory that describes the changing relationship between the host country and the investor over time and makes the point that infrastructure investments are particularly prone to government supervision. In synthesising these different arguments, reasons are presented for why political risk exists for the international investor in infrastructure.

Having established possible causes of political risk, the chapter tackles the problem of how to assess risk, revisiting the literature and categorising the methods that can be found there into two groups: subjective and objective. Methods in both categories have their respective strengths and weaknesses and some of these are briefly considered, along with the use of cross-national data to test empirically the efficacy of the risk assessment approaches. With these foundations in place, the chapter introduces the political constraints index and various political risk methodologies are briefly considered. Finally, the chapter introduces and

evaluates a new approach to political risk assessment, the Political Constraints Index, indicating how this technique can be placed within the context of the other methodologies and suggesting how to augment the index so that it can be used as a useful adjunct during the investment decision.

2.2 Causes of Political Risk

2.2.1 Trends in Private Participation in Infrastructure

In 1990, investments in private infrastructure projects totalled only \$18 billion (Harris 2003:5)¹¹. Annual investment grew rapidly from this low base and the decade recorded an average yearly investment of \$60 billion in projects with private participation. The trend peaked in 1997; since then, private investment in infrastructure has seen a marked decline, although aggregate figures are still high. By 2001, developing countries had seen nearly \$755 billion flow into more than 2500 private infrastructure projects (Harris 2003:6).

¹¹ Figures are expressed in 2001 US dollars and are taken from the World Bank's Private Participation in Infrastructure Project Database (Harris 2003:5). Although these figures include both public and private investment in these projects, the World Bank estimates that private financing accounts for between 85 and 90 per cent of total investment flows averaged over sectors and regions (Harris 2003:5).

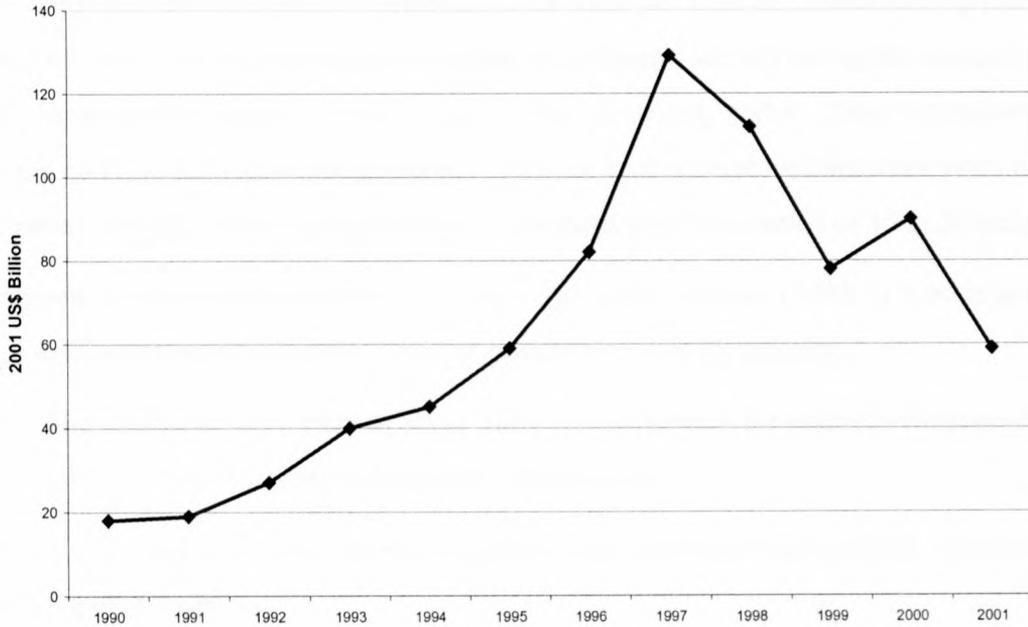


Figure 5: Investment in Infrastructure Projects with Private Participation, 1990-2001¹².

The figures show that developing countries have become more receptive to foreign capital. The upswing in investment during the nineties, however, does not necessarily indicate that the inherent risk of the investment environment has been transformed. Despite a number of emerging markets embracing more investor-friendly stances, commercial and political risks still remain problematic.

Renegotiation of contracts is a common dilemma. A World Bank study shows that over 50 per cent of concessions offered to attract foreign investment into the electricity industry are re-negotiated within 10 years (Sarkar & Sharma 2001:5). According to the study, most renegotiation takes place relatively soon after the award (an average time of 2.2 years)¹³. As infrastructure investments are typically long term projects with high initial capital requirements, early renegotiation implies large losses in planned revenue.

¹² Originally sourced from the World Bank PPI Projects Database and reproduced here from Harris (2003:7). It should be noted that the graph shows yearly flows and not cumulative investments.

¹³ The study shows that renegotiations are more likely when concessions are awarded on the basis of lowest bid tariff and less likely when a regulatory body oversees the concessions or when tariffs are based upon cost of service rather than lowest bid.

Other industries are also heavily affected. Over forty per cent of concessions granted to foreign investors in the Latin American water and transport sectors during the nineties have been renegotiated (Guasch 2003:5). As in the electricity sector, these renegotiations occurred early in the lives of the projects – sixty per cent occurred within three years of the concession's award, when, in principle, the agreement was for a period of 15 to 30 years.

Investment in private infrastructure is clearly still risky. Moran (1999:7) lists important trends in the contemporary era that suggest possible reasons for this risk.

- The decline in authoritarian states allows more leeway for political violence in the form of ethnic tensions and separatist movements.
- The spread of democratisation enhances the importance of popular opinion and populist reactions.
- The decentralisation of power and the heightened role of the sub-national state increase the complexity of decision making, possibly affecting the stability of the investment environment.

As a result of these trends there may be enhanced motivation for “opportunistic” behaviour by host country political authorities.

The influence of all three factors mentioned by Moran can be felt in India and its electricity sector in particular. While these recent trends do help to explain why risk has persisted despite the relatively widespread advent of democracy and the recent enthusiasm for liberal investment regimes amongst developing nations, it is also useful to consider a more robust theory explaining the existence of political risk.

2.2.2 The “Obsolescing Bargain” Hypothesis

The ability of governments to alter the terms of an initial investment and to renege on incentives can be explained by Vernon's description of the power dynamics between host governments and foreign firms (1980). Vernon centred his original argument, which he termed the “obsolescing bargain” hypothesis, on the changes in relative power between the

two parties over the lifetime of a mining project¹⁴. The theory predicts that passage of time will result in the erosion of the multinational's bargaining position¹⁵.

Initially, the firm holds the majority of the bargaining power because the host government lacks the necessary capital, technology and expertise for resource extraction. Being unable to develop its own mining operation, the country occupies a weak bargaining position and will make heavy concessions to the foreign company to entice it to invest. Consequently, the initial investment contract will be weighted in the investor's favour.

Once the investment is complete and the mining operation has begun, the power structure suffers a rapid alteration. Domestic workers begin to move up a learning curve and the local industry starts to absorb the new technologies that the company brought with its operation. Foreign knowledge and expertise become less important.

As the mine cannot be physically moved and because most of the costs of establishing the venture are sunk, the host government is now in a strong position to renegotiate a more attractive contract, while the investor faces only two possibilities: continuing its operation, but at lower revenues than originally planned, or losing its entire investment to expropriation, with or without appropriate compensation¹⁶. As the lifespan of the project grows, variations in remuneration, taxation, or the regulatory environment tend to have an increasing impact on profitability.

¹⁴ The obsolescing bargain hypothesis was created to analyse the treatment of foreign direct investors in natural resources. Despite this focus, it can be generalised to explain the evolution of relations between all types of investors and host governments, particularly those related to private infrastructure projects (Moran 1999:8).

¹⁵ Other causes of political risk were put forward before the "obsolescing bargain" hypothesis. Bronfenbrenner (1954) suggested that expropriation could be explained in terms of the tangible economic benefits that accrue to the country. He hypothesized that confiscation could be a viable development alternative by increasing the rate of economic development. History has largely disproved his views. Examples such as the nationalization of US operated copper mines in Chile and the nationalization of the Zambian and Zaire copper mines show that confiscation does not necessarily lead to greater rates of economic growth (Chermak 1992:169). Johnson's (1965) explanation for expropriation distances itself from economic rationale, suggesting instead that non-rational, ideological, or even emotional factors could be causes. In short, the governing elites of a country and the population in general are considered to be willing to sacrifice material advantage for the satisfaction of nationalistic acts, such as the confiscation of foreign controlled companies and the displacement of foreign nationals in highly paid jobs. His hypothesis is difficult to verify empirically and is mostly speculative in nature (Chermak 1992:169).

¹⁶ Although traditional expropriation (the loss of ownership *per se*) was the consequence Vernon envisioned, the theory holds for other methods of interference. Government meddling can also be indirect and implemented through subtle means (Bergara *et al* 1998:20). Attempts may be made to restrict the company's pricing flexibility, the company may be required to undertake particular investments, purchasing or employment patterns, or the government may try to restrict the movement of capital. These less transparent activities will impact negatively on the profitability of the enterprise and assist the government's objectives, be those to recoup losses from concessions granted or to win favour amongst voters.

The erosion of the multinational's bargaining power is reflected in lower bargaining success, which is a measure of how close the deal negotiated is to the objectives of the host country, rather than to those of the foreign firm (Vachani 1995:161).

2.2.3 Incentives for Intervention

Private infrastructure projects, such as power, water, transport or communication services, tend to be more susceptible to government supervision and intervention than other forms of investment. This is a consequence of the political economy of the project and the broad spectrum of players who have an interest in how it is conducted.

There are five main factors that make infrastructure regulation attractive to governments (Bergara *et al* 1998:19, Sarkar & Sharma 2001:1, Moran 1999:3).

- As the obsolescing bargain hypothesis states, once large scale direct investment has been undertaken costs tend to become sunk and mostly irreversible. Pay back periods stretch into the long term, and the balance of bargaining power shifts dramatically.
- The impact of economies of scale in the infrastructure sector helps to make these sectors natural monopolies. Governments will keep a wary eye on their operations because of this and are more likely to play a prominent role in the regulation of entry, prices, quality of services and other aspects of investor behaviour. Monopolies provide the opportunity for greater rents and therefore an incentive for government scrutiny and possibly intervention.
- Infrastructure tends to be massively consumed, implying that the scope of the services provided in fields such as power, water, transport, and telecommunications will add further incentive for interference. Broad consumer bases are also broad voter bases. If prices rise or services deteriorate, popular protest could be very damaging to an incumbent government, suggesting that intervention in the interest of averting broad popular protest will be considered a worthy cause. This also introduces new stakeholders, consumer groups, with both direct and indirect influence on the operation.

- Government-owned companies tend to be key suppliers to, or purchasers from, private infrastructure firms. Governments may be tempted to regulate their suppliers or purchasers to manipulate revenues.
- Private infrastructure operations seldom involve export operations. As a result, they tend to rely on host country agencies to ensure currency convertibility and remission. This makes them particularly susceptible to government exchange rate policy.

2.2.4 Ability and Motive

Vernon's obsolescing bargain establishes the ability of government to interfere in the operations of the infrastructure investor. Modern trends that allow and reward "opportunistic" behaviour, the massive consumption of outputs, economies of scale and natural monopolies provide motive.

With motive and ability established the host's decision to expropriate or behave adversely to the investor's interest rests on possible consequences. Expropriation of sunk assets or attempts to appropriate revenues may be profitable to government if the direct costs (such as the reputation lost in the eyes of foreign investors and the global community) and the indirect costs (for example the institutional damage that will result from disregarding the judiciary or ignoring administrative procedure) are small when compared to the short-term benefits of such an action (such as being re-elected). From this it derives that incentives for expropriation or adverse behaviour are greatest in countries where there are no formal or informal governmental procedures for regulatory decision making, where regulatory policy is centralised in the administration, where the judiciary is weak and unable to review policy making, and where the expected lifespan of the incumbent government is relatively short (Bergara *et al* 1999:20).

2.3 The Methodology of Political Risk Assessment

Prior to 1950, political risk was considered to be the field of international diplomacy and international law, and concerned itself with very little other than the possibility of confiscation and the likelihood of subsequent compensation (Chermak 1992:167). During

the 1970s and 1980s, political risk studies became more abundant and the associated body of literature began to grow. This section analyses the political risk literature and some of the assessment methodologies available, pointing out relative strengths and weaknesses.

2.3.1 Subjective Methods

These assessment approaches are based on the subjective views of people believed to be experts in the potential market and the various factors that affect political risk. They range from informal decision assistance, such as grand tours and “old hands” assessments, to structured approaches, such as the Delphi technique, comprehensive qualitative assessments, Bayesian methods and expert models¹⁷. Regardless of how they are implemented, these approaches are all based upon the subjective impressions of one or more individuals. The most immediate shortcoming of such methods is the dependence on the knowledge of an “expert”, who may be completely unqualified for the task entrusted to him or her.

Firms sometimes make use of informal decision assistance in their political risk analysis. They send key executives on **grand tours** of the potential host country to develop a firsthand opinion of the risk environment, employ “**old hands**” (employees or outside consultants who have had experience working or investing in the country) to provide political risk advice, or rely on the knowledge and impressions of key decision makers within the firm’s executive.

Such approaches are likely to result in inaccurate, incomplete and biased assessments of risk. Simon (1985:137) argues that the key to understanding such methods lies in the examination of the underlying power structures and personality dynamics within the management hierarchy of the multinational. Although intermediate and lower-level managers may provide a sheaf of research papers and financial analysis statements, the ultimate decision to invest in or disinvest from a host country usually rests with one or two senior corporate executives.

The impressions of these individuals of the host country, its government, its economy and its social and cultural characteristics can overturn months of careful research by others

¹⁷ For an overview of these approaches, see Simon (1985), Chermak (1992), and Frei & Ruloff (1987).

within the corporation. Stereotypes of foreign societies begin to play a decisive role, as do internal power politics within the company.

The Iranian revolution of 1978 serves to illustrate how impressionistic assessments can distort the perception of risk (Simon 1985:137). Prior to the revolution, the pro-Western stance of the Iranian shah, the country's military strength vis-à-vis its neighbours and the large-scale internal military apparatus designed to quell any internal dissension led many CEOs to expect a continuing stable environment within the country. Foreign investment was actively encouraged and enthusiastically undertaken.

Iran's friendliness towards the West allowed Western executives to define the situation in terms of their ideological and political preferences. When internal unrest erupted, the large amount of capital invested in the form of factory plants, projects, and subsidiaries resulted in a natural reluctance for multinationals to admit the gravity of the situation. Wanting to believe that the condition was manageable, executives tended to interpret subsequent events from the same perspectives that originally encouraged investment and tough disinvestment decisions were delayed with disastrous results. When top executives make unstructured and impressionistic "analyses" of the risk environment in host countries, the resulting decisions are vulnerable to their own political and ideological biases.

For these reasons, impressionistic methods are no longer widely employed in their original form. New methods have been developed to contribute structure to opinion based risk analyses and to allay the influence of stereotypes and selective perceptions. The **Delphi technique** (Simon 1985:140; Chermak 1992:173) uses structured interviews of country experts to formally elicit and interpret their opinions of risk. It is believed that because more experts are approached and because a formalized interview process is used, results are less biased, more objective and more readily compared across countries and across timeframes.

The technique attempts to distil the views of the participants to arrive at an informed risk consensus, progressing through a series of interview rounds, each time feeding the responses of the previous round back to the group for re-evaluation. The experts are questioned individually so that a certain level of anonymity can be maintained. The results of these private interviews are returned to the group for discussion and critique, without the

identity of the authors of particular views being disclosed. In this way it is believed that debate can be maintained while still moving towards a consensus.

The Delphi technique takes advantage of each expert's knowledge and experience and allows each expert to defend his or her perspective should it deviate from the norm, yet presents the danger that group consensus can be forced rather than arrived at (Simon 1985:140). As the objective of the Delphi technique is to achieve a group position and since each expert is aware of where he or she stands relative to the group, there is constant pressure for a "dissenter" to bring his or her views into line with the norm. This could lead to a form of intimidation and distorted results. Furthermore, the role of facilitator is also particularly important, as it is this person's job to coordinate the views obtained in the private interview sessions. By emphasizing or deemphasizing certain views, he or she can shift and manipulate the process, whether unwittingly or not.

Comprehensive qualitative assessments can be used to good effect in analyzing the risk environment of the firm. Such methods produce a detailed, qualitative analytical evaluation of the potential investment, and their explanatory nature ensures that the sources of risk can be well understood. Within the corporation, different individuals from different departments or subsidiaries can produce a multitude of reports that cover many functional areas. Legal departments, financial officers and dedicated political analysts can combine to produce a body of work that encompasses the various spheres of risk.

While comprehensive, such approaches do present problems. The first is that there may be an overflow of information that could make decision-making difficult. Secondly, if a number of individuals are involved in the process, it is conceivable that structure and consistency across the reports may not be maintained (Simon 1985:137). Lastly, each participant may overemphasize his or her area of expertise, adding hidden distortions that may detract from the accuracy of the method.

Despite these concerns, qualitative assessments contain a significant advantage that should not be understated. They allow the nuances and specificities of the individual risk problem at hand to be highlighted and reported upon. Such methods, with their focus on describing the entirety of the risk environment, must perforce create a made-to-measure assessment that may well be far deeper and, in that respect, superior to any effort towards systematic

quantification. For this reason, such methods should not be abandoned, but rather included as a corollary element in any risk assessment study (Frei & Ruloff 1987:6).

Structure can be added and bias reduced by adding probability estimates to qualitative assessments. Known as the **Bayesian** method, this approach works from the assumption that human judgment can be a valuable asset in forecasting events and attempts to incorporate personal hunches and convictions in a systematic way (Whitford 2003:909)¹⁸. The analyst assigns a probabilistic weight to the likelihood of an event occurring. He or she then refines this probability when new information becomes available. This allows his or her subjective judgment of the risk situation to be incorporated into the analysis in a systematic way, and forces the analyst to take cognizance of his or her preconceived ideas of the risk environment.

A model can also be used to inject structure into an expert generated assessment¹⁹. Risk assessment services regularly make use of such models and some that have been created are the BERI (Business Environmental Risk Index), the World Political Risk Forecast and POLICON (Chermak 1992:173). The BERI, for example, consists of 15 weighted variables believed to be related to political risk. A panel of experts taken from the US and the country being assessed are requested individually to rate the country in terms of each variable. The results are tabulated and the mean response of the group is fed back to each expert. Adjustments to individual scores are then allowed, an average for each variable is calculated and an index out of a 100 created. Scores closest to 100 correspond to the lower possible political risk.

The benefit of using a model is that it forces the expert or experts to judge the country in a structured way according to predefined variables. This allows for the expert's opinion to be "quantified" and for the results of the assessment to be compared across countries and timeframes.

¹⁸ For an example of a study of political risk that uses the Bayesian method, see Clark & Tunaru (2003). For a text on the use of Bayesian inference and computing in general social science studies, see Gill (2002).

¹⁹ See Alon & Martin (1998) for an example of a normative, structured model that purports to assess risk. The model considers government-, society- and economic-related factors for both external and internal dimensions. Values are assigned to a range of variables in each category according to an expert's assessment.

2.3.1.1 Discussing Subjective Methods

There are a number of problems with risk approaches based on expert opinions. The first is that the lack of empirical and statistical testing of the factors used implies possible subjectivity (Chermak 1992:174, Frei & Ruloff 1987:7). The second is that personal opinion allows for greater bias, although as more opinions are sought, prejudice should be reduced. It cannot, however, be eliminated. The third problem is that the results of such systems are relative and are therefore only meaningful when considered in the context of other rankings. This means that they cannot easily be incorporated into economic analysis.

Although attempts to construct formal methodologies for expert analysis have been made, a fourth problem is that the implied mathematical rigour and precision behind the resultant ratings can be misleading. Consider the “quantified” ratings of an assessment model. The numerical value associated with the assessment hides the truth that the result is only a formalised combination of subjective views and is not necessarily accurate. This can present a danger in itself – the findings of risk assessment services may be overrated because of the implied mathematical rigour. Furthermore, expert selection is also seldom transparent to the end user of the assessment – the qualifications of the person making the judgment may not be particularly noteworthy (Frei & Ruloff 1987:7).

A fifth problem is that experts’ methods may not be sufficiently complex to do justice to the political risk environment of the country in question. In fact, the results of a study published by Bilanz (1983 in Frei & Ruloff 1987:7) support this view. Statistical analysis of ratings delivered for 72 countries by four risk assessment services (BERI, World Political Forecast, Institutional Investor, and NSE Consultants) revealed that close to 50 per cent of variance observed across the risk ratings could be explained by a variable as simple as the per capita gross national product (GNP) of the countries in question.

This indicates that experts implicitly equate underdevelopment and risk, using per capita GNP (the most common indicator of development) as a proxy for risk. This finding clearly demonstrates the dangers of biased views: the conclusion of such experts would be that less developed countries would automatically be riskier investment options, regardless of the type of investment or the sector it is intended for – a view that is not necessarily true.

Even in thorough, well-documented assessments, it is conceivable that such bias may have an unwanted impact.

Finally, the last paragraph hints at another critique of the expert opinion led assessment – ethnocentricity. When the experts conducting the assessment are sourced largely from the developed West, the group itself, the facilitators and the decision makers may all exhibit the same form of cultural and ethnic prejudice. A large panel of experts and structured analysis methods may not be sufficient to combat this bias. This may result in an overstated risk assessment and the foreclosure of possibly lucrative investment opportunities, or even the understatement of risk due to shared ideology and stereotypes, as demonstrated by the Iranian revolution of 1978.

2.3.2 Objective Methods

Objective assessments rely on measurable variables to develop a view of risk through various mathematical or econometric processes. The variables used are typically financial and economic in nature as these lend themselves well to analysis.

The banking industry, for example, uses objective measures to assess country risk which, according to Levinsohn (2002:40), can be considered a broad category that includes political risk. He maintains that country risk can be assessed by considering a combination of economic, financial, geopolitical, sociological and historical factors and that country risk analysis and forecasting techniques can be used to identify political risks themselves²⁰.

Country risk assessments focus on the ability of the country to meet its foreign debt repayments, as this is the area of most interest to the bank. Unlike a company with a direct investment in the country, banks are relatively unconcerned about the danger of asset expropriation or the passing of laws that limit profit repatriation. The nature of their business allows them to narrow the range of their assessment and to make use of “hard” economic data augmented with broad and subjective overviews of political risk.

²⁰ See Harms (2002) for an example of the use of country risk measures, in the form of the International Country Risk Guide's ratings, as a proxy measure for political risk.

2.3.2.1 *Discussing Objective Measures*

There are obvious problems with such approaches. Firstly, whereas economic variables lend themselves easily to quantitative expression, political variables do not. Data on a country's GDP, debt service ratio, inflation figures, unemployment and the like are readily available through various publications and are apt inputs to rigorous analysis. Political variables cannot be measured as easily and numbers that are associated with them are often based on subjective ratings given by individuals (discussed above)²¹.

As a result, political factors may be underestimated because they are not as easily measurable as economic factors (Simon 1985:142). There may also be an overemphasis on the political factors that *can* be measured in an objective fashion because these can easily be incorporated into the assessment while the impact of those that cannot easily be measured may be understated or ignored. To compound the issue, economic variables are, to some extent, used as proxies for political variables – a distortion that results in misleading analyses.

Furthermore, it can be argued that there is a certain degree of subjectivity in the selection of the variables that will be used in the objective assessment. If this subjectivity is ignored, a hidden bias may be produced that will confuse the analysis. Western views of risk may emphasise certain economic factors over others, yet these factors may not be as important in the context of the country being analysed.

A high incidence of acts of corruption in a country, for example, may lead to the conclusion that the country is high risk, yet the “corruption” observed may be institutionalized and part of the business “culture” of the country concerned. In some cases, the corruption could even be formalized, tolerated and predictable. It would therefore be less of a threat to foreign investors than its objective measure would have anticipated. This would make comparing assessments that include corruption as a political variable difficult because the corruption value would have to be adjusted to suit each country. Such adjustments would

²¹ Consider variables mentioned by Léonard such as the degree of ethnic fractionalisation, government legitimacy and the presence of an organised opposition (2001:493). These variables are difficult to operationalise. How does one measure the presence of an organised opposition? The measure would depend heavily on the definition of organised and would probably incorporate some degree of interpretation. This in turn implies that it is not a true objective measure and this inherent subjectivity, unless carefully explained, may remain hidden. As Léonard warns, some models used by rating agencies, various US government departments and country risk publications include ongoing biases towards different regimes (2001:493).

have to be performed on a subjective basis by a country expert, implying that the measure is no longer objective.

To summarise: so-called objective approaches to political risk assessment, such as country risk ratings, are not well suited to companies that intend to invest or have invested directly in a foreign country. Political variables cannot be as easily measured as economic variables and their measurement and selection often include a certain level of subjectivity that may lead them to be incorrectly interpreted if not adequately explained. They do not encompass the full milieu of political risk, providing a broad overview at best. A more thorough understanding of the sources and influences of risk is preferable.

2.3.3 The Meta-Discipline of Political Risk

Continuing alongside the actual practice of creating political risk assessments is a meta-discipline that attempts to test the methodology of the creation of risk models to establish objective criteria and explicit procedures through which to understand political phenomena (Simon 1985:143). Such studies are usually undertaken by academics, and employ **cross-national quantitative political analysis**.

One of the lasting criticisms of typical approaches to political risk assessment was that most studies were conducted on a case by case basis, making comparison across countries and across timeframes difficult. Cross-national quantitative analysis attempted to correct this by producing a body of research that could identify and define perpetual factors of political risk, thereby allowing objective and generalized models to be created. This newer area of the political risk discipline is the focus of much of the modern state of the art.

These forms of analyses derive objective measures of political conditions from secondary sources of information, such as international yearbooks containing country profiles. From these profiles, factors such as the type of political system, the number and strength of the opposition, the composition of ethnic-religious groups, international alliance commitments and so forth are garnered and compared across countries and against measures of political risk. This allows an empirical testing of the various theories and methodologies of risk assessment, generating a collection of adjacent research that can support or disprove the various approaches to risk assessment. New theories and hypotheses about risk can be

tested in a comprehensive and structured way, using a reservoir of country data that was not available during the 1960s and 1970s.

Broad and general in scope, these methods cannot be directly applied to the specific needs of international investors. This having been said, their findings do have bearing on the methodologies of risk assessment employed by MNCs.

A leading criticism against quantitative methods of risk assessment (listed above under “objective” measures, and not to be confused with the meta-discipline of cross-national analysis) is that they are incapable of including certain important conceptual variables, and this deficiency retards their predictive value. Stevens (1997) addresses this problem in an evaluation of the statistical interrelationships between market and economic variables and foreign direct investment. Using both correlation and regression analysis, he compares the levels of foreign direct investment (the dependent variable) in nine lower to middle income countries against a selection of common indicators (independent variables) used to develop quantitative political risk indexes, namely, gross domestic product, balance of payment equilibrium, external debt, debt service, private interest rate and official interest rate.

If the quantitative approach to a political risk rating scheme were reliable, Stevens hypothesizes, the results of the statistical analysis would reveal a proportional relationship between the dependent and independent variables for the majority of the countries in the study. In other words, the political risk indicators used would have a similar relationship with the level of FDI in each of the countries under inspection. His results do not, however, reflect this. Only a few of the variables show high correlations in a few of the countries, and the same variables show low correlations in the majority of the countries.

Stevens concludes that the “quantitative approaches to political risk analysis almost all suffer from being unable to distinguish the different risks of different industries; they measure only the risk of the country” (Stevens 1997:83). Quantitative methodologies tend to be less meaningful to micro-risk assessments than to macro-risk assessments and are therefore in danger of obscuring potentially lucrative business opportunities.

The study suffers from a fairly common problem encountered when attempting to assess the various risk methodologies: how does one operationalise political risk? Stevens has used FDI as a proxy for political risk, implicitly assuming that the greater the level of

foreign investment in a particular country, the lower the level of risk associated with that country. Such an assumption involves circular reasoning: foreign investment is based upon perceptions of political risk and therefore cannot be used as an accurate indicator of the level of risk itself. FDI, therefore, is only an indication of the collective *perception* of political risk amongst investors, and does not indicate the actual *degree* of political risk in the country. This is a fitting illustration of a point made earlier: quantitative methods (both cross-national theory testing and actual quantitative risk assessments) can produce spurious results and, what is worse, inspire false confidence in those results because of implied mathematical rigour.

2.3.4 A New Approach to Political Risk Analysis

Henisz (2000, 2002) and Henisz and Zelner (1999) suggest a fresh approach to the problem of predicting risk. This method attempts to shift the traditional emphasis on macroeconomic accounting and subjective risk ratings to an analysis of the structure of the political regime, the consequent credibility of policymakers' commitment to a given policy regime, the likely extent of lobbying by affected consumer groups and the affect that this lobbying will have on the operations of the investor²². They advocate the

“[development] of a richer understanding of the links between the structure of a nation’s political institutions, the preferences of the political actors that inhabit them, the level of political organisation of relevant interest groups, and most importantly the manner in which these forces interact to determine the stability of the policy environment and the likely direction of any changes in that environment” (Henisz and Zelner 1999:4).

²² Harms (2002) argues congruently to Henisz and Zelner, postulating that political risk can be explained by group politics and that a state's policy preferences are determined by the ability of different groups to influence policymakers. According to Harms, favourable policies are the result of the influence of actors benefiting from international investments and their interest in supporting ongoing liberalisation. Hostile policies are the outcome of the influence of marginalised actors left out of the process who are determined to secure a share of the benefits for themselves (Léonard 2001:496).

By taking this approach, Henisz and Zelner hope to create a methodology that is more prospective in nature, rather than based on observations of the past behaviour of policymakers. Their focus is on the political and other aims of the various players in the industry and how capable they are of achieving those aims given the structure of the political institutions within which they operate.

To this end, Henisz constructs an index of political constraints with the explicit goal of measuring the likelihood of changes in the policy regime and the resulting stability or credibility of the policy environment (Henisz 2000:1-4)²³. The measure is based upon the number of independent veto points that exist within a country's political system and is derived from a spatial model of political interaction among branches of government²⁴. The index uses data on the number of independent branches with veto power and on the distribution of political preferences across and within these branches. In addition to the executive branch, it considers the legislative, judicial, and sub-federal branches.²⁵

Multiple independent branches of government with veto power over policy outcomes have important ramifications for a country's commitment to an existing policy environment: they restrict the discretion of policymakers to make policy changes. In order to change the

²³ Studies of the credibility and stability of the policy environment were originally based on subjective indexes derived from the opinions of local businesspeople or country experts (see Borner, Brunetti, and Weder (1995) and Knack and Keefer (1995)). The shortcomings of these approaches are that they lack historical consistency, the link between the expert opinions and the political institutions is unknown and the results are not easily generalisable to or comparable with other countries (Henisz 2001:5). It is these problems that prompted Henisz to develop his objective measure of policy credibility.

²⁴ Veto players are defined as individual or collective decision makers whose agreement is required before the status quo can be changed. The theory of veto players was originally developed to act as an analytical tool for all types of political system, regardless of regime (presidential or parliamentary), party system (one-, two-, or multi-party), and type of parliament (unicameral or multicameral) (Tsebelis 2000:441-442). Political systems differ widely across numerous dimensions. In order to come to terms with these dimensions, theorists had constructed numerous typologies and classifications that, according to Tsebelis, were incomparable and had resulted in confusion and parallel debate. Tsebelis' idea was to begin from the final policy outcome of any political game. Working backwards from there, he rationalised that if different characteristics of political systems are important, it is because of the effect that they have on policy outcomes. In order for a departure to be made from the status quo policy, a certain number of actors within the system had to agree to the ringing of the change. This need for agreement, Tsebelis argues, is typical of every system, yet it is the number and nature of the players who must agree that differs from institution to institution. By way of example: in order to change legislation in Greece, parliament (collective player) has to vote a new law. Contrast this with the same task in the US. There the House, the Senate and the President (two collective players and one individual player) have to agree before the law can be passed. Tsebelis's work identifies veto players in different political systems and generates expectations regarding particular combinations of institutional characteristics.

²⁵ For data on the existence of unicameral and bicameral legislatures, as well as sub-federal units with substantive veto power, Henisz relies on the Polity database (available at <http://bsos.umd.edu/cidcm/inscr/polity/index.htm>). Both the ICRG (available from *Political Risk Services*) and Polity databases were used for information on the independence of the judiciary. Data on the party composition of the legislatures comes from various issues of *The Political Handbook of the World* and *The Statesman's Yearbook*.

status quo, the political actors need to propose and sell an alternative policy to each of the independent branches with veto power.

Assumptions are made to simplify the preferences of the actors in these institutions so that a first-stage measure of the viability of policy change can be developed based solely on the number of veto points²⁶. This initial measure is then refined with the addition of data reflecting the alignment of preferences across the various veto points, derived from the party composition of executive and legislative branches of government, and the appointment history of the judicial system. The index is tempered with further data to reflect the heterogeneity within the various legislative branches, which increases (decreases) the decision costs involved in overturning policy for aligned (opposed) government branches (Henisz & Zelner 1999:13)

The distribution of political preferences is important because, if the preferences of the legislature were perfectly aligned with those of the executive, the existence of an independent legislature would not restrict the discretion of the executive in any way. The larger the number of independent veto points and the farther the preferences of these branches from those of the executive, the greater the constraints on the ability of the policymakers to modify regulatory policy, tax policy, or other relevant policies.

²⁶ The political constraints index is limited by its assumptions. Nevertheless, Henisz defends it thus: “[w]hile [the index is based on], admittedly, strong assumptions, the incorporation of more refined and realistic game structures and preference distributions presents severe complications for analytic tractability. It is hoped that ... the strength of the results obtained using the simple framework presented here will provide an impetus for future research” (2002).

The computed index is normalised so that all values fall between 1 and 0. A higher number indicates a greater level of political constraint. Drelichman sums it up concisely:

“... the [index] can be interpreted as the probability that a proposal taken from random from the executive’s sphere of interest doesn’t fall within the range of acceptable policies of one of the veto holding powers. The index takes into account the degree of alignment of the veto holding players with the executive. Clearly, more veto points imply a larger value for the [index], while a larger degree of alignment of a veto point reduces the value of the index” (2000:4).

2.3.4.1 Discussing the Political Constraints Index

Henisz uses his political constraints index to predict the commitment that a government will have to a particular policy. His hypothesis is that institutions with more checks and balances will reduce volatility in the policy regime by limiting the ability of political actors to pursue short-run political or social objectives that favour one group over another (Henisz 2001:7). Where multiple independent veto points exist, biased actions are more likely to be exposed in public debate or successfully opposed within the political institution by another actor representing the disadvantaged group.

Using cross-national data on fiscal policy drawn from 172 countries over periods up to 39 years (1960-1998), Henisz finds that the countries that ranked higher on the political constraints index have lower levels of policy volatility for capital expenditures, non-revenue, taxes on capital, lower volatility in goods and services expenditures, and lower volatility in subsidies (2001:14-17). These results indicate that the index does reflect commitment to a specific policy regime.

In another study, Zelner and Henisz (2000) demonstrate that the levels of political constraints and of political competition within the industry also influence the quantity of

investment and hence of political risk²⁷. They empirically show that investors prefer countries with higher political constraints when there is significant political competition, because the likelihood of political competitors (industrialists, agriculturalists, producers or other significant actors) being able to lobby successfully for policies that will advantage themselves over the investor is diminished.

On the other hand, lower levels of political constraints are preferred when political competition is weak, because then the decreased opposition faced by the investor will make him or her more able to agitate for changes that act in his or her favour and reduced constraints will make the likelihood of advantageous policy change greater. The tacit implication is that higher levels of political constraints combined with high levels of political competition lead to lower levels of political risk and are therefore more favourable for investment.

This form of analysis represents a move away from the traditional political risk assessment with its focus on security and stability studies or country risk modelling. Viewing political risk as a normal policy outcome adds significant explanatory power and provides *ex ante* insight into the likelihood of hostile policies being adopted (Léonard 2001:496). Analysts are able to monitor the relative influence of different groups and their attitude towards foreign investments, certain industries, or even companies, allowing scope for risk to be assessed at a micro level rather than concentrating on systemic factors that may have little bearing on specific instances of political risk.

Returning to the definition of political risk presented earlier, it now becomes apparent how a definition that includes more sources of political risk can be accommodated. The PCI, with its focus on policy outcomes, includes the various influences that actors in the different environments have on the government. Some of these influences are explicitly part of the computation of the index, such as those of the judiciary and sub-federal bodies. Others are implied. Consider, for example, the lobby actions of competitors in the business environments. These are implicitly included in the index because successful lobbying will

²⁷ The authors do not use the term “political risk” in this particular study, electing rather to discuss the level of investment in the electricity sector. Elsewhere (Henisz and Zelner 1999), they present evidence that they believe demonstrates the existence of a direct relationship between the level of infrastructure investment in a country and the level of political risk, allowing the assumption to be made that, for them, investment is an indicator of political risk itself.

affect the preferences of explicit role players, such as politicians of the upper or lower house.

The PCI, therefore, neatly incorporates the various influences on policy making. The manner through which policy affects the business environment and the firm must be explored through an analysis of the political economy of the sector of interest.

Investors in the electricity sector in India, it will be shown, are faced by a large degree of political competition from, amongst others, agriculturalists, consumer unions, labour, environmentalist lobbies and even political parties. India, too, registers relatively highly on the political constraints index in question. The findings of Zelner and Henisz (2000) would predict that the Indian electricity sector would be a preferred destination for investment, given the huge market potential and the stated intentions of the government to attract foreign participation. Yet investors have increasingly shied clear. Thus far, it would seem, for good reason²⁸.

Consider once more the definition of political risk: it is a measure of the probability of change in the operational environment of the firm as a result of the political process. In certain circumstances, the absence of the possibility of change predicted by a low risk rating may be detrimental to the firm if that change is necessary to protect the firm's profits.

This assignment, therefore, suggests an alternative interpretation for the index of political constraints. If more veto points and non-aligned political preferences make it more difficult to change policy, it follows that the index of political constraints is also a measure of status-quo bias. When reform of economic institutions, particularly politically important ones, is required, a strong status-quo bias will tend to work against change. Thus a disabling initial policy environment will tend to be propagated. From this perspective, it would seem that political constraints tend to prohibit positive policy change, thereby increasing or propagating the possibility of the loss of the operation's profits.

²⁸ See the discussion on economic reform in the electricity sector below.

2.4 Conclusion

Although private investment in infrastructure has grown significantly since the beginning of the nineties, infrastructure investors are still subject to potentially damaging political risks. After direct investment has occurred, the investor suffers a rapid alteration in bargaining power, allowing the host government more leeway to renegotiate the original terms of investment. Modern trends towards democratisation and the characteristics of infrastructure investment increase the incentive for sovereign governments to behave opportunistically. These arguments help to explain the existence of political risk in infrastructure projects and indicate why political risk assessment is an important component of the investment decision.

Various methods of assessing political risk have been developed and used since the inception of the discipline, although each has relevant strengths and weaknesses. Recently, a new approach has been suggested that is based on an index of policy constraints that attempts to measure the ability for political groupings to influence policymaking.

It will be argued beneath that it is only with an understanding of the initial policy regime that the political constraints index in question becomes useful. The next section of this assignment will discuss the Indian policy environment, the state of reform in the economy and the current issues faced by the electricity sector, before comparing the constraints index for India with occurrences in the policy regime. From this comparison it will be shown that the predictions of the index remain true, though the policy stability it predicts may not be beneficial to the investor.

3 THE POLITICAL ECONOMY OF THE INDIAN ELECTRICITY SECTOR

3.1 Introduction

The economic reforms that took place in India from 1991 were part of a seismic shift that moved the focus of Indian economics from state-led growth towards an open, externally oriented and market dominated economy. The reforms were a swift departure, both in policy and in intent, from the economic stance of the previous 40 years.

To understand this swing in Indian economic thinking, it is useful to consider both the actors in the political economy and the exogenous and endogenous factors that have influenced the reform process since its inception in the nineties. This chapter begins by briefly describing the federal structure of India, its bicameral legislature, the political dynamic that underlies the interaction between the federal and state governments and the country's primary political groupings. Such background information sets the scene for the discussion of the political economy of reform to follow.

The chapter then charts the progress of general economic reform in India, considering internal and external economic and internal political factors that have helped to keep the 1991 reforms on track. It assesses the general pace of reform and embarks on a focused discussion of reform under the incumbent Indian government (led by the Bharatiya Janata Party), highlighting how political opposition from within and without the party has complicated the reform process and slowed its progress. What is also noted is the large number of opportunistic actors in the Indian political sphere and their impact on the ability of incumbents to effect change.

Lastly, Chapter 3 focuses its attention on the state of the Indian Electricity Sector and the need for sustainable reform. It considers the problems left behind by the state-led development schemes of the past, the reforms that have been attempted since 1991, the disastrous Enron affair, opposition to tariff restructuring and the newly passed Electricity

Bill. The story of the halting progress of reform in the electricity sector provides material for the assessment of the Political Constraints Index to follow.

3.2 The Political Profile of India

3.2.1 Overview

India, a “Sovereign Socialist Secular Democratic Republic”, is a union of states with a Parliamentary system of Government²⁹. The multi-ethnic and multi-religious federal republic is comprised of 29 states and 6 union territories, with its capital situated in New Delhi. The country has a bicameral parliament, including the indirectly-elected Upper House, or Rajya Sabha (government assembly) and the directly-elected Lower House, or Lok Sabha (people’s assembly). The Judiciary is largely independent and the legal system is a derivative of English common law.

The country’s basis for governance is its Constitution, which was adopted by Constituent Assembly on the 26th of November 1949, and enforced on the 26th of January 1950. The Constitution governs the sharing of legislative power between Parliament and the State Legislatures, and provides for the vesting of residual powers in Parliament. The power to amend the Constitution also vests in Parliament.

3.2.2 The Union Government

The Union Executive consists of the President, the Vice President and the Council of Ministers, which is led by the Prime Minister to aid and advise the President.

3.2.2.1 President

The President is elected by members of an electoral college consisting of elected members of both the House of Parliament and the Legislative Assemblies of the states, with votes suitably weighted. The Presidential term of office is five years.

²⁹ The following resources were used to compile this summary of the Indian political structure and important political groupings: Economist Intelligence Unit Country Risk Report (2003:4), Indian Embassy (2003) and Sridharan (2002:55-76).

Among other powers, the President can proclaim a state of emergency in the country if it is believed that the country's security or that of any of its territories is threatened by war, external aggression, or armed rebellion. At the event of the constitutional machinery of the state failing, the President can confer any or all of the functions of government upon him or herself.

3.2.2.2 Vice-President

The Vice-President is elected in a similar fashion to the President and also holds office for five years. The Vice-President is Ex-officio Chairman of the Rajya Sabha (see below).

3.2.2.3 Council of Ministers

The Council of Ministers, comprised of Cabinet Ministers, Ministers of States, and Deputy Ministers, is the body responsible for issues relating to the administration of the affairs of the Union and for legislative proposals. It is the function of the Prime Minister to communicate all decisions made by the Council to the President. Generally, each department has an officer designated as Secretary to the Government of India to advise Ministers on policy matters and general administration. The Cabinet Secretariat has an important coordinating role in decision making at the highest level and operates under the direction of the Prime Minister.

The Legislative of the Union, called Parliament, consists of the President, Rajya Sabha (Upper House) and Lok Sabha (Lower House). All legislation requires the consent of both houses of parliament. However, in the case of money bills, the will of the Lok Sabha prevails.

3.2.2.4 Rajya Sabha

The Rajya Sabha consists of 245 members. Of these, 233 represent states and union territories and 12 members are nominated by the President. Elections to the Rajya Sabha are indirect; members are elected by the elected members of Legislative Assemblies of the concerned states. It is not subject to dissolution; one third of its members retire every second year.

3.2.2.5 Lok Sabha

The Lok Sabha is composed of representatives of the people chosen by direct election on the basis of universal adult suffrage. Currently, the Lok Sabha consists of 545 members with 2 members nominated by the President to represent the Anglo-Indian Community. Unless dissolved under unusual circumstances, the term of the Lok Sabha is five years.

3.2.2.6 State Governments

Each state has its own government that operates according to a system closely resembling the Union's government system.

3.2.2.7 The Political Dynamic

Thirty years ago, state politics in India consisted of coalition governments of convenience collapsing with alarming rapidity, forcing frequent elections. Parties seldom featured for long periods on the political scene. More recently, states have shown remarkable patterns of stability. The trend has been for more and more state governments to complete their full five-year terms. Moreover, the states have weathered not only the era of their own chaotic politics but also efforts to centralize power in New Delhi; India has moved toward a more genuine federal system. Chief Ministers now actively compete with each other – and with New Delhi – for investment from India and abroad (Sridharan 2002:66-67).

Many states now have two-party (or stable two-coalition) or three-party systems. The dynamics of state politics and its relationship to political dynamics in New Delhi play an important role in deciding which parties form coalitions and with whom: the pattern of opposition in the state determines what alliances are possible for the national election. Personal rivalries of party leaders also play an important part in coalition formation (Sridharan 2002:65-68)³⁰.

This dynamic has led to the shifting of power to the state governments and regional parties, making national coordination on macro policy increasingly difficult. As will be elaborated beneath further, fiscal consolidation in general and subsidy reduction in particular are

³⁰ Sridharan (2002) provides an articulate discussion of the trends and transformations in India politics during the nineties, particularly the eclipse of the one-party dominant system that typified post-independence India and the advent of what he calls the "era of coalition politics".

hampered when the national government relies on the support of powerful regional parties with parochial allegiances to interest lobbies (Bardhan 2003:6).

3.2.3 Important Political Parties and Groupings

3.2.3.1 *The Bharatiya Janata Party (BJP)*

The BJP, originally founded in an earlier incarnation as the Bharatiya Jan Sangh in 1951, leads the ruling National Democratic Alliance (NDA). The party is considered to be “Hindu nationalist” and is the political wing of a group of interconnected cultural and religious movements – the Sangh Parivar – of which the most politically significant is the Rashtriya Swayamsevak Sangh (RSS) (Economist 2002). The BJP’s attractiveness and strength have come from its reputation, somewhat sullied in recent years, for integrity and party discipline. It is one of the two parties in the country that has both national reach and national ambitions.

The BJP first emerged as a significant force in the 1989 general election, winning 88 seats on the back of a religious issue – the construction of a Hindu temple in Ayodhya, Uttar Pradesh. In the 1991 election, the BJP took four states and became the national opposition. Its first national government was formed in May 1996, led by the current Prime Minister, Atal Bihari Vajpayee. It lasted 13 days. In 1998, the party won 182 seats and constructed a coalition of 13 parties, which collapsed in April 1999. In September of that year, the BJP led the National Democratic Alliance to a clear majority 297 parliamentary seats in response to the Congress party’s 134. The remaining 106 seats were taken by non-aligned parties. Vajpayee was elected unanimously as the new Prime Minister and seemed set to rule with a strong mandate. At the time of rising to power, Vajpayee was confident that his government would be able to supply India with electoral stability, something that was needed considering that the country had had six governments since 1996. Recently, however, the coalition has threatened to crumble, putting that promise in jeopardy.

The BJP’s strongest ally is Shiv Sena (SHS), which began in the 1960s as a “sons of the soil” party in Bombay targeting immigrants to the city. It has since become virulently Hindu nationalist. Other allies include the Samata Party (SAP), led by George Fernandes, the Defense Minister, whose strength lies almost entirely in the state of Bihar. It has a

"socialist" ideology, and has joined with two like-minded parties, the Lok Shakti, (LS) of the Commerce Minister, Rama Krishna Hegde, a party confined to Karnataka, and the Janata Dal [United] segment of the Janat Dal (JD).

Other BJP allies from the 1998 election include the Asom Gana Parishad (AGP), a "sons of the soil" Assam-based party; the Shiromani Akali Dal (SAD), the Sikh party in Punjab, where it is the governing party and the West Bengal Trinamool Congress (WBTC).

In the 1999 election the BJP was also allied with the Dravida Munnetra Kazhagam (DMK), the ruling party in Tamil Nadu, a "cultural nationalist" party, originally separatist and with an anti-Brahmin ideology, and with the recently installed governing party of Haryana, the Indian National Lok Dal (INLD).

3.2.3.2 *Indian National Congress (INC)*

The Indian National Congress (INC) ruled India at the national level for 45 of the 54 years since independence. The party's major uncertainty is its continuing reliance for leadership on the Nehru-Gandhi dynasty, now represented by Sonia Gandhi, the Italian-born widow of former Prime Minister Rajiv Gandhi. Although she displayed greater self-assurance and more fluent Hindi on the 2002 campaign trail than during her previous campaigns, her foreign birth could remain an electoral problem. Still, voter reaction to the BJP's record may well overshadow these concerns.

The party currently has far fewer allies than the BJP. The only alliance that could be termed stable is with the United Democratic Front (UDF) in the state of Kerala. The Congress is the inheritor of the Congress movement that brought India independence. It has split many times since 1977 and remains a "catch-all" party accommodating a broad range of ideological and ethnic elements. Its strength is spread over the entire country. Its present allies of convenience include the RJD (Rashtriya Janata Dal), and the ADMK (Anna Dravida Munnetra Kazhagam) led by Jayalalitha in Tamil Nadu.

3.2.3.3 *The "Third Front"*

The "Third Front" is not an alliance, but the parties in it share a "secular" and "socialist" ideology, although differing considerably in their origins and social base. The Communist

Party of India [Marxist] (CPM), led by the octogenarian chief minister of Bengal, Jyoti Basu, is the "left-wing" Communist Party; it has partners in Bengal's ruling Left Front (LF), which includes the Communist Party of India (CPI), now a shadow of its former self. The CPM is also the major partner in the ruling Left Democratic Front (LDF) in Kerala and governs in the small state of Tripura. The Samajwadi Party (SP) is largely confined to Uttar Pradesh; its leader is Mulayam Singh Yadav, Defence Minister in the 1996–98 United Front Government. The TMC (Tamil Maanila Congress) split from the Congress in Tamil Nadu in 1996 and won overwhelmingly in partnership with the DMK, but lost badly to the ADMK-BJP alliance in 1998. The NCP (National Congress Party) is only three months old. It is led by Sharad Pawar, a former chief minister of Maharashtra and its strength is almost entirely in that state.

In a class by itself is the BSP (Bahujan Samaj Party) led by Kanshi Ram. Largely confined to Uttar Pradesh, it has succeeded in mobilizing the support of the *dalits* and other "underclass" social groups, and it speaks of "equal justice"; its ideology, however, is secondary to its willingness to bargain with the other parties for benefits for its constituency.

Some of the Third Front parties once had some national presence, but most wield serious power in only one or a handful of states. This includes the CPM, which is a serious presence only in West Bengal, Kerala, and Tripura.

In general, Congress and Janata Dal are considered to be centrist parties while BJP is termed a rightist party and CPI and CPM are leftist parties. Earlier, Congress had its support from Muslims and Scheduled Castes and Tribes. Recently it seems as though their support for Congress has been diminishing.

3.3 Economic Reform in India

3.3.1 Two Separate Reform Periods

Undoing years of state-organised economy is not an easy task and, for some, the staying power of the Indian reforms process is surprising (Jenkins 1999:1). In India there are powerful groups and individuals with vested interest in maintaining the status quo.

Bureaucrats, political elites and particular members of the private sector have traditionally gained from their privileged positions; not only financially, but in terms of influence as well. In theory, democracies should increase the problems associated with implementing reform (Jenkins 1999:2). Farmers fearing the loss of subsidies, protected industrialists fearing foreign competition and party leaders fearing the loss of electoral spoils are able to unite vertically with voting blocks to oppose reform.

Early attempts to modernise the Indian economy under Rajiv Gandhi in the 1980s spoke of such difficulties. These adjustments met with failure, despite the fact that the Gandhi government ruled with a relatively strong mandate by conventional standards. His Congress party was elected with 77 per cent of the seats in the Lok Sabha, the largest share of parliamentary seats in Indian history. Yet, after three years, reforms were summarily dropped in favour of the more comfortable state-led development schemes.

In contrast, the government in power during the inception of the massively more successful 1991 reforms, P.V. Narasimha Rao's Congress government, was comparatively weak, garnering only 226 of the 507 parliamentary places. Despite this weakness, the reform process initiated in 1991 is still in existence today and, according to some commentators, is irreversible (Josiam *et al* 1999:78).

3.3.2 Factors Affecting Reform

3.3.2.1 Internal and External Economic Factors

The comparative success of the 1991 reforms can partly be explained by the very different circumstances experienced by the Rao government. The increasing significance of globalisation had transformed the international political economy and demonstrated the opportunity costs of non-reform. Countries that had previously followed state-led development schemes began to allow market forces to have greater impact on their economies. China, Taiwan, Japan, Singapore, Thailand, Malaysia and Korea shifted their focus towards export markets, attracting foreign investment and placing themselves in the global production chain of multinationals. Faced with increasingly stiff competition, India found that its share of world trade fell from 2.4 per cent in 1947 to 0.4 per cent in 1990 (Mukerji 2002:4). It was soon apparent that India was falling behind.

Internal and external considerations play an important part in explaining why the direction of the 1991 reforms was maintained. Financial liberalisation had happened years earlier. The resort to foreign finance during the eighties allowed the country to fund current account deficits and to run large fiscal deficits. India's external debts nearly doubled from around \$35 billion at the end of 1985 to \$69 billion at the end of 1990 (Cerra & Saxena 2002: 402). In the years prior, Indian internal politics had become highly competitive and the Congress party had increasingly used contributions from the fiscus to ensure electoral success. Financial liberalisation was a useful tool and comparatively easy to implement: foreign borrowing allowed for the deficits needed to fulfil electoral promises, while not harming any politically significant interest groups.

In such a manner, international resources generated through financial liberalisation were used for short-term electoral interests, rather than long-term growth creating investment. As more foreign funds were borrowed, the leverage of international financial institutions over the Indian government grew, bringing with it growing external pressures for more widespread economic reform. Furthermore, development aid became harder to acquire and development agencies began publishing strong statements that their borrowers would have to increasingly seek funding from international capital markets for their financing needs. Lastly, the increasing global importance of portfolio investment and foreign direct investment created incentives to deregulate industries and thereby attract international capital (Dubash & Rajan 2001a:52). In these ways, pressure mounted to reform Indian economic policy and to make it more congruent with global economic trends.

By the end of 1990, India was increasingly vulnerable to external shocks as a result of its rising current account deficits and significant reliance on commercial external financing. In 1991, the catalyst that sparked the reform process came: a balance of payments crisis that resulted in a reduction in the country's bond rating in international credit markets, limiting the country's scope to use short term external borrowing to address the shortfall on their current account (Deardorff *et al* 2000:2, Dubash & Rajan 2001b:9). The crisis was reflected in the foreign exchange reserves, which amounted to little more than \$1 billion and were only sufficient to fund three week's worth of imports (the prudent level of reserves is generally accepted to be about three month's worth). It had been further exacerbated by the

Iraqi invasion of Kuwait the previous year and the subsequent loss of two export markets and the rise in spot oil prices (Rajaraman 1992:1, Cerra & Saxena 2002: 403).

For the reformists, the crisis was opportunely timed. Coming at the end of a moderate recession and combined with existing external and internal considerations, it resulted in considerable pressure to deregulate, or even privatise, an army of industries that had been carefully controlled by a state bureaucracy for close to half a century of democratic governance.

Changes were undertaken to address serious problems in the country's economic fundamentals (Deardorff *et al* 2000:2). In response to the balance of payments crisis, a programme of macroeconomic stabilisation was introduced that involved the reduction of fiscal deficit, control of the money supply, and correction of the overvalued rupee by means of a significant devaluation. It became widely accepted that India had to transform herself into a competitive economy, and the government of the time, led by the Congress Party, sought to do this through liberalisation in key sectors (particularly electricity), the reduction of licensing restrictions on industry, the lifting of government controls on the financial sector and partial emancipation of currency transactions.

3.3.2.2 Internal Political Factors

The internal dynamics of competition amongst Indian political parties also helps to justify the continuation of the 1991 reforms, despite the relatively weak position of the incumbent government. Rao's ascendancy to power in June 1991 marked the end of a time of considerable domestic turmoil. The previous government, headed by the Janata Dal, had fallen amidst a morass of caste and religious rioting, leading to great political uncertainty and ultimately the assassination of Rajiv Gandhi (Cerra & Saxena 2002: 403). The country was still reeling from this furore when Rao's administration took office. No party wanted to be seen as destabilizing the new government at a time of economic crisis as it was generally accepted that the electorate was willing to allow the government time to address the country's economic problems (Rajaraman 1992:1).

With these circumstances in mind, opposition parties introduced cut motions into parliament to provide the opportunity for debate on specific budgetary provisions that they

anticipated would be unpopular and undesirable. After giving the government a rhetorical lambasting in parliamentary debate, the opposition never united to pass their motions for fear of bringing down the minority government. Rao was allowed some breathing space.

There were also tactical reasons behind the opposition parties' desire to avoid bringing the downfall of the Rao government. Indian election campaigns are expensive and two campaigns had just been run in less than twenty months. A recess was needed to replenish the campaign coffers. In addition, each party wished to increase and to consolidate its popular support to improve their positions after the indecisive 1991 elections. The opposition anticipated that the Congress would be compelled to implement austerity measures that would erode its support (Dubash & Rajan 2001a:53). They surmised that, with time, the party would dig its own grave.

Contrary to expectations, the Congress grew more popular as it implemented its early reforms. This was dramatized by the November 1991 by-elections, in which the Congress won eight of fifteen parliamentary seats with Rao winning by the extraordinary margin of 580,000 votes (Dubash & Rajan 2001a:53).

Paradoxically, the weaker government of Rao succeeded where Rajiv Gandhi's stronger mandate did not. External factors like increasing globalisation and associated pressures and the internal instability of the early nineties help to explain this phenomenon.

3.3.3 The Progress of Reform

3.3.3.1 Direction of Reform Maintained

Since 1991, the direction of reform has been generally maintained, or at least paid lip service to, despite considerable political obstacles which have caused the pace of change to be somewhat erratic. There is a certain level of agreement between the BJP and Congress on matters economic. A good example can be taken from the period surrounding the fall of the BJP government after losing a vote of confidence and prior to the 1999 general elections³¹. After the fall, Congress failed to put together an alternative ministry and left

³¹ India's recent political history indicates that coalition failure is not only possible, but also a regular occurrence: in 1999, the BJP-led government lost a vote of confidence by one vote in the Lok Sabha, necessitating fresh elections, and two

suspended a critical piece of government business that had been tabled before the vote was taken: the passage of the Union budget that had been introduced to considerable acclaim in February of that year.

Legal requirements stated that the budget had to be passed by the Lok Sabha that was about to be dissolved. Even though the opposition had objected strongly to certain provisions, the budget was passed within a week, after some careful negotiation by all the parties and some minor changes (Rediff 1999, Asia Times 1999). A host of bills affecting the economy and other matters were left to die with the government (the business community mourned the loss of at least some of them).

This shows up a strange paradox. Parties that had been at each others throats a few days previously were able to pass the budget, one of most contentious documents in any regime. A primary reason is that democracy and democratic procedure in India has become second nature to all: it would be literally unthinkable for even a quite venal and irresponsible politician to hold up a constitutionally necessary step. But the other reason is more prosaic: the BJP, the Congress, and many parties of the United Front had come to accept an economic program that differs in significant but not fundamental ways (Kux 2002:102).

The agreement on fundamental economic policy among the parties, quite apart from the necessity of passing the budget, is clear. The general direction of the economic reforms instituted in response to the crisis of 1991 – though there had been early moves in that direction over the previous decade – have essentially been accepted by everyone except the left wing, represented mainly by the CPM. Even the socialist parties believe in measures such as privatization of public-sector undertakings (though not of the nationalised banks). This suggests that the reversal of the general direction of reforms is now a non-issue.

3.3.3.2 Opposition has Slowed Reform

The example presented in preceding paragraphs must not be taken to mean that parties are in agreement about the individual content of reform, or above opposing particular reforms to win political ground. Despite moments of cooperation at crucial junctures, the nature of

other governments in the three years prior to that collapsed due to the difficulties of keeping coalitions of diverse, not to mention venal and opportunistic, politicians together.

India politics has caused political actors to behave like mercenaries. Between 1991 and 2000 there were five general elections in India and five prime ministers at the central level alone. Each time power shifted from the ruling party to the opposition (Ruffin *et al* 2003:671). Parties that have been voted out of power have been known to curry political favour by opposing reforms that they themselves had initiated.

In 2002, for example, the Congress party opposed the liberalisation of India's print media industry, even though they had begun the process themselves amidst controversy almost a decade previously. Congress was not the only in opposition. An assortment of smaller parties, some of whom support the BJP's coalition government, also registered their disapproval (Shahin 2002)³².

The episode underscores the capricious nature of India political parties and the difficulties coalition governments experience in cobbling together support for any particular change. Reform has been a slow process and the examples given above show that the exigencies of day-to-day politics in India are a primary reason for this³³. As the country has become increasingly inclusive of hitherto subordinate groups and minorities, the need to find a common ground acceptable to disparate factions has become more urgent.

India's political battlefield ensures that there are few assurances that commitments made by one government or leader will be adhered to by successive ones, or even by the initiating regime itself when under pressure (Bardhan 2003:5). In India, political parties seldom stick to their election promises, particularly economic ones. As Kripalani (2002:1) notes, development and reform are issues that have yet to win an Indian election.

3.3.4 The BJP and Economic Reform

When the BJP came to power in 1999, general opinion seemed to indicate that the new government was unlikely to alter or reverse the direction of the 1991 reforms for the

³² Some of the arguments presented in this assignment (such as this one) are supported by examples that show resistance to reform in other industries and sectors. This is not to say that reform in these other sectors is required or necessary (the needs of these sectors are outside the scope of this assignment). The examples are used to demonstrate how the reform process can be impeded in general by the activities of political groups, with the implication that similar opposition can be expected in the electricity sector where, as will be shown, reform *is* in the best interest of the investor.

³³ A number of comments have been made in the literature and the press concerning the slow pace of reform. See, for example, Kux (2002:101), *The Economist* (2001), *Asia Monitor* (2002), and *Asiaweek* (1998). The pace of reform is discussed with reference to the BJP government in the section to follow.

foreseeable future, even though the party had campaigned on anti-liberalisation platforms during the 1996 and 1998 elections (Jenkins 1999:3). There was little reason not to believe the BJP promise to pursue economic reform through national consensus, and the party reinforced the view that it would continue the opening of Indian markets by actively encouraging foreign investment in core sectors, notably infrastructure. The BJP also agreed to honour all WTO obligations made by previous governments and stated that they would not abrogate any international treaties. Party leaders took effort to distance themselves from their campaign rhetoric and their earlier insistence on a *swadeshi* economy³⁴.

3.3.4.1 Internal and External Reform Resistance

Yet, despite these promises and wide consensus across parties in New Delhi about the necessity of economic change, the political reality of Indian coalition governments that the BJP faces is that reforms often need dilution in the interests of maintaining alliances. This in part explains why the process has occurred so slowly since 1991. In particular, controversial reforms, such as state sector privatization, tend to act as partnership breakers (Kripalani 1999). The era of multiparty coalitions that has dominated Indian politics since the Congress Party's 1996 government has regularly sacrificed reform for the more pressing issue of political survival.

Since 1991, for example, successive governments have promised but failed to open the telecommunications industry to foreign investors (Devraj 2002). Left-leaning members of the BJP coalition have shot down plans to raise local phone call charges and to lower prices for long distance calls, drawing out the reform process interminably. Reforms that have been undertaken have often seemed half-hearted.

In 2001, the government watered down its strategy to privatize the inefficient, state-owned firm Air India. Of the 40 percent of the carrier earmarked for sale, it was decided that foreigners would only be allowed to purchase 26 percent of the total. Additionally, Indian nationals were required to hold two-thirds of the airline's board and to serve as chairman and managing director. The residual government control did not rest well with private investors (Asia Pacific Bulletin 2001).

³⁴ "Swadeshi" loosely means "made in India". The term is a reference to a form of economic nationalism first advocated by Mahatma Gandhi during the anti-colonial independence movement.

Furthermore, despite fiscal austerity being a cornerstone of the reforms, the current government has seen public expenditure balloon. At the end of fiscal year 2002/2003, the consolidated budget deficit of the central and state governments was between 9 and 10 per cent of GDP, one of the highest in the world for a major economy (South Asia Monitor 2003). Expectations are that 2003 will see the budget deficit once more exceed its target (South Asia Monitor 2003). The downsizing of the expensive central bureaucracy has proved impossible, even though Vajpayee himself has intervened.

The halting progress of reform has been noticed by outside agencies. In August of 2001, two credit rating agencies, Moody's and Standard and Poor's, downgraded their ratings on Indian creditworthiness because of poor progress on economic liberalization (Asia Pacific Bulletin 2001:1). Standard and Poor repeated their downgrade in 2002, once more citing as a key reason the stalling reforms programme of the government.

The reform agenda is far from finished: at the end of 2002 there were at least three major bills that had been waiting for parliamentary approval for over a year, despite each of them being crucial to their respective areas. One of these was the Electricity Bill (Srinivasan 2002).

It would seem that, since the inception of the reform process in 1991, the politically palatable reforms have been passed, while the more controversial ones have been delayed and avoided, ultimately endangering the entire procedure. Rao, for example, made the bulk of his changes through administrative orders alone; Vajpayee has had to go to the legislature for his, requiring extensive political bargaining that a government fighting for re-election may be unwilling or unable to do. Reform has become more difficult as the process has progressed.

Leftwing parties, trade unions, non-government organisations, the bureaucracy, and, recently, even elements of the BJP itself have opposed reform since the party took office (Devraj 2002). Compared with the Rao era, Vajpayee's government seems to have little central thrust for reform. Manmohan Singh, Rao's Finance Minister, provided earlier thrust by forcing budgetary changes to cut down on government spending (Iyer & Bhattacharjee 2002).

Vajpayee is the only figure with the necessary stature to enact reforms and speculation is brewing that he will find himself isolated, along with his reformist colleagues, such as Privatization Minister Arun Shourie and Finance Minister Jaswant Singh (Kripalani 2002).

The rightist backers of the BJP, the Rashtriya Swayamsevak Sangh (RSS), have felt particularly disillusioned by the BJP's post-electoral abandonment of the *swadeshi* principle and its business friendly policies, stating that a "foreign model" of economic growth was unacceptable and publicly criticising the "urban-based, high energy-consuming, labour-displacing and ecologically-destructive Western model of development" that they allege the Vajpayee government is pursuing amidst pressure from the International Monetary Fund (IMF) and a cadre of Indian capitalists (Devraj 2002)³⁵. These BJP militants are broadly regarded as both anti-Muslim and anti-reform (Kripalani 2002).

The RSS is an influential and vocal group. Through its affiliates, the Swadeshi Jagran Manch (Forum to Protect Self-reliance) and the Bharat Mazdoor Sangh (Indian Workers Union), it has opposed plans to raise the limit of FDI in key sectors such as oil as outlined in a government paper. A third RSS affiliate, the Bharatiya Kisan Sangh (Indian Farmers' Union), has warned that the present government was going the way of the 1991 Rao government which, they contend, was voted out of power because its reforms were seen to concentrate wealth in a narrow crust (Devraj 2002). They have used protests in the capital to express their distaste.

Vajpayee might have been able to disregard the nationally-televised diatribes of the RSS and its affiliates if similar views were not held by other members of his multi-party coalition. Disinvestment, widely considered to be a crucial part of the reform process, has been criticised internally because it allegedly advantages powerful business groups in the name of gaining "strategic partners" in key state-run sectors. Proponents of the scheme point out that of the 232 state-run firms, which have a combined worth of more than \$33 billion, almost half are losing money (Basu 2002).

³⁵ The relationship between the RSS and the BJP is an old one. The BJP began under the political auspices of the RSS. Additionally, both parties are members of an umbrella organization known as Sangh Parivar. Some Indian observers, including the leading news magazine India Today, go so far as to call the BJP a "front organization" for the RSS. Many BJP leaders, including Prime Minister Vajpayee, are former RSS members, and some openly support the RSS. Home Minister L.K. Advani provoked a storm of controversy in October when he attended the RSS's 75th Anniversary celebration near Agra and declared, "The RSS exercises moral influence on the government and both Prime Minister Atal Bihari Vajpayee and I share a historical bonding with it." (Myers 2001:7-9).

The pace of disinvestment has reached unprecedented highs under Arun Shourie's leadership: the privatisation minister was able to raise US\$1.4 billion through divestments over a single five month period in 2002, compared to an intake of only US\$5 billion over the previous 10 years (Basu 2002). Despite these successes, opponents of reform, including BJP allies, have requested his removal. Internal resistance has come from four high profile ministers from the ruling coalition government in India, namely the IT and Telecommunication Minister Pramod Mahajan; the Minister for Petroleum Ram Naik; Defence Minister George Fernandes (who also leads the Samata Party, a current BJP coalition ally); and the Minister for Fertilizers and Chemicals, S. S. Dhindsa. Pressure from these cabinet ministers has forced Vajpayee to put on hold sales that may have fetched the government, according to a strategy outlined in parliament, an estimated \$10 billion in the current year (Basu 2002).

Objections are typically similar: divestments should benefit the ordinary Indian by improving competitiveness and eliminating monopolies³⁶. Offering state-run companies to large private investors will work against this, the ministers argue. It should be noted, though, that these particular politicians happen to have vested interests in the industries in question. The cash-rich publicly owned companies in the fields of telecommunications and petroleum, for example, provide convenient vehicles for political and financial patronage.

Shourie himself sums up the situation as follows: "The disinvestment program has run into a spot, I don't want to hide from that. The difficulty is that in a fragile and fractured polity and legislature, squalls of this kind can make all the difference" (Basu 2002). Despite the resistance, commitment to disinvestment by the BJP has remained strong. The party's spokesman, Arun Jaitley, assures that "the recent disinvestments were a success story of the government and will continue" (Basu 2002).

Further evidence of the opposition to reform amongst BJP allies was the removal of the Union Minister of Power, Suresh Prabhu, in August of 2002. Prabhu, was asked to resign by the Shiv Sena chief Bal Thackeray so that he could "do more party work" (IPG

³⁶ George Fernandes requested a complete review of the divestment policy after the powerful Tata group bought up the international long distance company Videsh Sanchar Nigam Limited (VSNL) and the Reliance group acquired Indian Petrochemical Company Limited, alleging that these sales would create monopolies by preventing other public sector corporations from bidding and by preventing the participation of retail investors.

2003:37, Alvares 2002). Prabhu had been a central driving force of the reforms initiative, launching the Accelerated Power Development and Reforms Programme last year and introducing the new Electricity Bill of 2001 in parliament. His replacement, Anant Greete, is regarded by many as being less aggressive than his predecessor, and some commentators anticipate that the pace of reform may slow further (Alvares 2002). Shiv Shena is a Hindu fundamentalist party and a close ally of the BJP, yet the Vajpayee government was powerless to prevent the Minister's removal (Devraj 2002).

Significant opposition to electricity reform in particular has come from outside the party as well. Speaking at a meeting of the Central Electricity Board in Kolkata, the power minister of the state of West Bengal said that his government will oppose the provisions of the new Electricity Bill in particular as it did not feel that "privatisation of the SEBs will solve the problems in the power sector. There is enough possibility that the SEBs can be revived financially within the government sector, and that is what we are trying to do" (Times of India 2002a).

In Andhra Pradesh, the Congress actively opposed the restructuring of the state's SEB under the ruling TDP party. This restructuring was proposed in 1997 at a meeting of political parties as a first step to the reform of the power sector in the state. Congress, the main opposition in Andhra Pradesh at the time, boycotted the meeting and the smaller parties present rejected the proposal. In the ensuing months, opposition parties launched outreach efforts, contradicting government pro-reform arguments and undermining public support for the suggestion (World Bank 2003).

Vajpayee is standing firm in his moderate position, and has defended the need for privatisation of state-run firms and industries on the grounds that they are loss-making and that the capital raised from sale can be used to boost growth and meet social objectives. In particular, he has singled out the slow pace of reform in the power sector. Yet commitment from the executive is uncertain, as is its political ability to enact reforms. Towards the end of 2002 it was still unclear whether the fragile nature of the ruling coalition and the resistance to reform, both from the BJP's allies and supporters and from members of the opposition camp, would permit the overhaul of sensitive industries.

3.3.4.2 Hope for the Reformists

Recent events, however, have provided some hope that the reform process can be resurrected. A decisive victory by the BJP in the Western state of Gujarat in 2002 may help to strengthen the party and assist its reform agenda. Of the 182 seats being contested in the state-level election, 126 were taken by the BJP. This success in Gujarat, a homeland of hardline Hindu nationalists and a leading industrial area, may help to calm nerves within the ruling coalition regarding controversial privatisations and subsidy cuts and may strengthen Vajpayee's hand (Desai 2002, Dasgupta 2002). With its two-thirds majority in Gujarat's state legislature, the BJP should be able to push through economic reforms in that state. There is even hope that confidence in Gujarat will spill over to the national level and allow federal level reforms to be taken forward.

Interestingly, one of the campaign issues during the elections was the question of power provision in the state, politically significant because of the large number of agriculturalists in the northern part of Gujarat. The Congress party promised a fixed rate of power to farmers in the area, while the BJP insisted on metered supply (Khanna 2002). Despite this, the BJP was able to take victory at the polls by a wide margin. The possibly implication is that, for Gujarat at least, the use of electricity privileges as a political tool is no longer as effective as before.

A second event that may provide impetus for change is the cabinet reshuffle of March 2003 in favour of reformists (Country Report 2003)³⁷. During the rearrangement, privatisation minister Arun Shourie's portfolio was enlarged to include communications and information technology. The party's general secretary, Arun Jaitley, was admitted to government as the new commerce and industry minister. Several reform opponents lost their jobs.

3.4 Reform in the Indian Electricity Sector

Under the Electricity Act of 1910 (prior to Indian independence in 1947) private companies or local authorities supplied more than 80 per cent of the total generation capacity in the

³⁷ The cabinet makeover was aimed at boosting the BJP's appeal prior to 2003 state elections and national elections in 2004.

country (World Bank 1993 in Dubash & Rajan 2001a:52). Independence brought with it the new Electricity Supply Act of 1948, which assigned the duties of generation, transmission and distribution of power to the states. Each state now constructed a vertically integrated state electricity board (SEB) to oversee these responsibilities and, by 1991, the Boards controlled 70 per cent of electricity generation in the country, forming the centrepiece of the Indian electricity infrastructure (World Bank 1991).

Financed through state government loans, the SEBs did not exhibit any form of financial independence from the state energy ministries. Their authority was limited. Under the control of the state governments, SEBs did not even hold sway over the critical tariff-setting function. Furthermore, the central Indian government was responsible for electricity policy, long-term planning, technical analysis, and project approvals through the power Ministry, Planning Commission, and Central Electricity Authority (Ramanathan & Bhatiani 1999:69, Dubash & Rajan 2001a:52).

This arrangement precipitated the energy crisis that was to ensue. Well before 1991, the sector was hamstrung by injudicious agreements with its electricity users and poor management. Possibly the most damaging of these practices was the decision to supply free or highly subsidised electricity to privileged consumer groups, which compounded other technological, institutional and political problems in the sector. This next section will consider the ongoing energy crisis and its possible causes in greater detail.

3.4.1 Problems with Power Supply

In the 1960s and 1970s, two developments began in India, one driven by technology and the other by politics. By the late 1960s, the country had entered a period termed the Green Revolution, and its economy was becoming increasingly dependent on the widespread use of high-yielding crop varieties³⁸. The nature of agriculture was changing: fields that had previously relied solely on rainfall were now subject to significant inputs of water and fertilizer. Farm productivity and profits were significantly increased and in states like Tamil Nadu and Punjab, two or three crops could be harvested each year. Early irrigation projects were large and publicly funded, usually involving surface water resources. As the

³⁸ For a discussion of the Green Revolution and its attendant political and economic consequences, see Frankel (1971).

Green Revolution gathered momentum, however, groundwater pumping on individual farms with electric or diesel pumps became more popular (Dubash & Rajan 2001b:3).

There was (and still is) broad political appeal to irrigation because of the two ends that it serves: guaranteeing food security and increasing the profits of farmers, giving them both the resources and the incentive to organize themselves into influential voting blocks (Monari 2002, Ladejinsky 1970:758)³⁹. In 1967, the Congress party split and, for the first time, the single dominant party model that had heretofore been in evidence was questioned. Regional parties in the South quickly came to power on populist platforms and recovery of these constituencies became an important item on the agenda of the ruling Congress under Indira Gandhi.

The mid-1970s ensured that recovery was no simple task for the Party. The international oil crisis of that decade had plunged the country into high inflation figures and Indira Gandhi was under suspicion of corruption and fighting a lawsuit. Faced with these troubles, a state of national emergency was announced, under which political foes were imprisoned, constitutional rights abrogated and the press placed under strict censorship. Come 1977, the Party was confident of its ability to consolidate its political support. The Emergency was ended and national elections announced. Congress summarily lost these and was forced to relinquish power for the first time in three decades (Dubash & Rajan 2001c:3369).

This set the scene for the first use of electricity subsidies as a political bargaining tool. During the 1977 elections, the Congress-led southern state of Andhra Pradesh offered flat-rate tariffs, which are based on the capacity of the pump rather than on measured consumption, to farmers as an election promise to help Congress get re-elected (Dubash & Rajan 2001b:4).

The strategy migrated to neighbouring states. The non-Congress party in nearby Tamil Nadu (the ADMK) decided to offer free electricity to certain groups of farmers in an attempt to shore up their fragile support after they had narrowly been voted into power. Subsequently, political leaders in Maharashtra, Karnataka and elsewhere began to view power privileges as an effective political tool, partly due to the growing political power of

³⁹ The farmers who benefited the most from the revolution were those whose farms were large enough to justify the investment in an irrigation well. Smaller farmers and labourers did not see the same benefits (Kanel 1974:198). The Green Revolution helped to concentrate power in the hands of the wealthy.

backward rural communities and partly because of the rise of the middle-class farmers' movement. Power subsidies were used as routine political instruments all through the 1980s, especially in agricultural states (Dubash & Rajan 2001c:3369).

Typically, the arguments for electricity subsidies are made on behalf of poorer farmers whose livelihood, it is claimed, would be endangered without free or reduced cost energy. Studies suggest, however, that the main beneficiaries of the concessions are the "kulak" or landed classes, who use the added profits to invest in irrigation infrastructure, using the water to either produce high value crops or to supplement their incomes by selling to other farmers (Sant & Dixit 1996). There may even be popular opposition amongst the poorer farmers to electricity subsidies as such measures can be seen as a way of furthering empowering the wealthy.

Nevertheless, despite the relatively small number of farmers that benefit directly from the subsidies, political parties have struggled to ring changes that might concede electoral territory to the opposition, due to the fragile nature of the political structure of most states and the relative strength and bargaining power of the entrenched lobby groups.

3.4.1.1 Implications

The extent of the subsidy problem is large. The World Bank estimates that electricity tariffs for farmers in India amount to less than 10 per cent of the cost of supply (Monari 2002). This means that the power subsidy for the agricultural sector is about \$6 billion each year – equivalent to 25 per cent of India's fiscal deficit, twice the annual spending on health or rural development and two and a half times yearly spending on irrigation.

A second problem is that flat rate or free electricity has rendered the meter redundant, and existing meters are often no longer monitored, or have even been removed and returned to the SEBs (Dubash & Rajan 2001:53). In Andhra Pradesh (where electricity subsidies were first used as campaign tools) the situation has become untenable. In 1999, the entire agricultural community of 1.8 million electricity consumers in the state had un-metered connections (Narayan 1999:4). Nearly 30 per cent of power generated for the state was

spent on agriculture, yet the power board received only 3 per cent of its revenue from this sector⁴⁰.

Simply put, the cost of maintaining the meters and installing new ones as power was extended to new businesses and communities was too great, considering that the meters themselves served no function. This “de-metering” has increased the financial and organizational challenge associated with the re-introduction of a consumption based tariff, and “re-metering” is likely to meet with popular resistance from a public accustomed to a meter-less society.

The subsidy policies have had spill-over effects in terms of the governance of the SEBs. Poor metering (or even no metering) resulted in highly inaccurate assessments of the quantity of electricity being subsidised. This inadequate knowledge of the electricity load for agriculture created a convenient cover for losses of a politically sensitive nature. As it is tremendously difficult to accurately apportion the quantity of electricity used by farmers, losses due to theft or because of technical inadequacies could be conveniently allocated to agricultural consumption.

Furthermore, the de-metering and subsequent inaccuracy of measurement made it impossible for the SEBs to claim adequate compensation from state governments that had declared social policies of electricity subsidies for agriculture. This meant that these losses had to be borne by the SEBs themselves, even though the parties in power received the political benefit of the donated electricity. To make up for these deficits, many SEBs developed a complex system of cross-subsidies from other areas of their business, typically relying on their industrial consumers to fund the shortfall. Eventually, it became cheaper for industrialists to establish their own generators to supplement or replace SEB electricity. In 1960, industrial consumption accounted for 67 per cent of SEB sales, but by 1991 its share had subsided to 40 per cent (TERI 1993). The end result was that cross-subsidies were insufficient to compensate for the shortfall in revenues.

With their income statements in the red, SEBs began to look elsewhere to break even. Employees of the electricity boards were the first to suffer: staff development budgets were

⁴⁰ This state of affairs has had a devastating impact on the local environment. Agricultural pumps have notoriously low efficiency rates, so agriculturalists use high power motors to compensate. Much energy is wasted as a result. Farmers tend to lift more water than they require, with deleterious effects (Narayan 1999).

cut, real wages became stagnant or even negative and sales per employee were registered as being amongst the lowest in the world (Gutierrez 1993). Staff morale plummeted.

Of the electricity generated, about 21-22 per cent was lost in the process of transmission and distribution (T&D) (IDFC 1998). A significant portion of these losses is attributable to inadequate metering and theft of electricity (Kux 2002:105). The difference between the amount of electricity generated and the amount actually metered is recorded as T&D losses. The concept has become a catch-all accounting measure. Theft is a major problem, although exactly how much occurs is hard to pinpoint. A relatively large proportion of electricity generated is transmitted at low voltages (beneath 11 kV), making theft less hazardous and easier to commit.

As a result of these compounded problems, the SEBs found themselves in an unenviable position: they were facing growing loss-making sections of their business, while driving off their profitable business attempting to cross-subsidise their deficits. Poor training, low wages and the resulting bad morale was leading to bad service and a vicious downwards spiral of financial losses and wage and development cuts.

3.4.2 Power Sector Reform Since 1991

It was in October of 1991 that the Power Ministry began to circulate a number of notifications aimed at encouraging private sector participation in the electricity sector. The India Electricity Act 1910 and the Electricity (Supply) Act 1948 were amended in 1991 to allow private investors to establish generating stations to supply power in bulk with the consent of state governments (D'sa *et al* 1999).

Under these acts, prevailing legislation was radically revised and independent power producers (IPPs) were allowed to enter into long-term power purchase agreements (PPAs) with the SEBs. At this stage in the reform process, the inclusion of private producers was seen as a way of adding additional resources to the state-run industry: privatisation *per se* was not necessarily intended. In fact, the problems in the sector were regarded as the result of capacity shortages rather than the result of the extreme fiscal crises of the state boards. The 1991 amendments were intended to address these shortages, and were never aimed at solving the structural problems in the sector (Upaday 2000:1023).

Significant incentives were introduced to woo IPPs. Government policy allowed for higher debt capital, higher allowance of depreciation charges, and recovery of fixed cost including post tax return on equity of 16 per cent, provided that the plant operated at its rated capacity for at least 6000 hours a year (Sarkar & Sharma 2001:2, Dubash & Rajan 2001b:10).

There were additional bonuses for improved capacity utilisation and a five year tax holiday, a two part tariff (the first to cover fixed costs, including asset return, and the second to allow for variable costs) and counter-guarantees from the central government to cover default by SEBs.

After the amendment of the Acts, state governments followed a competitive bidding route for potential projects. The system that was constructed was clearly intended to attract *foreign* capital, because it allowed 100 per cent foreign equity and insisted that Indian financial institutions not be responsible for more than 60 per cent of the total debt component of any project (Dubash & Rajan 2001b:10).

Initially, there was great excitement regarding the reforms and delegates from the Power Ministry sojourned abroad to brief potential investors in other countries, offering concessions and incentives that were hitherto unheard of in the power industry (D'sa *et al* 1999). A slew of tenders for generation contracts were made; the initial rush saw more than 200 proposals with a combined capacity addition of over 78 000 MW – a total investment of US\$ 80 billion (Upaday 2000:1023). Most of the major global power players were represented, including Enron, AES, Cogentrix, and CMS Energy.

Despite the euphoria, there were rumblings of discontent right from the start (Dubash & Rajan 2001b:11). IPPs were indignant about the bureaucratic delays in obtaining permissions and clearances and were concerned about the recovery of dues from the SEBs. In response to these worries, the IPPs joined together in 1995 under the Independent Power Producers Association of India (IPPAI). This organisation rapidly acquired the role of government lobbyist, taking steps to shape the direction and pace of reform through conferences and workshops and by discussing issues from financing, fuel allocation and regulation, to environmental and consumer concerns.

Central government was not unified over the IPP policy. Support for the reforms came mostly from the Ministry of Power and the Ministry of Finance. One reported view is that

although the IPP policy was “flawed”, it was nevertheless the best option at the time (Dubash & Rajan 2001a:56). Within the Ministries there were voices of dissension and concern that the incentives offered to the foreign investors were so generous that they would result in net outflows of foreign exchange rather than inflows.

Recognising concerns over the speed of implementation and the need for rapid addition to generating capacity, the central government declared eight of the most promising offers as “fast track” projects, granting them expedited clearance procedures and escrow accounts against non-payment of dues by SEBs (Vaghul 1999:8-9). One of these was the Enron Power Project; the other seven were awarded to multinational energy companies such as Daewoo, China Light, Cogentrix Energy, Electricité de France, National Power and STCMC.

Since the end of the nineties, the concept of “fast-track” has lost its relevance. Little has emerged from the plan, and the need to increase the pace of private power generation remains unchanged (IPG 2003:37-38). The eight projects were intended as test cases and were to be cleared as quickly as possible. Despite this, they ran into complex clearance and procedural issues, including fuel and transport linkage impediments, complications over approval of project costs and tariffs, renegotiation of power purchase arrangements, difficulties in negotiating and obtaining the centre’s counter-guarantee and even litigious and political controversy (Sahi 1998:163). The slow-moving bureaucratic procedures and the tedious interaction with both the state level and central governments have stunted the addition of power capacity⁴¹.

Of particular interest to this argument is the pressure investors experienced to accept re-negotiated power purchase agreements after deals had been signed. There are three notable examples involving Enron Power, Cogentrix Energy and BPL Power. The first highlights the danger of underestimating how political change and uncertainty play important roles in energy projects.

⁴¹ The array of clearances that the so-called fast-tracked projects required was bewildering. Some of the statutory ones including cost estimate clearance, techno-economic clearance from the Central Electricity Agency, water availability clearance from the state government, pollution clearance, forest and environment clearance, and rehabilitation and resettlement clearance from the Ministry of Environmental Affairs. Non-statutory clearances included land availability from state governments, fuel linkages from the departments of coal and petroleum and natural gas, transportation clearances from the ministries of railways, and shipping and transport clearances (Sarkar & Sharma 2001:3).

3.4.2.1 *Enron Power*

In April of 1992, Houston-based Enron was invited to bid for a power project to be established in the state of Maharashtra under the company's Indian subsidiary, Dabhol Power Company (DPC). The PPA signed in 1993 between the DPC and the Maharashtra SEB (MSEB) was for 2015 MW power projects, backed by a credible security package including a letter of credit, escrowing of MSEB's cash flows, guarantee from the Congress-led Government of Maharashtra and a counter guarantee from the Government of India (Sarkar & Sharma 2001:4). Both fuel and exchange rate risk were to be limited by permission to pass price fluctuations on to consumers. The deal was completed with alacrity and secrecy, even though it was a sizable investment that amounted to an estimated expenditure of around US\$1.3 billion each year (Dubash & Rajan 2001a:58).

In February of 1995, sensing electoral reverses in upcoming state elections, the government of the day, the Union Finance Ministry and the Ministry of Power acted quickly to provide the necessary clearances to bring into effect the PPA (Sahi 1998:394). In June 1995, a newly elected Shiv Sena-BJP government of Maharashtra scrapped the project alleging high costs and corruption, and proposed instead to invite competitive bids⁴². The Ministerial Review Committee that oversaw the termination of the contract ruled that neither damages nor compensation should be paid. International response was negative and the sustainability and viability of India's reform programme was questioned.

Allegations of under-handed dealings began to surface (Kux 2002:104). Power sector officials were accused of bending laws to accommodate Enron's requests and of sidestepping procedures to obtain the necessary clearances. A Human Rights Watch investigation unearthed evidence of systematic suppression of expression and assembly by the state government and discovered that violence had allegedly been used or threatened against opponents of the project (Dubash & Rajan 2001a:58).

These problems notwithstanding, two months after the cancellation of the project, a new PPA was signed under recommendation of a government committee. The state government requested a reduction in tariff, a cut in project cost, a shareholding stake in the scheme to be

⁴² The BJP had campaigned during the run-up to the elections on a platform of national self-reliance. A central tenet of their manifesto had been the scrapping of the Dabhol project (Sahi 1998:394).

given to the MSEB at face value and complete environmental protection. According to Enron, each day spent in negotiation added approximately US\$250 000 to the company's costs (Sahi 1998:399). The project was revived but, by 2000, had begun to generate severe financial problems for the previously viable SEB. In order to honour its obligation, the state had to buy power from the Dabhol project at twice the average production cost of electricity in Maharashtra.

The MSEB defaulted on its payment in October 2000 due to poor financial health. The DPC followed its contractual provisions, attempting to operate the escrow account and invoke the state and central guarantees, but these were not honoured (Sarkar & Sharma 2001:5). Following an appeal by the MSEB, the Maharashtra Electricity Regulatory Commission (MERC) restricted the DPC from accessing the funds that had been stored in the escrow account, and ordered the company not to instigate any arbitration proceedings against the MSEB. The company eventually invoked its counter-guarantee and dues were settled. Enron officials reportedly mobilised senior U.S-government officials to put pressure on the Indian central government (Dubash & Rajan 2001a:59). Shortly thereafter, Enron's own troubles began to surface and the company put its stake in DPC up for sale.

3.4.2.2 IPP problems

Dubash and Rajan list several of the implications that the IPP policy had for the sector (2001a:56). Firstly, key institutions for long term planning and technical and economic clearance were undermined. The favouritism shown to the investors raised the ire of some government departments and officials, who complained that the playing fields were tilted in favour of the foreign producers.

Secondly, the focus on rapid capacity expansion excluded the consideration of a more rational least-cost planning approach. Thirdly, the projects enabled shady deal making and malfeasance. Projects were not typically selected through competitive bids and purchase agreements were concluded non-transparently, despite their considerable reliance on long-term public financial obligations.

Finally, the IPP policy had a polarising effect on many levels. Early support by members of the middle class and industry became replaced by anger towards public interest advocates

at the perceived obstructionist stance adopted by the latter. Government itself was divided into two camps over the issue: those who saw the policy as the best of a selection of poor options, and those who were vehemently opposed from the start.

As Dubash and Rajan conclude: “technically, economically and politically, the policy created a hangover effect for future attempts at reform” (2001a:57).

3.4.2.3 The Need for SEB Reform

At the heart of the sector’s problems lie the SEBs, sandwiched between the consumer, the power producers and various political forces. Their role is varied from state to state, but they act generally as an intermediate end user, distributing power purchased from other producers or generating it themselves. Low revenue returns prevent the Boards from meeting their operating expenses while allowing for both interest on loan capital and depreciation. A direct cause of the SEBs’ losses is their inability to set their tariffs in accordance with their marginal costs, with the result that the cost of generating power is nearly Rs 1.50 per kWh, while actual average return from the sale of power is approximately Rs 0.96 per kWh (Sahi 1998:97).

The dependence of the SEBs on government has been a considerable contributor to their current predicament. Without sufficient independence in tariff setting, SEBs did not have the financial ability to raise the necessary capital to expand capacity. Government initiatives in the sector were aimed at permitting and attracting private participation to provide the necessary resources, not at restructuring the sector to empower the SEBs to perform this function themselves.

Ironically, private participation will place more pressure on the Boards if the current system is maintained, because the costs of private capital invested in private generation will have to be paid for by the SEBs through the tariffs they impose and the power purchase arrangements they enter into with private investors (Sahi 1998:98). Herein is the crux of the problem for the foreign investor: the State Boards are the sole purchasers of the bulk of privately produced power in the country, yet are financially weak because of their inability to collect revenues, their technical and non-technical losses, and their forced subsidies to the agricultural and domestic markets.

3.4.2.4 *World Bank Reforms*

Although it seemed clear to many in India that the technical, financial and management problems of the SEBs were the root of the electricity dilemma, very little consensus existed on how to unravel the political tangle that impeded their reform. The World Bank entered the fray, using the failing IPP plan as an open door for its 1993 policy for lending to the power sector. This was pioneered in the state of Orissa and later advocated for others (World Bank 2002a).

The Orissa reforms, centred on unbundling and privatisation, were intended to significantly restructure the SEBs and were thus far further reaching than the capacity focused IPP policy. A central part of the state level reform is the establishment of independent regulatory bodies responsible for the rationalisation of consumer tariffs.

The operational performance of the Orissa SEB was the poorest of all the electricity boards in India. This inability to pay for power prohibited investment in the sector, and resulted in a peak demand shortage of as much as 40 per cent in 1995 (Sahi 1998:113). Several factors contributed to this weak financial base, including inefficient capitalisation, low tariffs, poor bill collection methods, and certain state government policies that required it to undertake non-remunerative projects without appropriate compensation.

Orissa's Electricity Reform Act was passed in 1995. As part of the reform programme, the Orissa SEB was unbundled and dissolved and, in 1996, the Orissa Electricity Regulatory Commission (OERC) was established with a mandate to issue and enforce licenses, regulate licensees, promote economic efficiency and safety in transmission, distribution and use, regulation of tariffs, and promotion of competition (Ramanathan & Bhatiani 1999:73). The approach has been to privatise the generation and succession business at the earliest and to privatise the transmission business at a later stage⁴³.

The selection of Orissa as the testing ground for reform was facilitated by the state's low levels of political mobilisation and its low national political profile. With a small

⁴³ The model chosen by Orissa was one of five suggested by the central government to reform the SEBs and to make them financially viable. Each model has its differences, but all propose the establishment of independent regulatory commissions to increase the pace of tariff revision and to hand power distribution over to private entities (Sahi 1998:108). The models deal with the future of the SEBs differently, some advocate their complete withdrawal from the sector, some their corporatisation, and others their unbundling.

dependence on electricity in the agriculture sector, Orissa's farmer lobby was weak⁴⁴. This meant that tariff increases, which have inherent political and social implications, were easier to pass. This is vastly more difficult to achieve in other states where the agricultural sector relies heavily on government subsidies given through SEBs.

Despite the lack of political opposition to tariff reform, the international consultants contracted by the World Bank to advise the unbundling did have political issues with which to contend, for example minimising layoffs to avoid union opposition⁴⁵. They were also responsible for electing a single buyer system for Orissa based on their assessment that the commercial, institutional and technical capabilities in the state were insufficient to support wholesale competition (Dubash & Rajan 2001:58).

Since Orissa's unbundling of its SEBs, other states, such as Haryana, Andhra Pradesh, Karnataka, Rajasthan and Uttar Pradesh, have followed suit, using mildly adapted strategies (D'sa 1999).

3.4.3 Opposition to Tariff Restructuring

Opposition to tariff restructuring has been a consistent problem in the sector and the resulting lack of political will to adjust tariffs has contributed to the financial difficulties of the SEBs. Electricity provision is a subject of the concurrent list, meaning that, constitutionally, both the states and the Union have authority over how prices are set. Each state can fix its electricity tariff according to its requirements, but this has led to several problems for the Union government in opening the power sector to foreign and private investment. To resolve these problems, uniformity in pricing is being devised across the country. The sensitive nature of power tariffs and the way that they have been used as political implements makes the states hesitant to accept a centrally decided electricity rate. This in turn makes it difficult to decide upon a rational and sustainable electricity tariff and vocal groups within states are inclined to oppose attempts at realistic tariff restructuring.

⁴⁴ Agriculture consumes only 6 per cent of the state's power supply (Sahi 1998:128).

⁴⁵ Current labour policies in India are not conducive to retrenchment. The need to retrench is likely to increase in the future, as Orissa reforms are adapted and applied in other states. The issue of job loss will become an increasingly important element of how the Orissa model is accepted and changed by other states (Sahi 1998:136).

In November of 2002, the Tamil Nadu Electricity Board's (TNEB) proposal to increase tariffs was vehemently opposed by electricity user groups who, significantly, used the hearing to agitate for a review of the purchasing agreements previously entered into with the independent power producers in the state (BusinessLine 2002a)⁴⁶.

Representatives of agriculturalist unions, industry, power sector employee unions and consumer groups claimed that the high rates charged by the IPP were unnecessary and that cheaper power could be bought from central utilities like the National Thermal Power Corporation. The National Agriculturists Awareness Movement, in particular, objected to the TNEB's proposal to levy a tariff on agricultural connections, citing that free power was the only concession the farm sector had been given by Government, whereas every other sector of society had been granted some form of concession.

Furthermore, the PPAs signed with the IPPs had expected a high debt equity ratio and had therefore allowed for high tariffs to finance that debt. As prevailing interest rates had declined, the representatives argued, there existed scope for tariff reduction. The interest groups also called for the TNEB to enter into a contract with consumers, guaranteeing uninterrupted electricity at the correct voltage and frequency.

A similar example can be drawn from the state of Andhra Pradesh, where the state regulatory commission announced power tariff hikes in June of 2000 (IPAN 2000). The proposed increases, which would require consumers at all levels to pay substantially more for their electricity, were unsurprisingly met by large-scale protest. Under the new regime, domestic consumers would suffer the most, as the bill for some households was expected to be almost a 100 per cent greater, despite the average increase in tariff for domestic consumers being around 54 per cent. The average increase in tariff for non-domestic consumers was 15 per cent, 14 per cent for Low Tension industries, 35 per cent for cottage industries and 61 per cent for participants in the agricultural sector.

In an attempt to appease irate voters, the state government subsequently announced an electricity subsidy aimed at softening the blow. While government officials were concerned that it would be difficult to raise the required amount, Rs 250 crores, political rivals of the

⁴⁶ Over 400 objections were tabled from all sections of consumers (BusinessLine 2002b)

ruling Telugu Desam Party attempted to cash in on the voter despair, rejecting the amount as 'too little'⁴⁷. They threatened to launch a joint agitation to oppose the new tariffs.

The opposition leaders in the state assembly also protested vehemently against the state government's proposal to promulgate an ordinance imposing stiffer penalties for power theft. Andhra Pradesh's SEB reportedly reportedly loses Rs 9 crores every day due to large scale pilferage of power. The opposition, however, contends that it is the lack of "affordable" power that makes theft necessary (IPAN 2000).

The implications of such resistance are important for potential investors in the sector. Firstly, the complaints raised by the agriculturalists' union demonstrate how consumers view the role of government, and indicate that the desire for liberalising economic reform is not shared at all levels.

Secondly, this example demonstrates how persuasively user groups can put forward demands for PPA revision. Even if their demands are not met, there is an immediate practical implication of their lobbying – decisions are delayed with possibly deleterious results for producers. No decision was reached in Tamil Nadu, and subsequent sittings were arranged for the coming month. As a result of this resistance, the SEB's scope to influence the price it sets for its electricity is limited, rendering it unable to meet the supply and demand of the market effectively and hobbling its ability to weather fluctuations in the business environment.

Thirdly, the incident demonstrates how organised these groups are and how quickly they can mobilise. Lastly, the demand for restructuring of the PPA was based on the existing low interest rate regime not reflecting the original debt repayment requirements in the agreement. If a restructuring is performed and interest rates subsequently rise, this hearing would indicate that there will be little scope for the SEB to negotiate a subsequent rise in tariffs to compensate, as consumer groups seem to see tariffs as only adjustable downwards.

⁴⁷ This is not the first time that the opposition parties in Andhra Pradesh have hindered electricity reform in the state. When the ruling Telugu Desam Party tabled the controversial Andhra Pradesh Electricity Reforms Bill in 1998, all members of the opposition, barring the BJP, dubbed the bill as "anti-people and anti-employees" (IndiaExpress 1998a). Despite the resistance, the Chief Minister, N Chandrababu Naidu, asserted the need for reform amidst growing energy demands. The Bill was only passed after the members of the opposition were suspended from the house on account of stalling and abusive behaviour (IndiaExpress 1998b).

3.4.4 Electricity Bill 2001

The Electricity Bill that was originally introduced into the Lok Sabha in August of 2001 is the most dramatic initiative taken thus far by the central government to exercise leadership over the sector (Dubash & Rajan 2001a:62). Unlike the state level reforms, the Bill has been initiated and led by the Ministry of Power, with relatively little input from the World Bank. The draft Bill (originally tabled in a different form in 2000) was approved, subject to modifications, by a standing committee in February of 2003 and passed by both the Lok Sabha and the Rajya Sabha in April to replace existing legislation governing the country's power sector, namely, the Indian Electricity Act, 1910, Electricity Supply Act, 1948, and Electricity Regulatory Commission Act, 1998 (BusinessLine 2001).

Although the Bill itself was only compiled and introduced to parliament in 2001, many of its provisions have been subjects of discussion since 1993 when a committee of the National Development Council, comprising six chief ministers, was established (Godbole 2002). Despite a litany of conferences and resolutions since the committee's first meeting, little has been done thus far to implement proposed changes.

The new Bill is intended to bring together the Committee's suggestions and to enforce them through law. It seeks to free power generation from licensing, while allowing captive power plants to sell their surplus power directly to bulk consumers without going through the grid operated by State Electricity Boards. States will be required to unbundle their SEBs, and to establish independent State Electricity Regulatory Commissions (SERCs) that will be responsible for the setting of electricity prices. Government has been prohibited from issuing directives on tariff matters and will, according to the Bill, be held responsible for the cost of any subsidy provided at its direction. Distribution and transmission companies will have to obtain licenses from the concerned SERC. Power reforms will be boosted by reduced cross-subsidisation and metering of electricity supply will be mandatory (BusinessLine 2001).

The most important consideration in the proposed legislation is that it will end the monopoly of SEBs in the distribution of electricity and will allow power generation companies to sell directly to consumers. Furthermore, the legislation will override state level laws, allowing direct as well as third party sales. This is, of course, a significant step,

as power producers are currently mandated to sell electricity only to the government-run SEBs (IPAN 2001).

The Bill has received positive responses from business. The Confederation of Indian Industry has voiced positive support for the Bill, lauding its intention of ushering in a competitive market for electricity, and describing electricity stakeholders as “enthused” by the Bill’s prospects (CII 2000)⁴⁸.

Labour’s response to the Bill, however, has been less favourable. The Electricity Employees Federation of India voiced strong opposition and began mobilisation to halt its passage through parliament. Protests greeted the run-up to the parliamentary debate regarding the new legislation in the first quarter of 2003. Terming the Bill as “against national interest”, the Federation stated that attempts to remove cross-subsidisations of agriculture’s electricity would spell doom for farmers (Financial Express 2003).

3.4.4.1 Troubled Passage

The new legislation’s passage through parliament was far from effortless. The subject of three years of debate, the Bill was only passed by the Lok Sabha after 127 amendments had been made to the original document. In the Upper House, opposition parties favoured a further 81 amendments that spanned a broad range of issues. One tabled amendment sought to change the most basic tenet of the Bill, the unbundling of the SEBs, while another suggested that states be allowed to obtain finance from the Centre to subsidise “a class of consumers” if the tariff determined by the SERCs did not suit the political compulsions of state governments (Kumar 2003).

Rajya Sabha approval was only granted after the government promised to table a comprehensive bill in the next parliamentary session to incorporate outstanding recommendations of the Standing Committee on Electricity (IndianExpress 2003). The opposition agreed, on the strength of this promise, to withdraw its proposed amendments and allow the Bill to be passed.

⁴⁸ CII is a lobby group for Indian industry that acts at both state and central level.

The Bill, with its focus on market-driven forces, is the first comprehensive attempt at forward-looking legislation that will be able to keep pace with the changing economic scenario. Previous bills had been intended for a monopolised rather than market-driven sector, and the piecemeal legislative changes made during the nineties had not attempted to address this discrepancy. Although the Bill is not perfect, it does favour foreign investment and takes steps to create an enabling environment for the foreign company. At the very least, it attempts to redress some of the root causes of the high levels of deleterious political risk experienced by external players in the market before, most notably the role of the SEBs and the factors that have contributed to their financial instability, particularly tariff setting and subsidies.

3.5 Conclusion

The political dynamic of the Indian federalist structure and its coalition politics have important implications for policy making. The reliance of the party in power at the centre on support from parties on a state-level increases the number of actors who have influence on policy decisions and hinders the ability of the central government to determine and implement policy changes. Furthermore, the powerful regional parties on whom national governments rely often have parochial objectives incongruent to those of the centre. This, exacerbated by other factors such as internal party disunities and external resistance, has contributed to the retardation of the reform process in recent years. There have been implications for the potential foreign investor in the Indian Electricity Sector, where various attempts at change have done little to solve core problems.

Power reform has been an erratic and often piecemeal process. Although the need for reform of the SEBs is obvious, powerful stakeholders have provided considerable resistance to the process, propagating and contributing to the problems in the sector. Attempts to open the sector to foreign participation have been typified by a “big bang” approach – high profile, high capacity deals such as the PPA brokered with Enron have been concluded, only to be broken by the political mechanism relatively shortly thereafter. This has caused considerable damage to the country’s reputation as a safe destination for investment and has undermined the reform process. Sporadic and uncoordinated reform

attempts have harmed the legitimacy of the process and have called into question the wisdom of reform. Stakeholders are increasingly sceptical of the merits of a privatised power generation sector. The new Electricity Bill is an attempt to create a sense of cohesion in the sector, but it remains to be seen how successful it will be.

4.1 Introduction

The new Electricity Bill is a significant step towards the privatisation of the power generation sector. It is a response to the growing scepticism of stakeholders and the need to create a sense of cohesion in the sector. The Bill is a complex piece of legislation that will have a major impact on the power generation sector.

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4 ANALYSIS OF THE PCI AND CONCLUDING REMARKS

4.1 Introduction

This chapter compares the reform experiences of India, Brazil and China and discusses the Political Constraints Index and its implications for each. A study by Rufin *et al* (2003:653) indicates why, from the micro risk perspective of the electricity sector, it is useful to compare these three countries:

- In the past, all three have attempted to accelerate economic growth through heavy state involvement, particularly in the electricity sector;
- In the past decade, all three have formulated and implemented policies intended to attract foreign investment into the electricity sector;
- In the 1990s, all three were faced with a massive need for additional power capacity;
- All three were lumbered with inefficient and often corrupt state-owned power sectors, adding to high budget deficits and pressures to reduce the country's fiscal burden;
- During the past decade, each of them undertook to invite IPPs to participate in the production and sale of power domestically.

Finally, the PCI for India is related to previous discussions of the political economy of the Indian Electricity sector.

4.2 India in the Broader Context

As a bicameral parliamentary system and functioning democracy with an independent judiciary, India has a number of veto players able to prevent the executive from operating with impunity. This raises the expectation that the level of India's political constraints

should be high and the Political Constraints Index reflects this⁴⁹. The value of the index for 2001 is 0.735, with 1 as a theoretical maximum. This ranks India 41st out of the 161 countries for whom the index has been tabulated. In other words, India's political constraints are high enough to place the country in the top quarter of the field, with the theoretical implication that the country's level of political risk should be lower than 75 per cent of the countries considered⁵⁰.

With its index at 0.735 for 2001, India compares with countries such as the Netherlands (0.733), the United Kingdom (0.737), Greece (0.74), France (0.74) and South Africa (0.744). Towards the top of the index lie Switzerland (0.82), the United States (0.85), Australia (0.867) and Belgium (0.894).

4.3 The PCI for China, Brazil and India

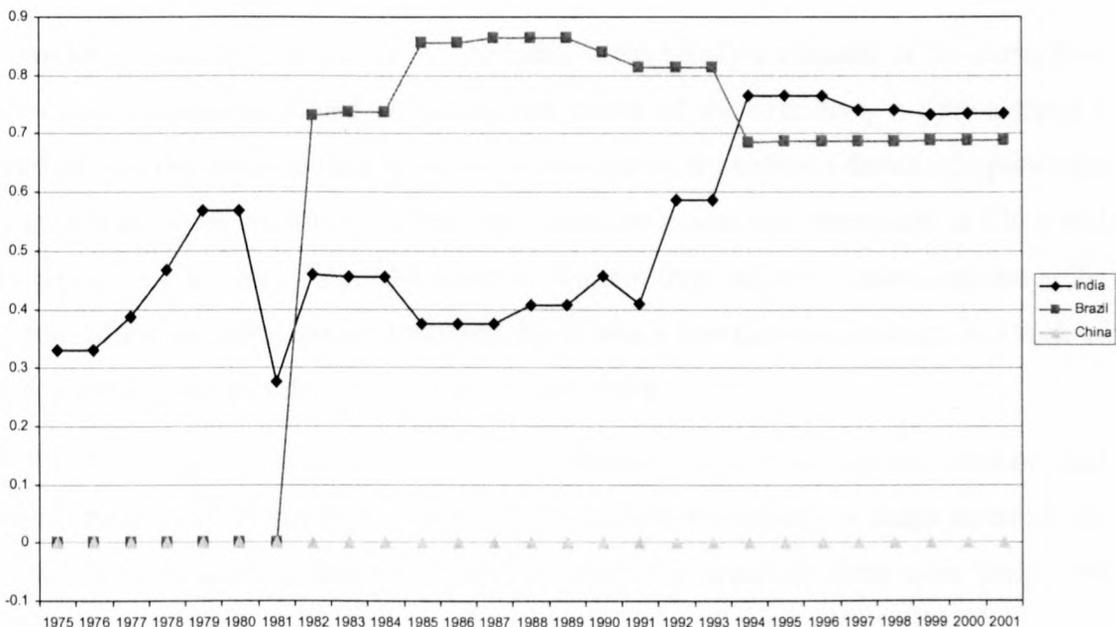


Figure 6: The Political Constraints Index for China, Brazil and India

49 The figures for the PCI are taken from Henisz' Polcon2002 database, which can be downloaded from his website: <http://www-management.wharton.upenn.edu/henisz/>. The index used is the PolconV_2002 index.

50 Some countries have been omitted from the PCI on the grounds that there is insufficient information available for the computation of the index.

Figure 6 compares the PCI for India with that of Brazil and China⁵¹ for the period 1975 to 2001.

Rufin *et al*'s study shows that China has been the most effective in restructuring its electricity industry so far, adding substantial new capacity through FDI (2003:654). Brazil has been moderately successful through the implementation of IPP policies, while India has been the least successful of the three.

According to Rufin *et al*, China's success can be attributed to ideological and institutional factors and the absence of powerful interest groups. Its powerful combination of communist ideology, nationalistic ambitions and pragmatism, combined with the central bureaucracy's control over policy creation, the relatively frictionless implementation of policy, the close coordination between government policies and provincial governments, a weak judiciary and repressed interest groups has enabled it to create a large IPP sector that sells power to state-owned integrated monopolies⁵².

Consider now the PCI for China. As the index is essentially a measure of the strength of democratic institutions aimed at limiting the power of the executive, it demonstrates a Western bias that discriminates against countries that do not embrace democratic principles or at least allow for checks-and-balances on executive power. Countries such as China and Singapore, because they do not subscribe to Western forms of government, register at the bottom of the measure and are therefore, by Henisz's interpretation, subject to a lack of policy stability and therefore considerable political risk.

Rufin *et al*'s study demonstrates that the lack of opposition to the creation and implementation of reform policies in China has allowed the country to sculpt an electricity sector that is attractive to foreign investors and that is perceived by them to be "stable and friendly" (2003:654).

Return once more to the definition presented earlier. It states that political risk is the probability of change in the operating environment of a firm because of the political

⁵¹ The People's Republic of China.

⁵² The authors mean pragmatism in terms of flexibility with regard to how ends can be achieved. They site Deng Xiaoping's reported statement that "it did not matter whether the cat was black or white so long as it caught mice" (Rufin *et al* 2003:671).

process. It expressly allows for changes both good for and damaging to the investor. Against this definition, the experiences in China's electricity sector support Henisz's view that China must be high risk, but place the emphasis for useful decision making on the perspective and orientation of China's centralist government. In this instance, the ability of China's leadership to push through reforms has been beneficial to potential investors.

The implication is that a simplistic view of the PCI may well lead to inaccurate conclusions. For the future investor in infrastructure in China, this argument shows that the index would only be useful when combined with an in depth understanding of the Chinese political environment. It is debatable how such an understanding can **best** be achieved, but a comprehensive qualitative assessment (such as the one presented by Rufin *et al* 2003) is a good starting point.

Brazil's efforts to restructure its electricity sector have fared better than India's but not as well as China's. The country has been somewhat successful at attracting FDI, but has not yet been able to reach its targets. According to the authors, Brazil's mixture of nationalism and social democratic ideology, its distrust of foreign investment, its approach of designing policy at the federal level but of implementing policy at the state level, the slow process of its courts, the influence of patronage politics and its relatively vocal interest groups have created mixed (private and public) infrastructure ownership in an unbundled industry, with some residual integrated, state-owned monopolies at provincial levels (Rufin *et al* 2003:657).

Once more, the predictions of the PCI support this, but in a non-intuitive way. For most of the 1990s, Brazil's level of constraints was lower than India's, implying that changes to policies could occur more easily. This has allowed the country to open its electricity industries to foreign investors, but not without some opposition, mainly represented by the Brazilian judicial process and increasingly powerful interest groups (comprised of managers of state owned generators, construction companies previously advantaged by political patronage, consumers and environmentalists) (Rufin *et al* 2003:665). Registering lower on the index, Brazil is subject to lower levels of policy stability and greater levels of political risk. It has been able to reform its electricity sector comparatively more successfully than India and in a way relatively beneficial to investors.

Considering the PCI for India, certain interesting points can be noted. After 1991, at the same time as the most recent trend towards liberalisation, constraints in India increased dramatically. This was a consequence, mainly, of the addition of an effective judiciary, but it also related to the increased fractionalisation of Indian politics. The liberalisation trend of the 1990s has been discussed above and it was concluded that the general direction of the trend has been maintained, despite government changes and various opportunistic attempts at opposition.

What was also shown in previous discussions was that the progress of reform has grown consistently slower, possibly because recent reforms have required legislative approval and consequent political bargaining. The PCI for India supports these observations: the increasing levels of political constraints, as the index predicts, have led to policy stability and an institutionalised resistance to change that has been detrimental to the reform process.

This has implications for the electricity sector where, as it has been shown, continued reform towards liberalisation is in the interests of private participants in the sector. From previous discussions, the following can be derived:

- As electricity production is an item on the concurrent list and, as such, is within the jurisdiction of both the federal and state level governments, crafting a consensual plan for reform has proven difficult. This inherent constitutional conflict regarding federal and provincial primacy has resulted in a lack of coordination between states and the central government with regard to power reform. Although Indian leadership has generally identified and agreed on the need for private participation in the sector, the large number of political entities with divergent objectives has complicated the process. The typical dependence that Indian governments in the centre have on support from alliance parties in the states has added to the complexity.
- Powerful interest groups in India, particularly farmers and agriculturalists unions, have long benefited from political patronage in the form of electricity subsidies. Patronage has shored up the support of governments at the state level and, because of the strong interdependencies, at the centre as well. These interest groups are able

to flex their political muscle to hamper reform. Union groups have also decried the privatization drive.

- The fractionalisation of the Indian democracy and the political bargaining required to change policy have resulted in a series of piecemeal, but palatable, reforms that have not addressed crucial deficiencies in power policy. This has damaged the legitimacy of the electricity reform process.
- India's powerful bureaucratic machine has contributed to policy inertia. The bewildering array of clearances required for power project approval belies the commitment to private participation that the centre professes.
- Opportunism amongst politicians has drawn out the approval of electricity reforms. When ruling, parties will support reforms; when not ruling they will oppose them, particularly politically sensitive policies required by the power reform process. The frequent change of governments at both state and federal levels has compounded this issue.

4.4 Conclusion

The examples of the Chinese, Brazilian and Indian electricity reform processes provide interesting observations about the PCI and its interpretation. Firstly, it is clear from the experiences in all three that the index cannot be interpreted simplistically and, importantly, that a sound definition of political risk is crucial. When it can be shown that reform is required and in the interest of potential investors in a particular sector, high levels of policy stability and consequently low levels of political risk are, counter-intuitively, dangerous to the investor because they propagate a disabling policy regime. This is the case particularly when there are a large number of actors with influence on policy makers who can stifle the reform process, as in India.

From these comparative examples and an in depth analysis of the political economy of the Indian Electricity Sector, Henisz's hypothesis that a high rating on the Political Constraints Index and large degrees of political competition should lead to lower levels of political risk may be true when risk is defined to include change both beneficial and inimical to the

operations of the investor. Such a risk rating should not be understood, however, to be necessarily indicative of a sound investment opportunity. The high level of political constraints appears to propagate the disabling policy regime as the previous discussion has shown, to the possible detriment of the investor. There are a number of implications and caveats:

- The index cannot be used simply to rank countries against each other and thereby determine safe locations for direct investment. To be useful in the investment decision, the index must be accompanied by a comprehensive analysis of the political economy of the sector in question and absolute clarity on the definition of political risk. Without this analytical support the index may be misinterpreted.
- The index shows only a probability that a path chosen by the executive will be vetoed by one of the other players in the political process. A comparatively high index does not show that policy changes are impossible, but rather that they are difficult to achieve. The result of this is that when policy alterations are tabled under circumstances of constraint, they are likely to be delayed and possibly changed themselves. This was illustrated by the passage of the Indian Electricity Bill, which officially took three years to receive approval from all players and was only passed after alteration and considerable political deal making⁵³. This also has an implication if the index is considered to indicate policy commitment and a safe investment opportunity: it must still be remembered that deleterious policy changes can still be effected if all players are in agreement. To use the index appropriately, the preferences of the various actors must be understood, suggesting that the index must be augmented with a comprehensive assessment of the political groups and the dynamic that governs their interaction.
- The index requires analytical support because it acts only as a measure of the probability of policy *change* and gives no indication of the likelihood of successful policy *implementation*. Although the new Electricity Bill appears to address some of the critical deficiencies in current power policy, the fact that it has been passed

⁵³ As much of its content had been suggested and debated previously, it can be argued that the Bill took, in fact, longer than three years to pass.

does not imply that it will be put into practice effectively. It is conceivable that resistance at various levels will delay the implementation of the Bill, causing further risk for the potential investor. It is advisable for an understanding of the political environment to be achieved so that the probability of the successful application of the Bill can be assessed.

The PCI may be a useful tool for determining reform resistance and may have application in areas other than political risk analysis. There exist opportunities for further research into this possibility. One possible study could involve devising an empirical test using cross-country data to further investigate the idea that relatively high PCI scores indicate a resistance to economic reform.

Such an investigation would begin by identifying countries that have been undergoing processes of economic liberalisation and determining a numerical rating or ratings that could be used to indicate reform success. The variables that comprise these ratings should be easily measurable and strongly linked to the theory of economic liberalisation. They could include indicators such as the number of liberalising policy changes successfully passed since the inception of reforms, the success of privatisation drives, the removal of trade and investment barriers and so forth. Once established, these ratings could be compared to the PCI for the country in question, using a method such as regression analysis.

The results of this study should evidence the existence or lack of a link between a country's PCI and the success of its economic reform endeavours. If such a link can be shown to exist, the PCI may be useful in assessing the likelihood of success of economic reforms before their inception, a finding that may be of interest to potential investors, policy makers and political commentators alike. It may also be possible to generalise the findings to other policy change initiatives. Further research could also focus on possible linkages between resistance to policy change and difficulties associated with policy implementation.

4.4.1 Final Remarks

This assignment has shown how the discipline of political risk assessment has shifted its focus and methodologies in accordance with changes in political thought and

understandings. As new theories have been debated and the quantity and quality of data improved, new tools have been proposed in the hope of creating more timeous and accurate risk assessments. These tools have increasingly taken a quantitative approach to assessment and, consequently, may be accorded a rigour and accuracy that they do not deserve. The arguments presented here have shown that, at least for the time being, qualitative considerations of the country in question and its political economy are indispensable to the understanding of both the micro and macro risk environments and to the correct interpretation of tools such as the PCI.

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