

# **Post-Liberalization India and the Importance of Legal Reform**

by

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## Section I. Governance and Second Generation Reforms

The cumulative impact of fifteen years of liberalization has transformed India. However, the process of liberalization has been slow, erratic and patchy. Policy makers were not just held back by political considerations but were constrained by the sheer scale of changes that were needed and by the considerations of sequencing. Therefore, outdated and inefficient practices still pervade the economic system and myriad areas remain where reforms are still sorely needed. The need for more change is widely recognized and we regularly hear demands for “second generation reforms”. So, what these second generation reforms and how are they different from the first generation?

In my view, the first generation of reforms was about liberalizing the system from the constraints of the inward-looking, public sector-dominated arrangement. At this stage “liberalization” and “reform” meant the same thing. Therefore, the first fifteen years of reform were about de-licensing the industrial sector, opening the country to foreign trade and investment and so on. Many commentators now argue that the next generation of reforms should follow up with changes such as full-fledged privatization and changes in labour laws. However, strictly speaking, privatization and labour laws are unfinished business from the first generation as they are still largely about liberalization.

In my view, second generation reforms are a fundamentally different set of changes. They are about adjusting existing institutional arrangements in order to support the new

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“market-based” economic system that has emerged as a result of liberalization. In essence, this is about building a healthy new relationship between the State and civil society in general and the economic system in particular. The first generation of reforms was about reducing the role of State so that the private sector could expand. This has been achieved to a large extent despite various remaining anomalies. The next generation of reform is about reforming the State itself and helping it to play its rightful role in the new India. There are a wide array of necessary changes ranging from administrative reform to improvements in provision of public goods and services.

Perhaps the most important service that the State fills is the provision of general governance. The term “general governance” is difficult to define formally although most people would agree on what it means. I suppose, one can say that general governance is the systemic order that needs to be maintained so that people can engage in economic and social interaction. Virtually all economic and social ventures require collaboration that would not be possible without “trust” that each party would carry out their end of the bargain. In turn, this trust is based on the rules of engagement and their enforcement. From the very beginning, therefore, economists have recognized the role of the state in creating and enforcing these rules. One need do no more than read Kautilya’s Arthashastra or Adam Smith’s Lectures on Jurisprudence (1762-1763) to realize how much emphasis even the earliest economists placed on the State’s role in ensuring general governance<sup>2</sup>.

## Section II. The Role of the Legal System

The legal infrastructure is the key institutional framework through which the State provides general governance. In the context of post liberalization India, the legal infrastructure plays a number of important roles. First, it is the means through which the State can create a generalized environment of trust so that various economic entities can interact with each other. This is always true to some extent, but it is even more true in a market-based economic system where resources are no longer being allocated according

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<sup>2</sup> The Arthashastra considered the provision of public order as one of the main functions of the State. Similarly, Adam Smith argued that laws were means through which the State promotes public prosperity.

to the government's administrative diktat. Of course, the State is not necessarily the only institution that can provide rules of engagement and ensure enforcement. There can be a number of other sources of "trust" ranging from religion to social/family linkages. Avinash Dixit and Francis Fukuyama have extensively discussed such alternative arrangements, but these are not the focus of discussion here<sup>3</sup>. In a vast and socially diverse country like India, it is probably not wise to rely on such informal systems as the primary source of trust. At best these systems are inefficient and at worst they can be harmful. For instance, in the state of Bihar, the lack of State provision of governance has led to the creation of caste-based organizations/networks that have further undermined generalized trust.

Second, the legal system is important because it is the means through which Justice is administered. It is important to recognize that Justice is a good thing in itself, over and above the impact it may have in encouraging systemic trust. Economists are usually utilitarian at heart and tend to ignore this, but others (for instance, moral philosophers) would probably consider the provision of Justice as a distinct and commendable service in its own right. The provision of Justice must be a central part of the redefined, post-liberalization State and, therefore, legal reform must be a focus of second generation reforms.

Third, the legal infrastructure can be an agent of change in common-law countries like India. This is a role that is most often ignored by economists because the legal system is seen as the blind and passive enforcement of a static body of rules. This may be largely true of those countries that function in the civil-law judicial tradition where the judiciary is merely expected to interpret a given legal code and no more. However, in the English common-law tradition, each judgment creates a precedent that can be used in future cases. In other words, each judgment effectively creates a new law. This is a major advantage of the common law system as it allows an endogenous system of updating laws without having to revert to legislative intervention for every small change.

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<sup>3</sup> See "Lawlessness and Economics" by Avinash Dixit, Princeton University Press 2004; and "Trust: Social Virtues and the Creation of Prosperity" by Francis Fukuyama, Penguin 1995.

The Indian judicial system belongs firmly to the English common law tradition (except in a few areas). This is potentially an important strength for a country that is undergoing rapid change. In a civil law system it would be almost impossible for the government and the legislature to constantly update and co-ordinate a huge body of laws and sub-laws. Indeed, it may be easier to create a completely new body of law as China has been attempting to do since 1978<sup>4</sup>. However, even this does not solve the problem because in a rapidly developing country the new laws themselves may become outdated very quickly and need to be replaced. The effort of coordinating these changes through the mass of laws and by-laws is great, especially if the changes are constantly subject to democratic scrutiny. In contrast, India can potentially use its judicial system to percolate reforms through the economic system. Once a general principal has been established by policy-makers or the legislature, other rules can be changed on an on-going basis as and when disputes are brought to the courts. In other words, a good judicial system can be an active agent of change in India rather than just a passive enforcer.

Given these above factors, the legal system can play a very central role in post-liberalization India. As we will discuss below, the Indian legal/judicial system has fallen short of all the three objectives. It is not surprising, therefore, that eminent thinkers like Bimal Jalan and Arun Shourie have repeatedly pointed to this as an area of failure<sup>5</sup>. This is unfortunate because the underlying judicial institutions are good and the system should have been a very major strength for the country. Therefore, legal reform must be focus area for second generation reforms.

### Section III. The Rules

Broadly speaking, the legal infrastructure is made up of two elements. The first element is the body of laws and regulations. These are the rules of engagement. The second element consists of the arrangement that enforces the laws – the police, the judicial

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<sup>4</sup> See “Chinese Legal Reform at the Crossroads”, Jerome Alan Cohen, Far Eastern Economic Review, March 2006

<sup>5</sup> See “The Future of India: Politics, Economics and Governance” by Dr. Bimal Jalan, Penguin 2005

courts, tribunals and so on. In addition, there are the legions of “inspectors” employed by different government departments to ensure compliance with various regulations. Regulatory bodies like the Reserve Bank and the Securities Exchange Board of India may also be considered a part of the enforcement mechanism, although they have very specialized jurisdictions. It would be tedious to try and encompass all forms of enforcement in this paper. For the purposes of discussion, therefore, we will restrict ourselves mostly to the mainstream judiciary although we must keep in mind the wider context.

India has a very large body of laws and regulations. Given the federal constitutional arrangement, there are national-level laws as well as state-level laws. In addition there are local government laws as well as administrative laws – these last include a plethora of rules, regulations, orders and administrative instructions issued by various government ministries and departments.

The first problem with this body of law is that no one seems know what these all rules are or even how many exist. The number of Central Statutes is often estimated at between 3500 and 2500, but Bibek Debroy<sup>6</sup> thinks that there is a lot of double counting of laws that have been amended. His estimate is around 1100. In short, we are not even sure how many central statutes are in existence. It is even more uncertain how many state-level laws are in effect. The Jain Commission had estimated that in 1998 there were between 25,000 and 30,000 state level statutes in existence in various parts of the country<sup>7</sup>. Note that this estimate was an extrapolation of laws existing in a single state and can hardly be considered a very good statistical sample. Matters deteriorate rapidly from here as there is not even an estimate of administrative and local laws. The Jain Commission had been set up to review administrative laws but could not even get a full set of rules, regulations and administrative instructions issues by the central government.

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<sup>6</sup>“ Judicial Reform – law and contract enforcement”, Bibek Debroy (undated internet version, [www.mayin.org](http://www.mayin.org))

<sup>7</sup> Report of the Commission on Review of Administrative Laws, September 1998.

The second problem with the existing body of law is that a large number of them are now very old and often dysfunctional. Many of these laws were enacted in the nineteenth century and, in theory, remain in effect. Here are a few of the central statutes that are still in effect: Bengal Indigo Contracts Act 1836, Bengal Bonded Warehouse Association Act 1838, Shore Nuisances (Bombay and Kolaba) Act 1853, Bengal Ghatwali Lands Act 1859, State-Carriages Act 1861, Sarais Act 1867, Oudh Talukdars Relief Act 1870, Chota Nagpur Encumbered Estates Act 1875, Bikrama Singh's Estates Act 1883, Mirzapur Stone Mahal Act 1886, Lepers Act 1898. This is merely a small sample of old central statutes. The number of outdated state laws and administrative regulations number in tens of thousands. For instance, the regulations under the Factories Act 1948 still stipulate that factories need to be whitewashed (other paints will not do), drinking water must be provided in earthen pots (water coolers will not do) and sand must be provided in red-painted buckets (fire extinguishers will not do)<sup>8</sup>.

Some readers may think that these old laws are harmless but we have repeatedly seen how these laws are invoked in cases that have no relationship with their original context. For example, the Sarais Act of 1867 makes it a punishable offence for inn-keepers to refuse drinking water to passers-by. This was used by the municipal corporation a few years ago to take a Delhi five-star hotel to court. Similarly, the Indian Telegraph Act of 1885 has been invoked many times by state-owned broadcaster Doordarshan over telecast rights for cricket matches. This nearly derailed the telecast of the Cricket World Cup of 1996. As one can see, there is ample scope for using these outdated rules for harassment, bribery and rent-seeking. Of course, many other countries have old laws. In a common-law system these old laws should not be a problem as the judiciary could update them by creating a precedent whenever a case comes up, but this requires a robust and quick judicial process<sup>9</sup>. This is not the case in India and this is a topic that we will return to later.

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<sup>8</sup> "Reforming the Legal System", Bibek Debroy (undated internet version).

<sup>9</sup> Civil law traditions deal with old laws through the doctrine of "Desuetude" by which laws are deemed outdated and unenforceable if they have not been actively enforced for a long time.

The third problem with the body of law is that there is little internal harmony or consistency. Many laws contradict each other. Definitions and classifications are not standardized. Some areas are absurdly over-regulated while others do not have meaningful laws. Labour laws provide a good illustration of how confusing the legal framework can be for an employer. According to the Indian Constitution, this is an area on the Concurrent List – meaning that there are both national-level laws and state-level laws. It appears that there are almost fifty laws just at the national-level together with associated rules and regulations. These include not only general laws such as the Industrial Disputes Act 1947 and the Factories Act 1948 but also a number of specialized laws. For example, there are at least three Acts related to just to the *Beedi* industry: the Beedi and Cigars Workers (Conditions of Employment) Act 1966, Beedi Workers Welfare Cess Act 1976 and the Beedi Workers Welfare Fund Act 1976.

In addition to these fifty odd central labour laws, there are a plethora of state-level laws and administrative directives that also apply. On top of these labour laws, there are several other state and central laws that directly affect labour such as the Dangerous Machines (Regulations) Act 1983. What makes it worse is that many of these laws are inconsistent and often contradict each other. Note that the author is not commenting here on the content and quality of these laws. That is a large area of debate in its own right. I am merely pointing out the sheer complexity of the legal framework related to the simple, routine act of employing workers.

Not surprisingly, such a confusing body of law makes it difficult for everyone to understand the rules of engagement. Even if a person was diligently law-abiding, it would be virtually impossible for that person to function without knowingly or unknowingly breaking some rule. Indeed, the much of the booming call-center outsourcing business is technically illegal according to some state laws. In 2005, the Labour Ministry of the Haryana Government invoked Section 30 of the Punjab Shops and Commercial Establishments Act 1958 to disallow women from working night shifts at call centers and outsourcing units in the town of Gurgaon. Women typically account for 40% of the workforce and the very nature of outsourcing requires them to work night shifts since

they are servicing clients in Western countries. Clearly, the ban would severely affect the business model of this sector. The matter was still under dispute at the time of writing but it highlights the dangers of having a body of law that is complex, outdated and sometimes blatantly absurd.

#### Section IV. Enforcing the Rules

In the previous section, we have seen that there are many problems with the legal rules for social and economic engagement. However, many commentators would argue that the enforcement of the rules is an even bigger problem in India. As mentioned earlier, enforcement is dependent on a number of agencies and institutions including the police, the judiciary, inspectors from various government departments and so on. Nonetheless, the judiciary can be said to be the critical linchpin of the formal enforcement mechanism because it is the main arrangement for dispute resolution. The Indian judiciary is a large and complex world consisting of the Supreme Court, the eighteen High Courts and the Subordinate Courts (which number in the thousands and include district-level courts, magistrate courts, fast-track courts and so on). In addition, there are a number of other quasi-judicial bodies including special tribunals and pre-trial dispute resolution forums like the Lok Adalats.

Most observers would agree that the biggest shortcoming of the Indian judicial system is that the very slow pace at which cases are processed. Even routine cases sometimes get bogged down for decades in the judicial quagmire. As a result, the system has a large and growing backlog of cases. According to a recent Law Ministry estimate that was widely quoted in the press<sup>10</sup>, there were over 25 million cases pending in the court system at the end of 2005. These include 32,000 in the Supreme Court, 3.5 million in the High Courts and 22 million in the subordinate courts. This does not include the large number of cases stuck in various tribunals and quasi-judicial bodies. Note that over 80% of the cases pending in the High Courts are civil cases while criminal cases account for only 12-15%. The situation is totally different in the subordinate courts where two-thirds are

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<sup>10</sup> The author was unable to trace the original Law Ministry statement.

criminal cases. Thus, the reader will appreciate why the Indian judicial system is seen as such a drag on general governance.

Although there is no objective measure to prove or disprove this, it is generally agreed that the Indian judiciary (at least the higher echelons) has a good record when it actually does pronounce a judgment. Of course, there may be occasional miscarriages of justice but it is accepted that mistakes are unavoidable in any large system. However, the present author feels that justice delayed is justice denied even if the eventual judgment is the correct one. This point is best illustrated by the infamous Uttam Nakate case<sup>11</sup>.

In August 1983, Nakate was found at 11:40 am sleeping soundly on an iron plate in the factory in Pune where he worked. He had committed three previous misdemeanors but had been let off lightly. This time his employer Bharat Forge began disciplinary proceedings against him, and after five months of hearings, he was found guilty and sacked. But Nakate went to a labor court and pleaded that he was a victim of an unfair trade practice. The court agreed and forced the factory to take him back and pay him 50% of his lost wages. Both parties appealed against this judgment (Natake wanted more money). The case dragged on through the judicial system for another decade and in 1995 another court awarded Nakate more money because he was now too old to be rehired. Bharat Forge eventually had to approach the Supreme Court and in May 2005 – more than two decades after the original incident – the apex court finally awarded the employer the right to fire a worker who had been repeatedly caught sleeping on the job.

The above case is usually taken as an illustration of the country's ridiculous labour laws. However, it is an equally good illustration of the miscarriage of justice by the judicial system. The first generation of reforms did not made a dent on labour laws; they are largely the same today as they were in the early eighties. The Supreme Court's final judgment was based on the interpretation of laws that have not changed. The judicial system could have arrived at this common sense result at any stage of the proceedings (after all, the facts of the case were not really in dispute, Nakate always accepted the fact

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<sup>11</sup> Bharat Forge Co. Ltd. Vs Uttam Manohar Nakate 2005.

that he was sleeping). Therefore, one should not be impressed by the fact that the judicial system eventually got the judgment right.

The failure to deliver justice is even more pressing in the criminal justice system. As already mentioned, two-thirds of the pending cases in lower courts relate to criminal cases. This reflects two forms of gross injustice. First, there are a very large number of under-trials who are left in limbo, many of them being forced to live in jail as they cannot afford bail or do not have the legal support to apply for it. Indeed, an estimate shows that in 1996, 72% of all prisoners in Indian jails were under-trials. Many these prisoners have been in jail for years without coming to trial and some may have long exceeded the maximum sentences for their alleged crimes. Second, the judicial system seems unable to identify and punish genuine offenders. According to Bibek Debroy, the conviction rate is less than 5%!

The Jessica Lal case is a well known example of this problem. Jessica Lal was an upcoming model. On April 29, 1999 she was working as a celebrity barmaid at Tamarind Court, a bar-cum-restaurant frequented by socialites. At 2am, a group of young men led by Manu Sharma entered the bar and demanded a round of drinks. Jessica Lal refused since the bar was already closed. Manu Sharma, so the story goes, lost his temper and shot her dead. This incident was witnessed by several people and they reported it immediately to the police. After a manhunt that lasted several days, Manu Sharma was arrested.

The case was brought to trial in August of that year and almost immediately began to run into trouble. One by one the witnesses turned hostile and changed their story. What would appear at first sight to be an open-and-shut case dragged on for years. Eventually in February 2006, Additional Sessions Judge Bhayana freed Manu Sharma and his friends. Indeed, he agreed with the defense counsel that the “police had decided to frame the accused”. It is believed by many that Manu Sharma was able to use his political connections (his father is a powerful politician belonging to the Congress Party) to subvert the judicial process. There was a public uproar and the Delhi High Court has now

allowed an appeal against the judgment. The re-trial is now likely to drag on for several more years.

We are not concerned here with whether or not Manu Sharma is guilty. The above case is merely an illustration of how the legal system is unable to enforce some basic laws in even the national capital. Of course, this is not just the fault of the judiciary since it also involves other agencies such as the police (in this case, the witness protection mechanism has been particular failure). However, this distinction between various arms of the State is not relevant from our perspective. The point is that the enforcement of laws is a serious concern. It also does not matter to the economy at large whether the miscarriages of justice is in commercial or criminal cases because both of them are a part of overall general governance. The author feels that the post-liberalization State must make this as its central focus.

## Section V. The Importance of Legal Reform

Given all the issues discussed above, it should be no surprise that one should wish for reforms in the legal system. As mentioned at the very onset of this paper, the broad legal infrastructure is necessary for providing a formal set of rules for social/economic interaction as well as providing a means for enforcement. However, this is even more relevant in post-liberalization India where we expect a market-based economic arrangement to bring prosperity to the country, particularly to the poorest sections of society. As pointed out by economists like Hernando de Soto, market-based systems work to reduce poverty only when there is an integrated formal system of enforcing contracts (especially in the case of property rights). According to Hernando de Soto, this is the key reason why market-based economic systems are so successful in some countries but fail in others<sup>12</sup>. Unfortunately, we have seen how the Indian legal infrastructure is currently unable to cope with this requirement. This is a major failure and second generation reforms should try to redress it as soon as possible.

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<sup>12</sup> “The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else”, Hernando de Soto, Basic Books 2000.

The legal system is the main mechanism through which Justice is administered. As argued earlier, the administration of Justice is an important service in itself and will always remain a key role of the State. In my view, policy-makers should push for change in this area because it will directly improve the lives of the people and will disproportionately benefit the poor. Besides, unlike other areas of economic reform, there is unlikely to be any major political opposition to reform of the legal infrastructure. One could even argue that visible improvements in this area would go far in garnering popular support for other changes.

Finally, a good legal system can be an important partner in furthering the reform process itself. It is virtually impossible for the executive and legislative arms of the State to keep up with all the rules governing a vast and rapidly changing country like India. Even if all existing possibilities are taken into account by formal legislation, there will always be unforeseen circumstances that will emerge. Thus, what is needed is a system that endogenously renews itself. India's common-law based judicial system can potentially fill this role but it must be made capable of doing this quickly and consistently.

There are many things that need to be done in order to improve the Indian legal infrastructure. The body of law should be rationalized through both legislative and administrative initiatives. Many outdated laws should be scrapped or replaced. Similarly, efforts should be made to simplify legal provisions in areas with a multiplicity of rules and regulations. The process of enforcement and dispute resolution also needs radical changes. These include changing court procedures, introducing modern technologies in the judicial process (including full computerization of records), improving training and management in the lower courts, and harmonizing basic definitions. There is also need to increase the number of judges. At present, India has 13 judges per million population compared to 107 for the United States, 73 for Canada and 51 for Britain. This is not just a matter of creating new positions but of filling up existing vacancies. There are currently thousands of vacant judicial posts. There is also a need alter the system of Appeals – the current system encourages everyone to appeal to higher courts against the decisions of

lower courts. This is major reason why cases drag on for so long. Finally, the government itself should re-look at this own role as a litigant. At present, a very large proportion of cases involve the government and these are very often appeals against the judgments of lower courts.

This is not the place to discuss the various necessary reforms in detail. Much has been written about it over the years. Law Commissions are periodically instituted to suggest necessary changes and the interested reader may read through their various reports. The main purpose of this paper is to draw attention to the central importance of legal reform within the context of second generation reforms. Unfortunately, this area is usually seen as peripheral to the economic reform process and only rarely attracts attention in the wider debate. In my view, however, this is probably the single most important area requiring reorganization and it would have dramatic multiplier effects through the rest of the economy.

What makes it even more attractive is that it is unlikely to require a great deal of additional public expenditure. No formal estimates are available of how much money would be needed to set the judicial system right but my guesstimate is that to stabilize the judicial backlog at current levels (together with significant quality improvements) would need an additional allocation of about Rs. 40 billion worth of fixed investment (2005 prices) and around Rs 20 billion worth of annual recurring costs (0.12% and 0.06% of GDP respectively). This is a very small amount of money compared to likely systemic gains. Besides, it would probably pay for itself through increases in court fees and general tax collections.