

# Pro-Business versus Pro-Crony

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*India's aspiration to become a \$5 trillion economy depends critically on promoting "pro-business" policy that unleashes the power of competitive markets to generate wealth, on the one hand, and weaning away from "pro-crony" policy that may favour specific private interests, especially powerful incumbents, on the other hand. Economic events since 1991 provide powerful evidence supporting this crucial distinction. Viewed from the lens of the Stock market, which captures the pulse of any economy, creative destruction has increased significantly after reform. Before liberalization, a Sensex firm expected to stay in it for 60 years, which decreased to only 12 years after liberalization. Every five years, one-third of Sensex firms are churned out, reflecting the continuous influx of new firms, products and technologies into the economy. Despite impressive progress in enabling competitive markets, pro-crony has destroyed value in the economy. For example, an equity index of connected firms significantly outperformed the market by 7 per cent a year from 2007 to 2010, reflecting abnormal profits extracted at common citizens' expense. In contrast, the index underperforms the market by 7.5 per cent from 2011, reflecting the inefficiency and value destruction inherent in such firms. Pro-crony policies as reflected in discretionary allocation of natural resources till 2011 led to rent-seeking by beneficiaries while competitive allocation of the same resources post 2014 have put an end to such rent extraction. Similarly crony lending that led to wilful default, wherein promoters have collectively siphoned off wealth from banks, led to losses that dwarf subsidies directed towards rural development.*

## **PRO-BUSINESS, CREATIVE DESTRUCTION AND WEALTH CREATION**

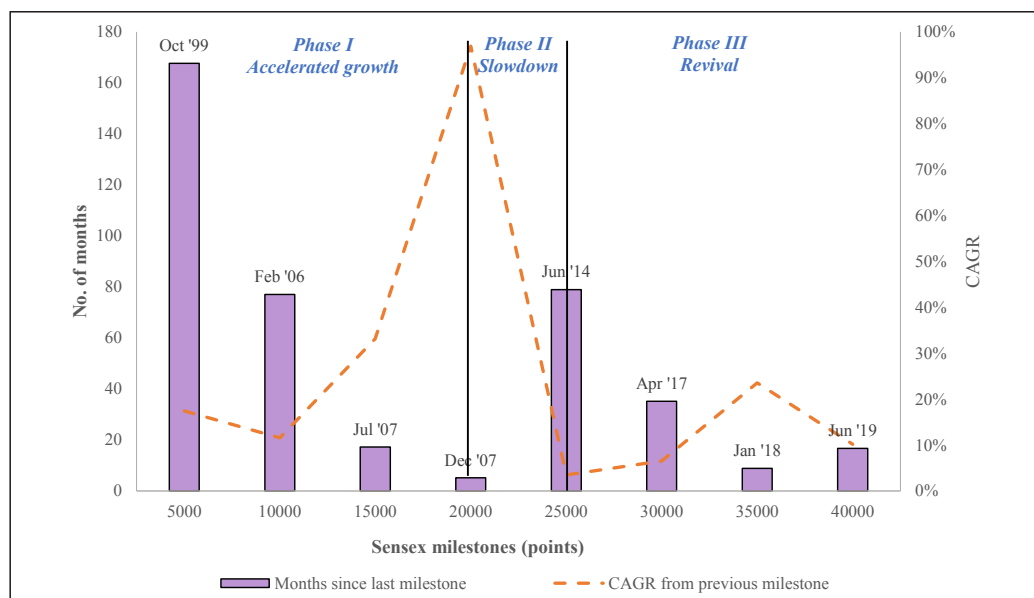
3.1 The liberalization of the Indian economy in 1991 unleashed competitive markets. It enabled the forces of creative destruction, generating benefits that we still witness today. Using the lens of Indian equity markets as captured in the S&P BSE Sensex,

we can clearly see an increase in market dynamism in the pro-business India of the post-liberalization period. Figure 1 reveals that after the market reforms of 1991, Sensex has not only grown, but has grown at an accelerating pace. Whereas crossing the first incremental 5000 points took over 13 years and was achieved in 1999, the time taken to achieve each incremental milestone has substantially reduced over the years.

3.2 Broadly, the growth of the Sensex as seen in the Figure 1 can be divided into three phases after 1999. Phase I from 1999 to 2007 saw an acceleration in the growth of the Sensex, with each successive 5000-point mark taking lesser and lesser time to achieve. Phase II from 2007 to 2014 saw a slowdown in the index's growth. This phase coincides with the global slowdown in 2008 among other unfavourable events. Phase III began in 2014 and saw a

revival in response to structural reforms and improvement in global liquidity. Strikingly, in this phase, the Sensex jumped from the 30,000 mark to the 40,000 mark in just two years. As the Cumulative Abnormal Growth Rates (CAGR) shown in the chart depict clearly, the acceleration in the Sensex was not due to the base effect. In fact, the higher acceleration stemmed from higher CAGR.

**Figure 1: Sensex- Incremental months taken to cross each 5000-point milestone**



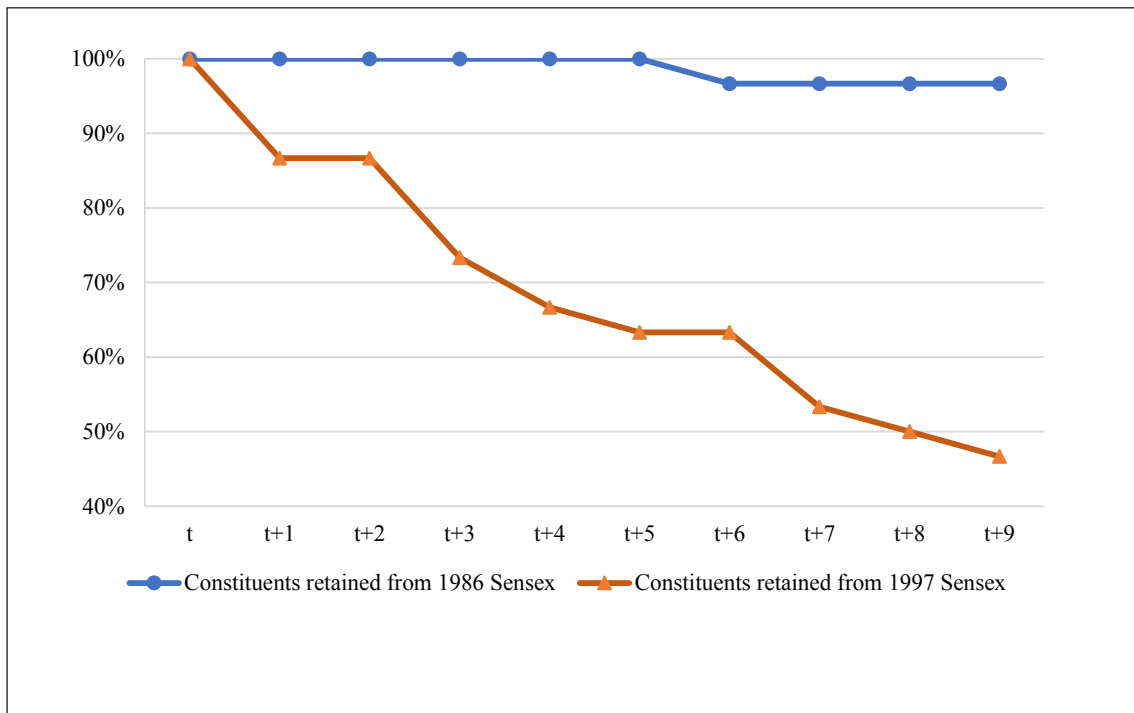
Source: BSE

Note: Time to cross each milestone is defined as the time elapsed between the first time the Sensex closed at the previous milestone and the first time it closed at the present milestone. CAGR is computed over the period from the previous milestone to the current one. Time elapsed is recorded as number of calendar days and converted to months assuming 30 days a month.

3.3 The relationship between pro-business policy and creative destruction is mirrored in the composition of the Sensex over the years.<sup>1</sup> For the first ten years since the Sensex's inception in 1986, the firms that constituted the index barely changed. As Figure 2 shows, of the firms that constituted

the index during its inception in 1986, nearly all the firms were retained for the majority of the next decade. On the other hand, the constituents of the Sensex of 1997 were steadily churned out over the next decade, so that the Sensex of 2006 had barely half the firms from the Sensex of 1997.

<sup>1</sup> Data gathered from BSE and Bloomberg. Full market capitalization is used rather than free-float capitalization for comparability over time, as free-float methodology was initiated only in 2003. Sensex constituents and market capitalization data were obtained from BSE for 1985-2000. Data is available from BSE on the following dates of observation: Dec '91, Jun '92, Jun '93, Nov '94, Mar '95, Mar '96, Mar '97, Jun '98, Mar '99, Mar '00. Data for subsequent years obtained from Bloomberg with Sept of each corresponding year as the month of observation, basis the latest available data as of this writing (data for 2019 is as of 3 Sept 2019).

**Figure 2: Percentage of Sensex constituents retained over next decade**

Source: Bloomberg, BSE

Note: Due to slight discrepancy in the month of observation before and after 2001 (due to distinct data sources), consider individual annual churn rates for 2000-02 as approximate; however the aggregated churn over these years is accurate.

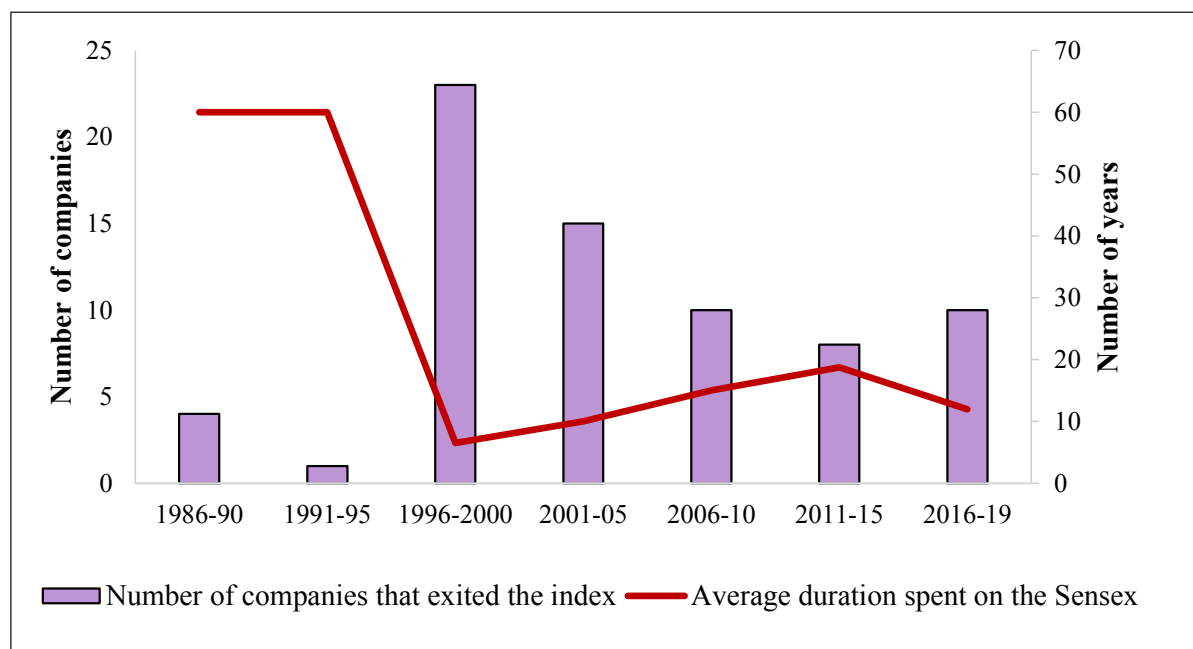
3.4 The lack of dynamism in the constitution of the index in its initial years was largely representative of the lack of dynamism in the Indian economy in general. However, the years following 1991 liberalization saw the rapid emergence of new firms, new ideas, new technologies and new operating processes, causing a steep revision of the Sensex in 1996. In 1996, half of the constituents of the index were replaced. After 1996, the Sensex underwent more frequent revisions, owing to the more dynamic nature of the now substantially more competitive Indian market.

3.5 Figure 3 shows the number of firms that exited the Sensex in each five-year period following 1986. Pro-business policy, i.e., liberalization caused a spike in the number of firms churned in the years that immediately followed it, but the churn rate did not decline to pre-liberalization levels in later years.

Ten firms were churned out in the five years from 2006 to 2010, eight in 2011-15 and ten in 2016-19. Put differently, every five years, roughly one-third of the firms in the index are replaced.

3.6 The figure also indicates the average duration a Sensex constituent remains on the index. Given that only 5 firms exited the index in the ten-year period 1986-95, had liberalization not occurred, a firm that entered the index in 1986 could have expected to stay on the index for the next sixty years! Following the 1991 reforms, the average duration a firm spent on the index declined drastically. Currently, a firm is expected to remain on the index for only 12 years – one-fifth of the expected duration prior to the reforms.

3.7 A pertinent question that arises at this stage is whether the churn illustrated above was beneficial to the Indian economy.

**Figure 3: Increasing churn in the Sensex**

Source: Bloomberg, BSE

Note: Average time spent on Sensex is calculated as the reciprocal of the churn rate in that period. Because of the very low churn in the first two periods, the total churn rate during 1986-95 is used to infer the time spent on the Sensex for these two periods.

A monopolist taking the place of another identical monopolist is hardly beneficial. However, in the Indian case, the Sensex does represent a process of creative destruction rather than spurious dynamism. The firms

that displaced the incumbents on the Sensex brought with them new ideas, technologies and processes. For an illustration, consider Table 1 that depicts the major Sensex revision of 1996 following market reforms.

**Table 1: Revision of the constituents of the Sensex index in 1996**

Exit		Replacement	
Firm	Industry	Firm	Industry (new in bold)
Ballarpur Industries	Materials	Arvind Mills	Consumer Durables & Apparel
Bharat Forge	Materials	Bajaj Auto	Automobiles & Components
GSFC	Materials	Ambuja Cements	Materials
Indian Organic	Materials	ICICI	<b>Diversified Financials</b>
Mukand Iron	Materials	MTNL	<b>Telecommunication Services</b>
Bombay Dyeing	Consumer Durables & Apparel	BHEL	Capital Goods
Century Textiles	Consumer Durables & Apparel	Colgate	<b>Household &amp; Personal Products</b>

Indian Rayon	Consumer Durables & Apparel	IDBI	<b>Diversified Financials</b>
Phillips	Consumer Durables & Apparel	Ranbaxy Labs	Pharma, Biotech & Life Sciences
Voltas	Consumer Durables & Apparel	Tata Chemicals	Materials
Ceat	Automobiles & Components	BSES	Utilities
Hindustan Motors	Automobiles & Components	HPCL	Energy
Premier Auto	Automobiles & Components	SBI	<b>Banks</b>
Kirloskar Cummins	Capital Goods	IPCL	Materials
Siemens	Pharma, Biotech & Life Sciences	SAIL	Materials

Source: BSE, Bloomberg.

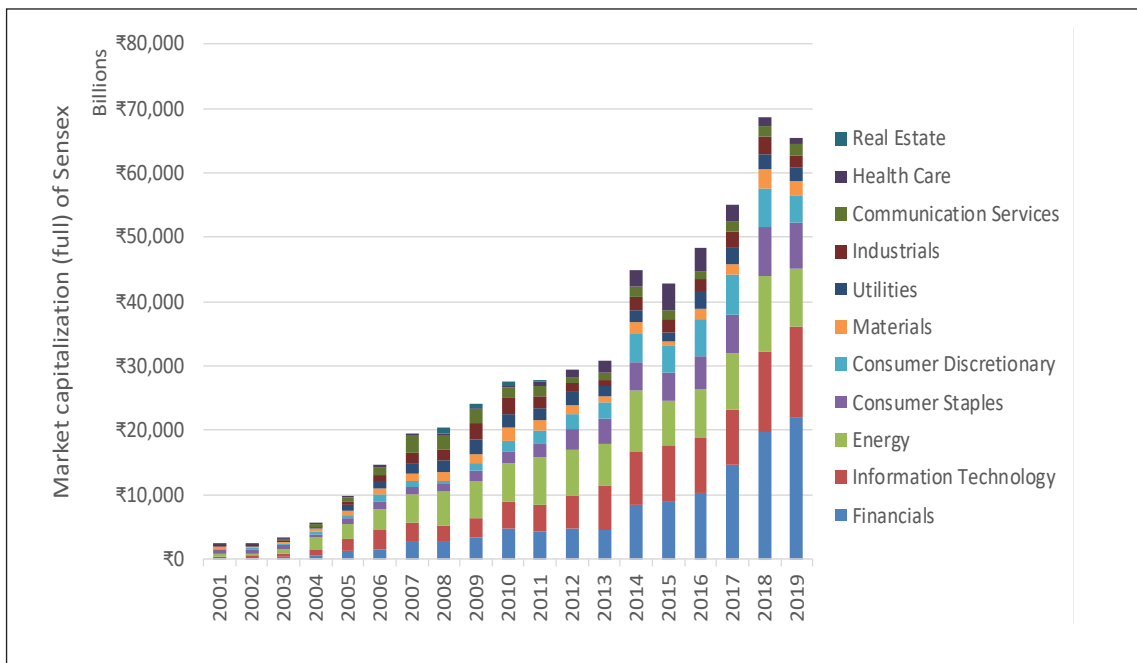
Note: Highlighted cells represent new sectors that entered the index for the first time.

New sectors like banks and financials entered the index for the first time, eroding the predominance of the manufacturing sector on the index, placing the services sector on the map for the first time, and reflecting the far-reaching changes that the Indian economy

was witnessing in the wake of liberalization.

3.8 Figure 4 depicts the size of various sectors in the Sensex by market capitalization over time. Financials and information technology, which were virtually non-existent in the Sensex of the early 1990s,

**Figure 4: New sectors emerged in the Sensex following liberalization**



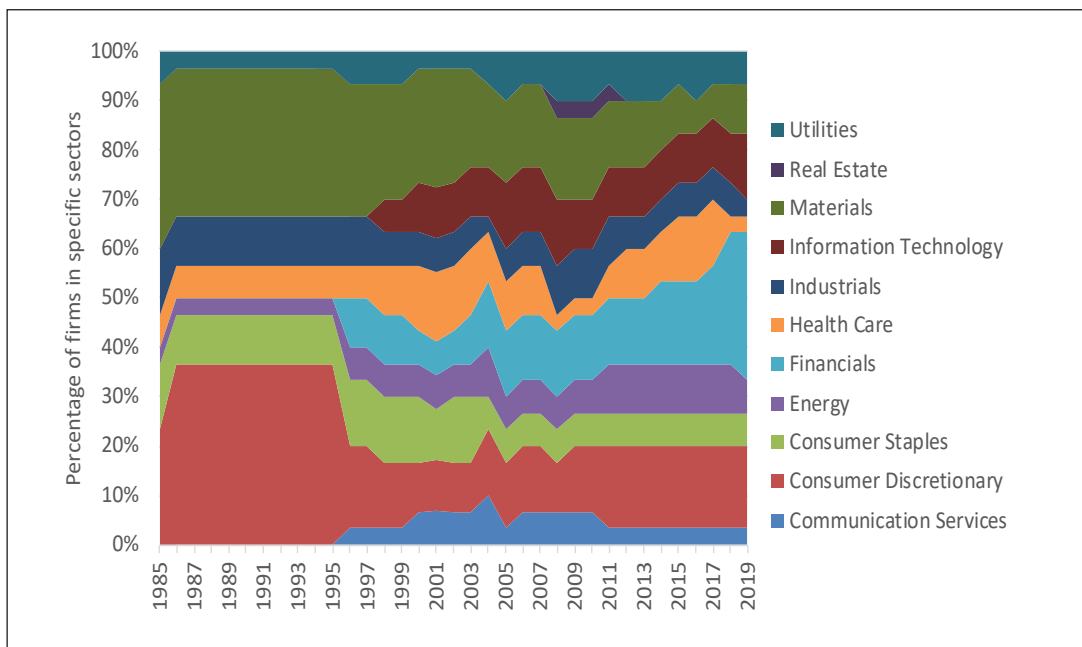
Source: Bloomberg, BSE

are responsible for more than 50 per cent of the market share of the Sensex today. It is therefore incontrovertible that the churn in the Sensex represents a very real process of creative destruction that brought altogether new technologies, products and services to consumers.

3.9 The diversity of sectors in the Sensex steadily increased over time following market reforms, as shown in Figure 5 below.

The initial Sensex of 1986 was dominated by the Materials and Consumer Discretionary sectors, accounting for two-thirds of the firms on the Sensex. Sectors like financials, telecommunications and information technology were non-existent in the index then. With the entry of these new sectors, today's Sensex is far less concentrated than the Sensex of the 1980s and 1990s, and mirrors the far lower sectoral concentration of the Indian economy as a whole.

**Figure 5: Sectoral concentration of the Sensex decreased post-liberalization as new sectors emerged**



Source: Bloomberg, BSE

3.10 India has followed an idiosyncratic growth pattern, wherein the prime mover of the economy has shifted from agriculture to services. Almost 60 per cent of Indian GDP is attributable to the services sector. As shown by Figure 6, the number of Sensex firms in manufacturing has reduced while those in services has increased between 1988 and 2019. Thus, over the years, the share of services sector in the total number of companies on the Sensex has changed from being negligible in the 1980s to the dominant

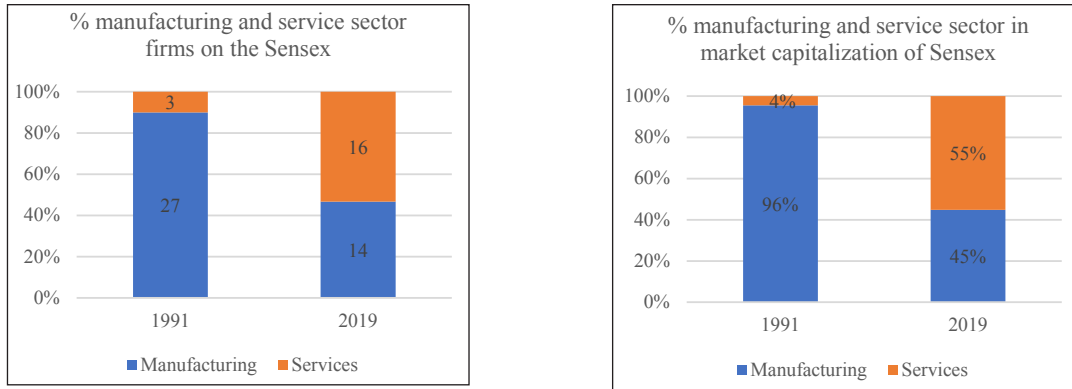
status today.

3.11 Today's Sensex is not only composed of a larger number of sectors, but is also far more democratic in terms of the size of companies. In 1991, the largest firm on the index was roughly 100 times the smallest in terms of market capitalization. Ten years later, the ratio declined to roughly 75. In 2018, the ratio was only 12. The benefit of liberalizing markets does not end with a one-time drop in the ratio and continues to be felt

even today, as indicated by the decreasing trend in the ratio in Figure 7. Similarly, while the largest firm of 1991 constituted around 20

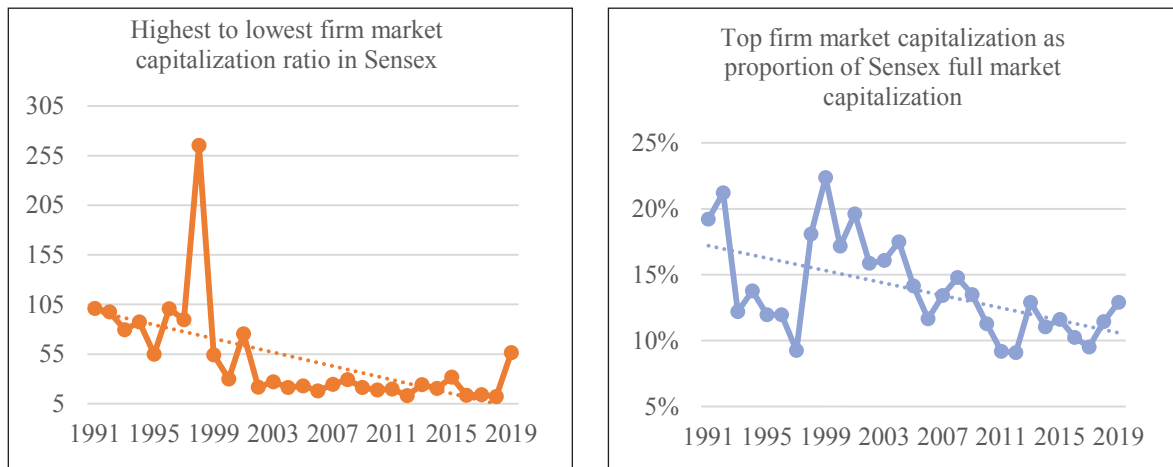
per cent of the market capitalization of the Sensex, the largest firm of 2019 contributed only 13 per cent.

**Figure 6: The rise of services in the Sensex**



Source: Bloomberg, BSE

**Figure 7: Decreasing size concentration of firms in the Sensex**



Source: Bloomberg, BSE

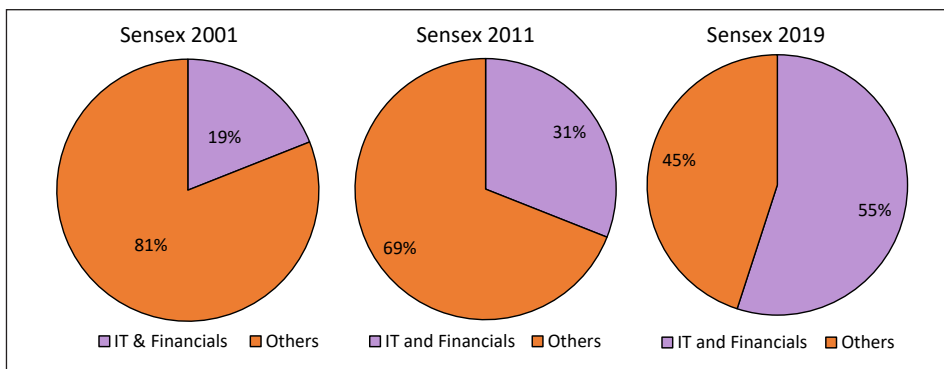
Note: See earlier footnote about the dates on which market capitalization for each corresponding year is observed. Data for 2019 is as of 3 Sep 2019

3.12 The forces of creative destruction following liberalization in the Indian economy have led to the rise of new sectors such as financials and information technology. Virtually non-existent in the Sensex of the early 1990s, the share of these sectors in the total market capitalization has increased over the years, so much so that these sectors dominate the Sensex today (Figure 8). At first glance, this trend indicates

a cause for concern: a potential case of more concentration or a reversal in creative destruction in the economy. However, a closer look reveals otherwise.

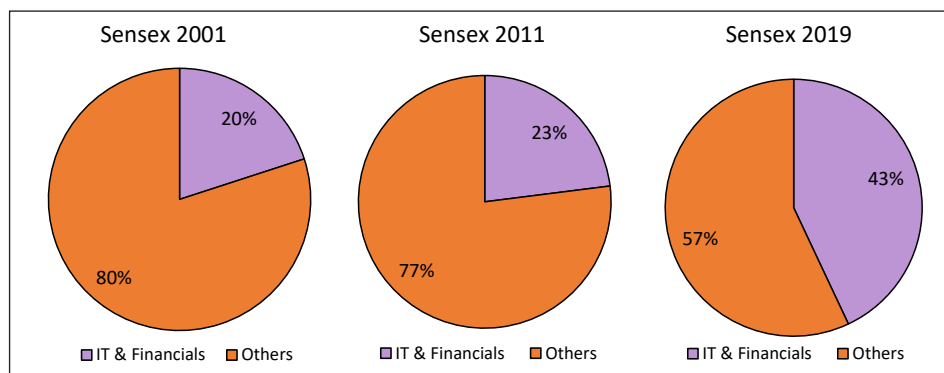
3.13 Firstly, the rising share in market capitalization has been accomplished by a rise in number of companies rather than a rise in size of incumbents, suggesting greater competition within these sectors (Figure 9).

**Figure 8: Increasing Share of IT and Financials Sector in Total Market Capitalization of Sensex**



Source: Bloomberg, BSE

**Figure 9: Increasing Share of IT and Financials Sector (By Count) in the Sensex**



Source: Bloomberg, BSE

3.14 Secondly, using the Herfindahl Index to analyse degree of competition within the two sectors reveals an overall decline in concentration in both sectors. However, the IT sector has recently begun to show a slight increasing trend in the Herfindahl index, indicating that there is room to increase competition in the sector (Figure 10).

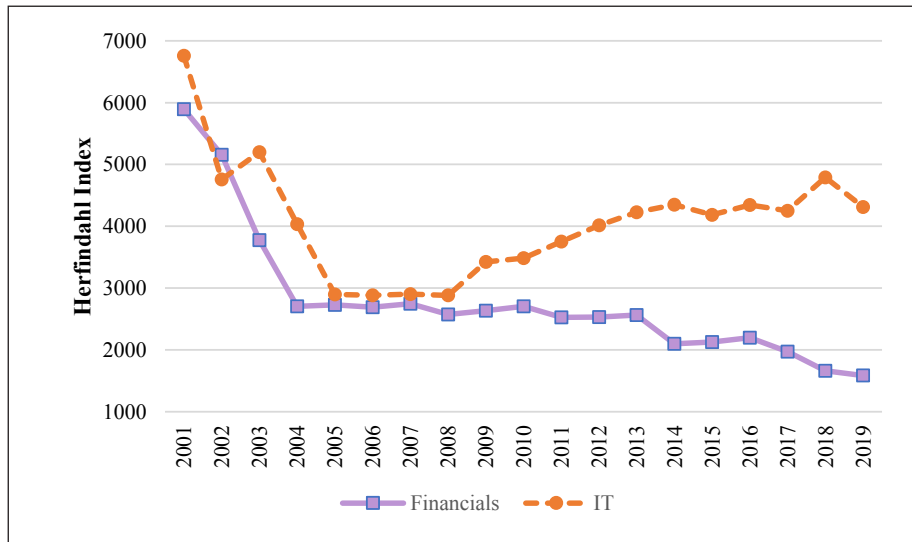
3.15 Three key insights emerge from the analysis above. First, we can expect today’s dominant firms to remain dominant for only one-fifth of the time that their pre-liberalization counterparts did. Second, sectors once considered mainstays of the Indian economy are being displaced by new sectors bringing with them new technologies and products. The competitive advantage of

entrenched firms is being rapidly challenged by new, smaller and more agile firms; every five years, roughly one in three firms in the Indian economy can expect to be challenged in a massive way by the forces of creative destruction. Finally, the difference between the sizes of the largest and smallest firms are rapidly shrinking, and consequently monopoly power in the economy is declining and making way for more competitive markets. Consumers benefit from an increased variety of goods and services, lower prices and incessant improvement in the quality of existing products.

3.16 “There is a common misconception that people who are in favour of a free market are also in favour of everything that big



**Figure 10: Herfindahl Index of Financials and IT sectors**



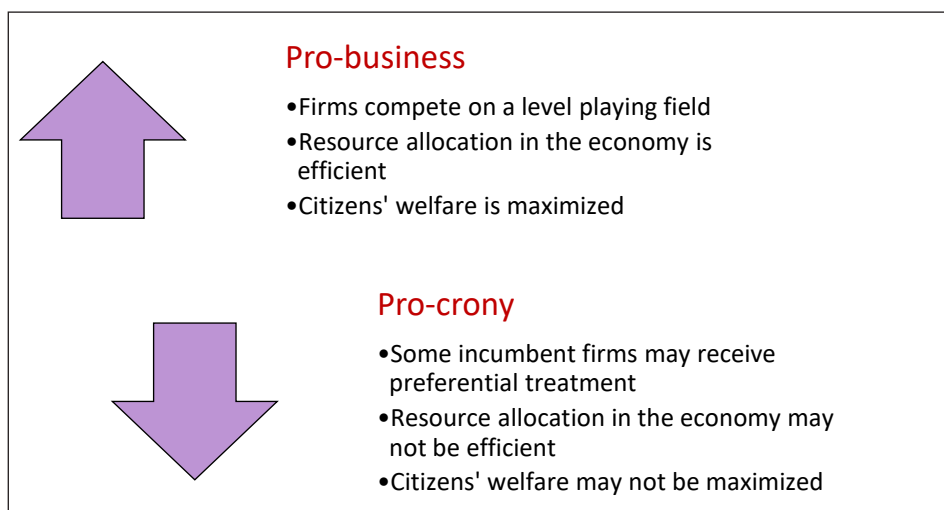
Source: Bloomberg, BSE

business does. Nothing could be further from the truth,” wrote Milton Friedman (Friedman 1999). Pro-crony policy supports incumbent firms but does not necessarily foster competitive markets (Figure 11). On the other hand, policy that fosters competitive markets (hereafter pro-business policy) creates a level playing field for businesses to compete. It unleashes the powerful forces of creative destruction, which create wealth. Austrian economist and creator of the term, Joseph Schumpeter, described creative destruction

as a “process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one.”

3.17 Creative destruction brings new innovations into the market that serve people better than the old technologies they displace. It brings new firms into the markets, which compete with existing firms and lower prices for consumers. It brings dynamism to the marketplace that keeps firms on their

**Figure 11: Difference between pro-business and pro-crony policy**



toes, always on the lookout for the next big way to serve consumers. It has only one prerequisite – a pro-business policy stance that fosters competitive, unfettered markets.

3.18 When creative destruction is fostered, sectors as a whole will always outperform individual companies within the sector in creating wealth and maximizing welfare. Therein lies the motivation for India to pursue pro-business, rather than pro-crony, growth.

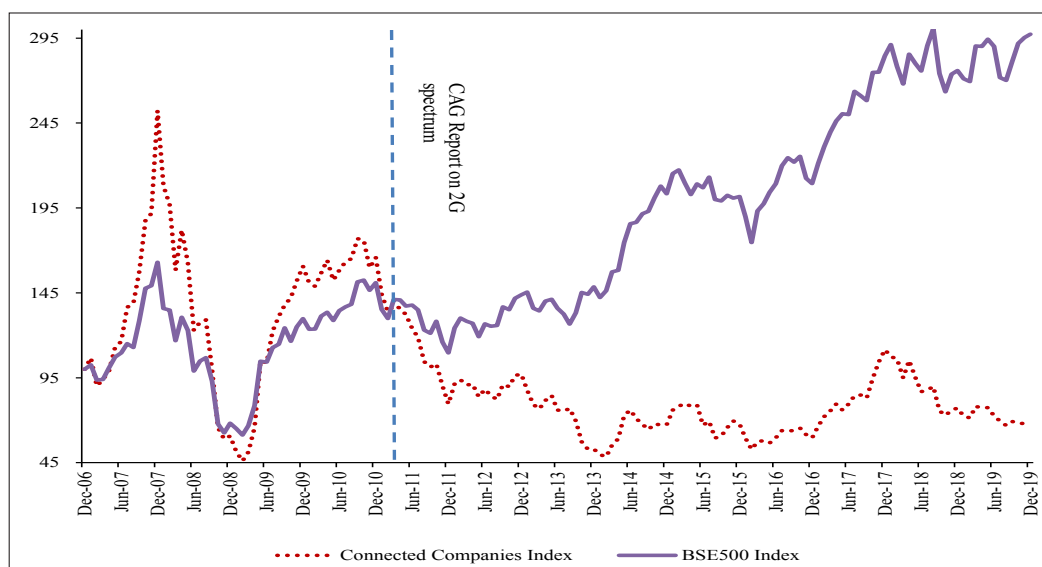
## PRO-CRONY AND WEALTH DESTRUCTION

3.19 Pro-crony policies, in contrast to pro-business ones, erode wealth in the economy as cronyism fosters inefficiencies by inhibiting the process of creative destruction. Raghuram Rajan and Luigi Zingales stressed the need for “saving capitalism from the capitalists” in their eponymous book, referring to the dangers of regulatory capture by private interests (Rajan and Zingales 2003).

3.20 Ambit Pvt Ltd, a brokerage, publishes a stock market index of 75 Indian firms that they define as “connected”. For our purposes, they proxy firms that may benefit from pro-crony policies. Figure 12 compares the performance of this index to the BSE 500 index over time.

3.21 Prior to 2010, it clearly paid a firm and its shareholders if the firm’s promoters had “connections”. The index of “connected” firms consistently outperformed the BSE 500 index as these firms systematically made more profits than would have been possible in a more competitive economy. The market priced the current and future abnormal profits of these firms. In late 2010, the Comptroller and Auditor General’s audit report on the 2G spectrum allocation named a list of private companies that benefitted from alleged collusions in the allocation of the 2G spectrum. The timing of the report’s release is demarcated on the chart with a vertical line.

**Figure 12: Investor wealth generated by connected firms before and after CAG report on the 2G scam**



Source: Ambit Capital research, Capitaline, BSE

Note: 1) The connected companies index is an aggregate market cap index which has been rebased and is adjusted for demergers, 2) 70 companies with political dependence and connectivity as on Dec'06 as per Ambit analysts.

3.22 The CAG report on the 2G allocations appears to have reversed the fortunes for “connected” firms. The “connected” index started to underperform the market starting 2011. In fact, the gap for the investor wealth destroyed by “connected” firms is widening over time, which reflects the inability of such firms to systematically create value for their investors from extracting rents based on their political connections (Kishore 2016).

3.23 Had an investor invested ₹ 100 in these “connected” firms at the start 2007, her investment would have grown to ₹ 190 by the start of 2010. On the other hand, had she invested ₹ 100 in the BSE500, the investment would have grown to ₹ 150. The “connected” index yielded an average return of 17.5 per cent per annum during this period, whereas the BSE 500 index yielded an average return of 10.5 per cent per annum. “Connected” firms thus outperformed the broad index of the stock market by 7 percentage points

a year on average till 2010. Put differently, from 2007 to 2010, “connected” firms realized 7 percentage points higher returns than they would have in a more competitive market.

3.24 This pre-2010 outperformance of “connected” firms indicates the possible extent of rents extracted by these firms at society’s expense. In contrast, the significant post-2010 underperformance – following the release of the CAG report – illustrates the fact that such “connected” firms were likely to have been inefficient ones. Between 2007 and 2016, “connected” firms have earned, on average, 7.5 percentage points lower returns than the BSE 500 index per annum. This phenomenon of rent-seeking by inefficient, “connected” firms, though unhealthy to the economy, is not unique to India. In fact, several global studies reinforce the relationship between such connections and rent-seeking activities when institutional checks and balances are weak (Box 1).

### Box 1: Global evidence that political connections lead to rent extraction

Several studies from around the globe find that political connections lead to rent extraction.

Faccio (2006) examines politically connected firms in 47 countries and finds that around the time that a firm announces that managers or large shareholders are entering politics, there is a positive impact on stock price. The result is consistent with the theory that markets anticipate additional sources of profit for the now politically connected firm despite no change in firm fundamentals. Faccio *et al.* (2006) study financial distress in politically connected firms in 35 countries and find that distressed politically connected firms are significantly more likely to be bailed out by the government than their non-connected counterparts. Claessens *et al.* (2008) show that Brazilian firms that provided contributions to (elected) federal deputies experienced higher stock returns than firms that did not make such contributions around the 1998 and 2002 elections. Further, contributing firms substantially increased their bank financing relative to a control group after each election, indicating that access to bank finance is an important channel through which political connections operate. They estimate the economic costs of this rent seeking over the two election cycles to be at least 0.2 per cent of gross domestic product per annum.

A recent World Bank study of cronyism in Ukraine finds that the country would grow 1 to 2 per cent faster if all political connections were eliminated (Kahkonen 2018)! Politically connected firms in Ukraine account for over 20 per cent of the total turnover of all Ukrainian companies. The study finds that these politically connected firms (i) are larger than non-connected peers, (ii) pay lower

effective tax rates, (iii) are less productive in terms of total factor productivity (TFP), (iv) are less profitable, and (v) grow slower (World Bank 2018).

### **Evidence from Asia**

#### **China**

Firth *et al.* (2009) find that political connections play a role in the allocation of bank loans to Chinese firms. They find that having the state as a minority owner helps firms obtain bank credit. Political connections especially benefit firms located in areas with a less developed banking sector. Deng, Zeng & Zhu (2019) provide evidence that firms in China actively build political connections to alleviate the cost of market frictions. Firms facing severe market frictions are not as financially constrained as they would be expected to be; the key reason is that they possess strong political connections which alleviate these costs. Chan *et al.* (2012) find that politically connected firms in China display much lesser financing constraints compared to firms without such connections. Chen *et al.* (2017) find that politically connected underwriters increase the likelihood of clients' IPO applications being approved by the Chinese Securities Regulatory Commission. Further, consistent with the rent-seeking argument, they document the post-IPO underperformance of such firms, indicating that minority shareholders' interests may be compromised.

#### **Thailand**

Bunkanwanicha & Wiwattanakantang (2009) find in Thailand that when business owners come to political power, the market valuation of their firms increases dramatically. Business owners in top offices use their policy-decision powers to implement regulations and public policies favorable to their firms. Civilize *et al.* (2015) undertake a longitudinal study of firms in Thailand and conclude that higher realized stock returns are systematically associated with political connectedness. Consistent with the view that such a relationship provides economic rents, this finding is particularly prominent in more regulated industries. The politically connected premium is higher for higher level political connections and when the political bodies hold an equity stake in the firm.

#### **Indonesia**

Fisman (2001) estimates the value of political connections in Indonesia by looking at how stock prices of firms with differing degrees of political exposure moved when former President Suharto's health was reported to change. Adverse health reports led politically connected firms to realize lower returns than less dependent firms.

#### **Malaysia**

Johnson & Mitton (2003) find that the imposition of capital controls in Malaysia in 1998 primarily benefitted firms with strong ties to the President, suggesting that capital controls provided a screen behind which firms with political ties leveraged their connections for favours. A study of Malaysian politically connected firms finds that such firms are perceived as being higher risk by the market, audit firms and lenders. Such firms have higher likelihoods of reporting a loss, having negative equity, and being charged higher interest rates by lenders (Bliss and Gul 2012).

#### **Vietnam**

Rand (2017) examines over 2000 Vietnamese SMEs over a 10-year period and finds that political connections decrease the likelihood of a firm being credit-constrained by 4 percentage points. Further, politically connected firms accessing credit face lower cost-of-capital than non-connected SMEs not excluded from formal financial markets.

These studies unanimously document a myriad of benefits enjoyed by politically connected firms. These benefits represent direct and indirect forms of rent unduly enjoyed by the connected firm's shareholders at the expense of unconnected firms and society at large.

3.25 Pro-crony, when compared to pro-business, policies can create various indirect costs as well. When opportunities for crony rent-seeking exist, firms shift their focus away from growth through competition and innovation towards building political relationships, thus undermining the economy's capacity for wealth creation (see Box 2). Further, the rents sought by cronies are paid for by genuine businesses and citizens who are not receiving any preferential treatment. Such a transfer of wealth exacerbates income inequality in the economy, as crony firms leverage their connections to extract a larger share of existing wealth instead of expanding the available wealth.

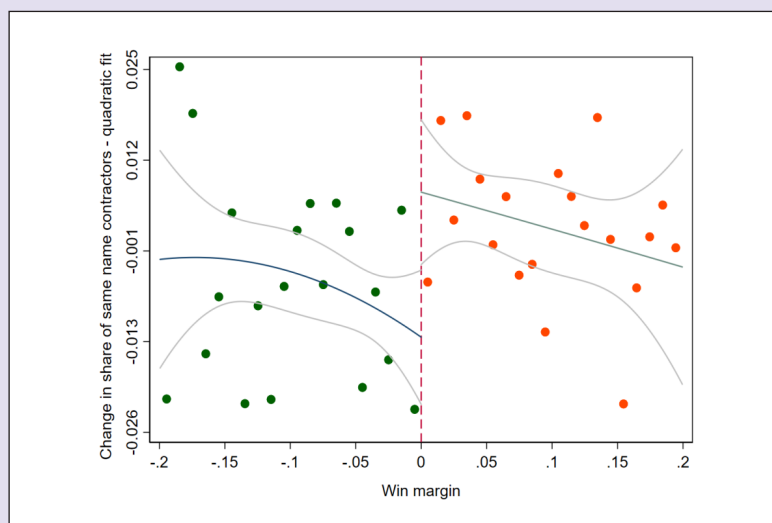
## DISCRETIONARY ALLOCATION OF NATURAL RESOURCES VIS-À-VIS ALLOCATION VIA AUCTIONS

3.26 In this section, we consider a case study from the natural resource allocation process in India. India has the fifth largest coal reserves in the world behind USA, Russia, China, and Australia. Coal is the most important indigenous source of energy for India; it meets more than half of India's energy requirements. Therefore, allocation of such an important natural resource provides us a nice case study to contrast pro-business and pro-crony policies.

### Box 2: Political clout and preferential allocation of contracts (2001-13): A case study of road construction in India

Many businesses in India use their political clout to obtain preferential allocation of projects and resources from the government. Lehne, Shapiro & Eynde (2016) examine bidding data on more than 88,000 rural roads built under the Pradhan Mantri Gram Sadak Yojana (PMGSY) and juxtapose this data with election results. Using a large sample spanning 8116 candidates in 4058 elections from 2001 to 2013 and employing a regression discontinuity design, the study finds that after close election victories, contractors affiliated to the winning politician are more likely to be awarded road projects. Figure below depicts this result graphically, plotting the change in the share of contractors who have the same name as the winning politician against the politician's margin of victory in the election.

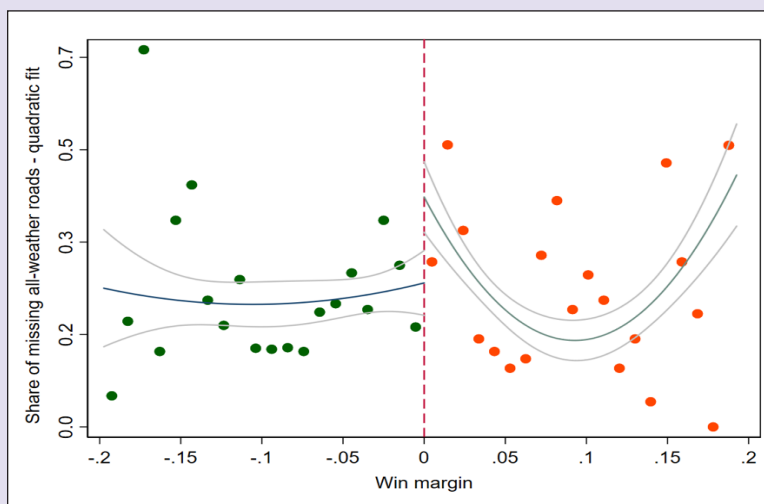
**After close election victories, the share of road construction contractors who appear affiliated to the winning politician increases**



Source: Lehne, Shapiro & Eynde (2016)

Further, the authors use Census 2011 data at the village level to check whether roads listed as completed in the PMGSY monitoring data are also captured in the Census data. Several roads recorded as complete in PMGSY monitoring data are missing from the Census, suggesting that these roads were never actually built or completed. Around 26 per cent of roads listed as completed prior to the census in PMGSY data are missing from the 2011 Census data. Preferential allocation of roads increases the likelihood of such “missing” roads by as much as 86 per cent. The figure below depicts this dramatic effect.

**After close election victories, the share of missing all-weather roads increases when the contractor appears affiliated to the winning politician**



Source: Lehne, Shapiro & Eynde (2016)

The authors find that preferential allocation accounts for an additional 497 missing all-weather roads that would have served roughly 860,000 people. Clearly, PMGSY contracts that seem to have been politically influenced lead to suboptimal economic outcomes.

3.27 Prior to 1993, no specific criteria for the allocation of captive mines existed. Amendments introduced to the Coal Mines (Nationalisation) Act 1973 in June 1993 allowed private companies to carry out coal mining for captive use. In July 1992, a screening committee was set up under the chairmanship of the Secretary of Coal to consider applications made by various companies interested in captive mining and to allocate coal blocks for development. In August 2012, the CAG report on coal block allocations examined the effectiveness

of the processes adopted in allocation of coal blocks.<sup>2</sup> On 24 September 2014, the Supreme Court of India cancelled 214 of the 218 allocations made by the Government of India over a span of 15 years.<sup>3</sup> The Coal Mines (Special Provisions) Bill, 2014, and its subsequent rules, were passed in December 2014, and the Coal Mines (Special Provisions) Act, 2015, was included in the Indian mining legislative framework. The Act ensured that any future allocation of coal blocks would solely be through competitive auctions.

<sup>2</sup> The report can be found here:

[https://www.cag.gov.in/sites/default/files/audit\\_report\\_files/Union\\_Performance\\_Commercial\\_Allocation\\_Coal\\_Blocks\\_and\\_Production\\_Ministry\\_Coal\\_7\\_2012.pdf](https://www.cag.gov.in/sites/default/files/audit_report_files/Union_Performance_Commercial_Allocation_Coal_Blocks_and_Production_Ministry_Coal_7_2012.pdf).

<sup>3</sup> Manohar Lal Sharma vs. The Principal Secretary & Ors., Writ Petition No. 120 of 1012. A copy of the order can be accessed here: <http://www.prsindia.org/uploads/media/Coal%20Mines/SC%20order.pdf>.

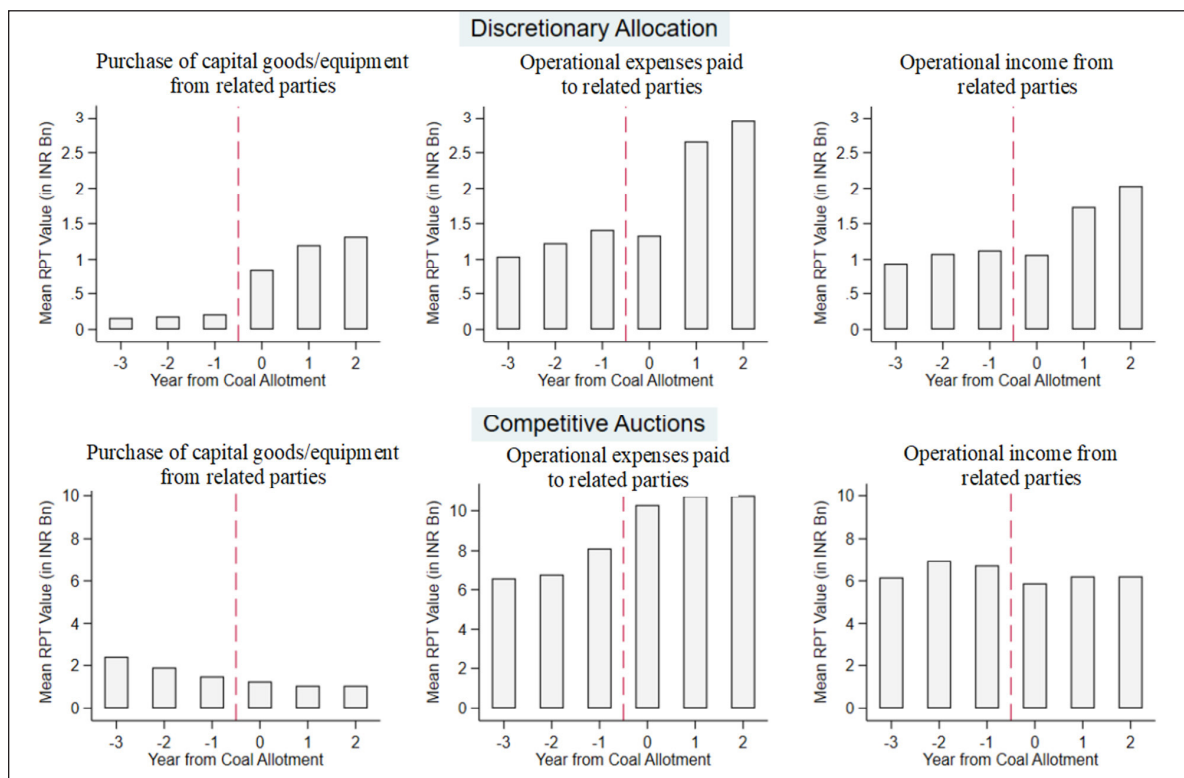
### Use of Related Party Transactions in Discretionary Allotment of Natural Resources

3.28 Abraham, Chopra, Subramanian & Tantri (2018) find evidence that the form of coal block allocation has an impact on the value of Related Party Transactions (RPTs) engaged in by firms that are beneficiaries of the coal block allocation. Comparing the RPTs in the 3-year period post the allotment against the 3-year period prior to the allotment, they find significant differences between the rupee value of RPTs undertaken by beneficiaries of the committee-based allotment versus the beneficiaries of the competition-based allotment.

3.29 Figure 13 graphically depicts the comparison for RPTs under three heads. First, RPTs used for purchasing capital goods/

equipment from related parties are classified as “Capital Purchases”. Capital purchases offer an ideal mechanism to transfer wealth because they are large one-time non-recurring cash outflows that can serve as an opportune mask to hide transactions from regulators. Second, operational expenses paid to related parties are classified as “Revenue expenses.” Third, operational income from related parties are classified as “Revenue income.” These three RPTs show a marked increase in the three-year period following the receipt of a coal block through the committee-based allocation as compared to the preceding three years. No such increase is seen in the case of auction-based allotment. The other three main types of RPTs – Capital Sales, Loans and advances given and taken do not show any particular increase in the case of the committee-based allocation.

**Figure 13: Impact of coal block allocations on Related Party Transactions**



Source: Abraham, Chopra, Subramanian & Tantri (2018)

### RPTs to unlisted/foreign entities and tax havens

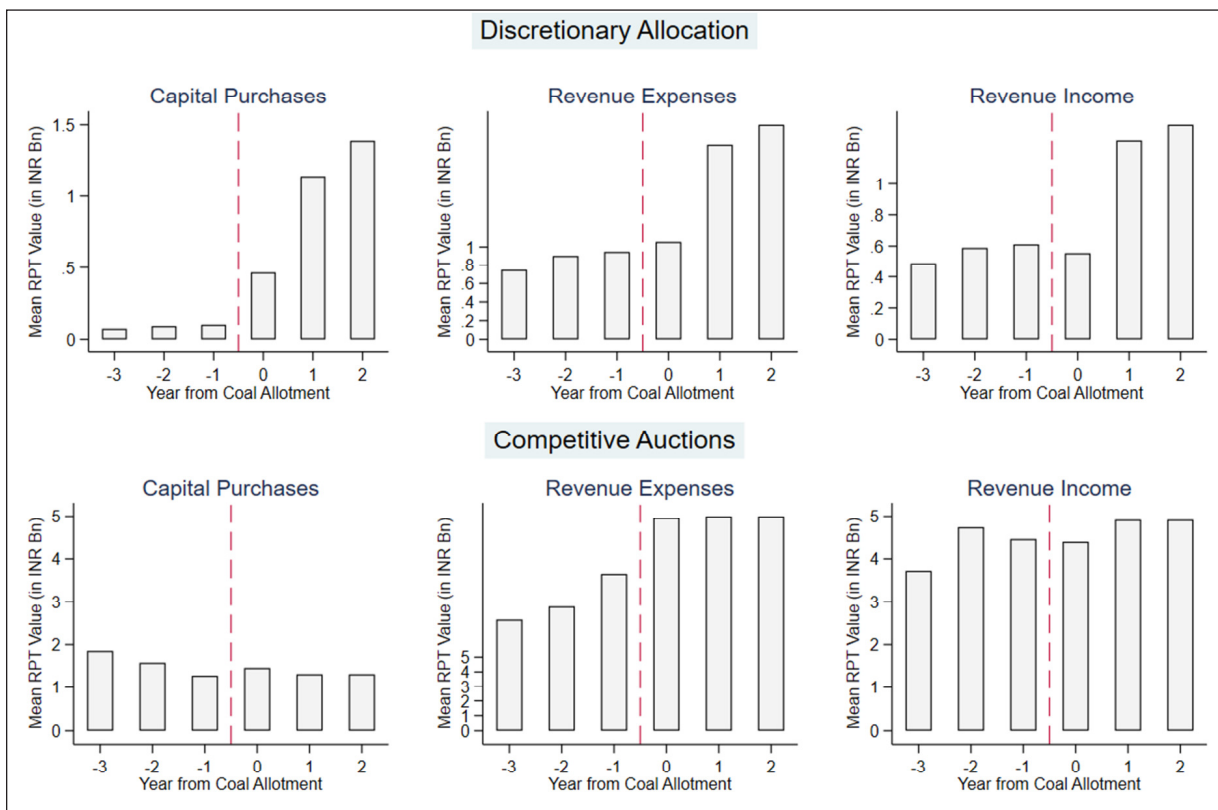
3.30 Figure 14 shows RPTs with unlisted/foreign entities and related parties that are based out of internationally recognised tax havens. Unlisted/foreign entities are either individuals or unlisted domestic enterprises or enterprises incorporated in a foreign jurisdiction. As such entities are harder for the domestic enforcement authorities to track, RPTs with such entities are likely to manifest for purposes of opacity. Similarly, tax havens are characterised by opaque disclosure regulations and hence serve as an ideal sink to tunnel corporate wealth away from other stakeholders. As the figure shows,

firm behaviour is nearly identical to the earlier figures, with capital purchases, revenue expenses and revenue income showing a remarkable increase post the receipt of the coal block in the committee-based allotment process, while no such increase is seen following competitive auctions.

### Director compensation and consulting expenses

3.31 The authors also find evidence that one-time payments to directors like commissions, perquisites and consulting expenses increase following the discretionary allocation. Director commissions increase by 12 per cent, director perquisites by 5.7 per cent and other consulting expenses by

Figure 14 : RPTs to Unlisted/Foreign counterparties and tax havens



Source: Abraham, Chopra, Subramanian & Tantri (2018)



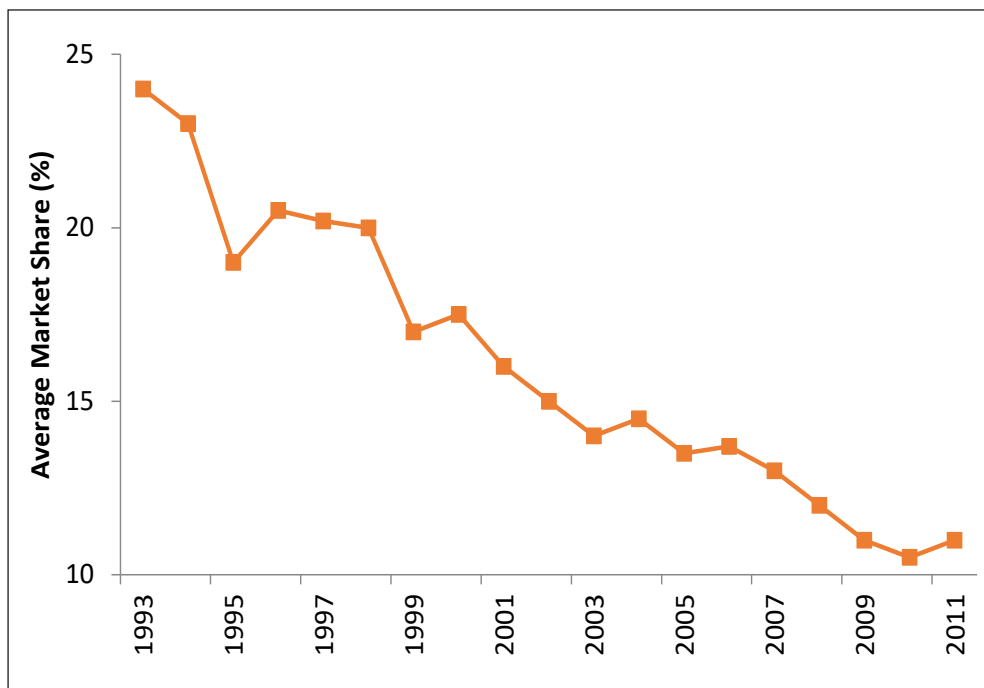
7.6 per cent. We find no increase in the case of salary expenses for normal employees suggesting that only the directors benefit post the discretionary allocation. In the case of auctions, we see no such increases. In fact, we find that director salaries decrease post the auction-based allotment.

### Firm productivity and performance

3.32 Figure 15 shows the evolution of the average market share of firms that received

the committee-based allocation from 1993 to 2011. There has been a steady decline in the market share of these firms despite them getting a windfall gain from the discretionary allocation. The gain of an almost free resource should have aided firm productivity and business fundamentals. Instead the market share has fallen over the years - suggesting a case of Dutch disease – firms that got the free resource diverted efforts towards the tunnelling of the windfall gain instead of towards productive business activity.

**Figure 15: Market share of allottee firms (committee-based allocation)**



Source: Abraham, Chopra, Subramanian & Tantri (2018)

3.33 Indeed, the authors find that total income declines by 54.9 per cent over a 3-year period from the date of allocation as compared to firms that did not receive an allocation, total expenses reduce by 58.7 per cent and PAT by 37.8 per cent. There also seems to be a loss of productive assets - total assets reduce by 76.2 per cent and Land and Building reduces by 48.2 per cent

and Plant and Machinery reduces by 51.1 per cent. They find no such decline in the case of competitive auctions.

3.34 Overall, the evidence suggests that discretionary allocation of natural resources by a committee provides avenues for rent-seeking. Subsequently, firm owners divert their focus towards tunnelling away these rents rather than furthering productive

economic activities. A shift to market-based allocation of resources takes these avenues away, encourages productive economic activity and generates more wealth.

### Riskless Returns: The Case of Wilful Default

3.35 Although the primary tenet of any investment is that high expected rewards come with high risk, many Indian firms have found a peculiar way to reap rewards without commensurate risk. Many firms enjoy profits in good times but often rely on the state or their financiers to bail them out in bad times. A particularly egregious form of such riskless return is the phenomenon of wilful default – a classic case of a one-way gamble in which “heads, the promoter wins; tails, the lender loses”. Wilful default occurs when firms take loans, divert the proceeds out of the firm for the personal benefit of owners, default on loans and declare bankruptcy, thereby expropriating a range of stakeholders – lenders, minority shareholders, employees,

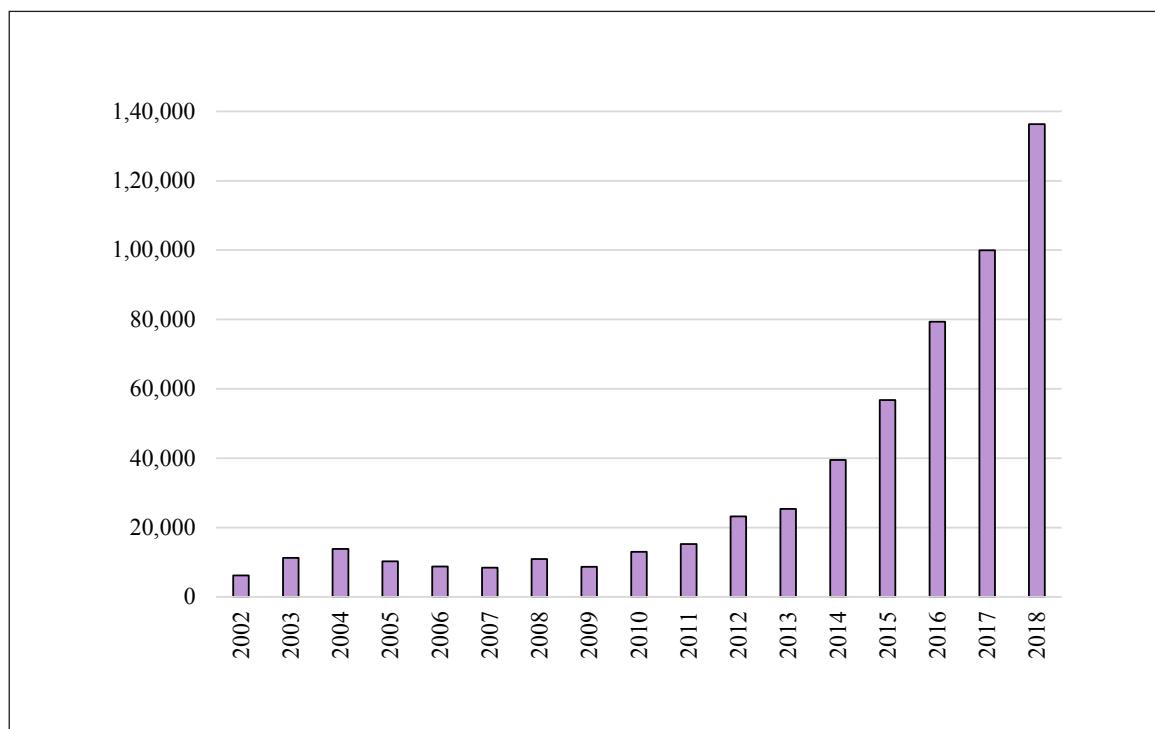
regulators and state coffers.

3.36 The RBI defines wilful defaulter as a firm that has defaulted in meeting its repayment obligations even though it has the capacity to honour these obligations. A firm could also be branded a wilful defaulter if it uses the funds for purposes other than what is sanctioned by the lender, siphons the money out to related parties or removes the assets used to secure the loan.

3.37 Every rupee lent to a wilful defaulter constitutes an erosion of wealth. Money lent to a genuine business creates assets, which generate profit and employment. On the other hand, money lent to a firm that has no intention of investing the proceeds in *ex-ante* profitable projects is money wasted. Besides making cronies rich, it contributes nothing to the economy.

3.38 Figure 16 and Figure 17 show the wealth that wilful defaulters have taken out of the Indian economy. As of 2018, wilful

**Figure 16: Aggregate outstanding amount owed by wilful defaulters (₹ crores)**



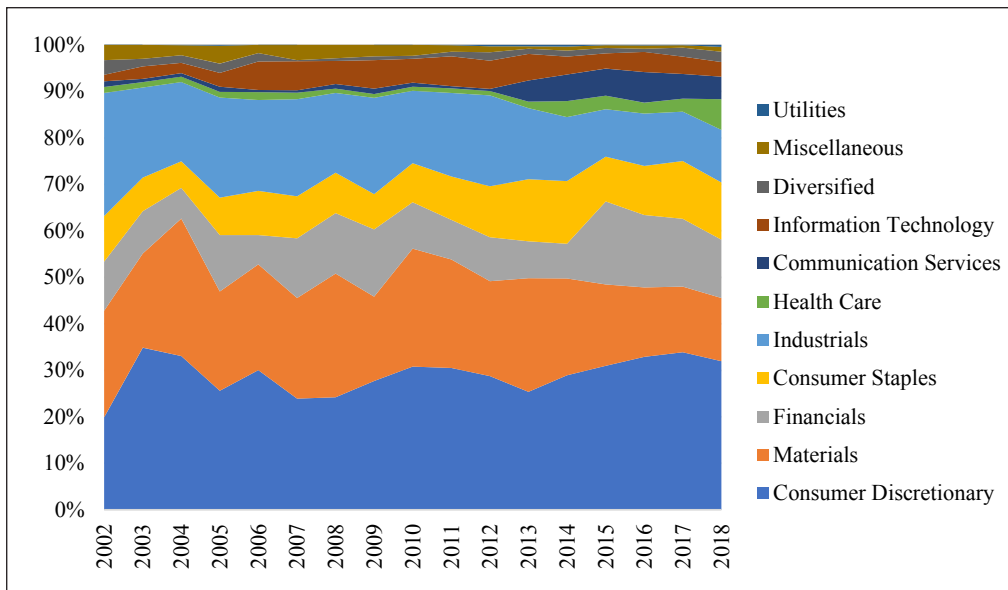
Source: TransUnion CIBIL Suits Filed database

defaulters owed their respective lenders nearly ₹1.4 lakh crores. The number has been steadily rising since the early part of the current decade. The defaulters are spread across several sectors, with manufacturing firms constituting the largest share.

3.39 To put in perspective the quantum of wealth eroded by wilful defaulters, consider

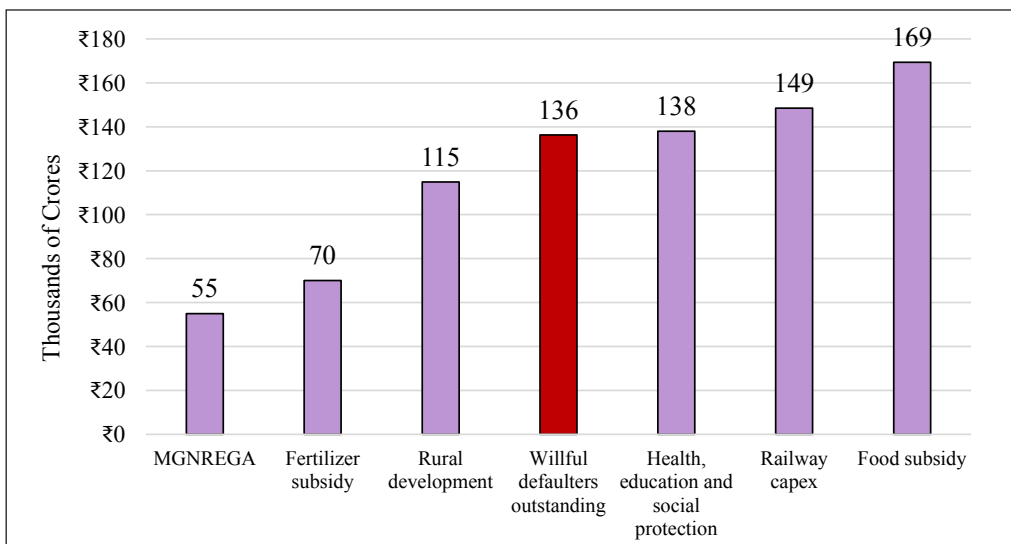
Figure 18, which compares the amount owed by wilful defaulters in 2018 with the Union budget allocations towards citizen welfare in the same year. Had the money siphoned away by wilful defaulters stayed in the economy, the resulting wealth would have been equivalent in value to that needed to *double* the allocation towards health, education

**Figure 17: Split of aggregate outstanding amounts of wilful defaulters by sector**



Source: TransUnion CIBIL Suits Filed database, CMIE Prowess database

**Figure 18: Wealth destroyed by wilful defaulters in comparison to Union Budget Allocations**



Source: TransUnion CIBIL Suits Filed database, Union budget reports

and social protection, *double* the allocation towards rural development, or *triple* the allocation towards MGNREGA.

3.40 Figure 19 depicts three distinguishing characteristics of wilful defaulters in India. First, wilful defaulters tend to be more opaque than both non-defaulters and firms that default out of genuine distress (hereafter distress defaulters). Whereas roughly 60 per cent of non-defaulters and distress-defaulters provide related party disclosures in their

annual report as legally required in India, barely 40 per cent of wilful defaulters do.

3.41 Second, promoters at the helm of wilfully defaulting firms pledge, on average, almost 50 per cent of their shareholding to lenders. In contrast, the corresponding figures for distress defaulters and non-defaulters are 30 per cent and 11 per cent respectively. While the pledging of shares prevails in advanced economies also, it has taken a peculiar form in India. Promoters, especially

**Figure 19: Wilful defaulters tend to be opaque about their RPTs, pledge substantial proportions of promoter shares, and advance large loans to related parties**



Source: CMIE Prowess, TransUnion CIBIL Suits Filed database.

Note: A firm is said to have made an RPT disclosure if its annual filing contains an RPT section (even if the firm states it had no transactions that year). Net outstanding loans refers to the total balance of loans given by firms to their related parties, net of loans taken from them. It is expressed as a percentage of the firm's total assets. Wilful defaulters are those classified as such in the CIBIL Suits Filed database, while distress defaulters are those with a default credit rating at least once in the sample period but those who have not been classified as 'wilful defaulters'. Non-defaulters are all other firms. Data spans 2002-18

those of wilful defaulter firms, pledge shares to obtain financing not for external ventures or personal endeavours but for the firm's own projects. Such a practice is suboptimal for lenders as the value of collateral used to secure loans should not correlate with the value of the project being funded. When a firm is in distress, the value of pledged shares falls. Precisely when it is required to, the collateral stops serving its purpose. As promoters have no personal liability beyond their pledged shares, they care little when the pledged shares fall in value as any reduction in their wealth is offset by rents they have already extracted. In many cases, promoters are unconcerned about losing control of the company as they may have already siphoned out the extracted rents before the share price collapse.

3.42 Third, wilful defaulters make large loans to related parties. The outstanding balance of loans given to related parties for distress defaulters and non-defaulters is negative, meaning that the average firm in the sample is a net recipient of loans from related parties. Wilful defaulters, on the other hand, are net givers of loans. Peculiarly, they are net recipients of external loans and defaulters on these loans at the same time that they are net givers of loans to their related parties. This is consistent with a theory of issuing debt only to siphon the proceeds out of the firm for the personal benefit of owners and their cronies.

3.43 The cost of such wilful default is borne by the common man. Public sector banks get their equity from taxes paid by the common man. They get their debt from deposits made by the common man. When unscrupulous firms willfully default, it is the common man who loses. While most policy

initiatives aim to redistribute wealth from the rich to the poor, wilful default achieves the opposite. Rich businesses that want to get richer use wilful default as an instrument to redistribute wealth *away* from the poor.

3.44 Not only that, wilful default if unchecked would increase the cost of borrowing for everyone else, including genuine businesses with profitable investment opportunities before them. In fact, at high enough credit spreads, adverse selection may force genuine borrowers to exit the market altogether, leaving only cronies in the market and resulting in a market failure that slows economic growth, employment and wealth creation capacity.

## CONCLUSION

3.45 While pro-business policies increase competition, correct market failures, or enforce business accountability, pro-crony policies hurt markets. Such policies may promote narrow business interests and may hurt social welfare because what crony businesses may want may be at odds with the same. For example, crony businesses may lobby the government to limit competition in their industry, restrict imports of competing goods or reduce regulatory oversight. These initiatives enhance the lobbying group's income but undermine markets and reduce aggregate welfare. Thus, pro-crony policy can inadvertently end up being hurtful to businesses in general.

3.46 Pro-business policies, for example, those that make it easy to start a business, register property, enforce contracts, obtain credit, bid for natural resources, get permits, and resolve insolvency help firms to function effectively and thereby enable competitive

markets. Making it easy to do business in a jurisdiction furthers the eventual goal of maximizing social welfare. Reforms aimed in this direction must continue. However, catering to the needs of crony businesses

alone without regard for other businesses and the remaining stakeholders in the economy may end up benefitting the preferentially treated firms at the expense of other firms, market efficiency and social welfare.

## CHAPTER AT A GLANCE

- India's aspiration to become a \$5 trillion economy depends critically on promoting "pro-business" policy that unleashes the power of competitive markets to generate wealth, on the one hand, and weaning away from "pro-crony" policy that may favour specific private interests, especially powerful incumbents, on the other hand. Economic events since 1991 provide powerful evidence supporting this crucial distinction.
- Viewed from the lens of the Stock market, which captures the pulse of any economy, creative destruction has increased significantly after reform. Before liberalisation, a Sensex firm expected to stay in it for 60 years, which decreased to only 12 years after liberalisation. Every five years, one-third of Sensex firms are churned out, reflecting the continuous influx of new firms, products and technologies into the economy.
- Despite impressive progress in enabling competitive markets, pro-crony policies has destroyed value in the economy. For example, an equity index of connected firms significantly outperformed the market by 7 per cent a year from 2007 to 2010, reflecting abnormal profits extracted at common citizens' expense. In contrast, the index underperforms the market by 7.5 per cent from 2011, reflecting the inefficiency and value destruction inherent in such firms.
- Pro-crony policies as reflected in discretionary allocation of natural resources till 2011 led to rent-seeking by beneficiaries while competitive allocation of the same resources post 2014 have put an end to such rent extraction. Similarly crony lending that led to wilful default, wherein promoters have collectively siphoned off wealth from banks, led to losses that dwarf subsidies directed towards rural development.

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