1 Political Finance in a Developing Democracy

The Case of India

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Indian elections are among the most contested polls in the world. In fact, they are so competitive that candidates speak not of 'contesting' elections, but of 'fighting' them. In 2014, the size of the electorate was a gargantuan 834 million, out of which 554 million (66.4 per cent) voters cast their ballots on election day in favour of one of 8,251 candidates representing 464 political parties.[1] While Indian elections have become increasingly free and fair over the past quarter century, the area of political finance remains decidedly murky; politicians spent an estimated $5 billion on the costs of campaigning during the 2014 general election, the vast majority of which was not publicly disclosed. Not surprisingly, political finance is widely perceived to be one of the foremost drivers of corruption in the world's largest democracy.[2] In this chapter, we survey the legal and regulatory history of political finance in India, situating it in the context of India's political economy.

[1] Sruthi Gottipati and Rajesh Kumar Singh, 'India Set to Challenge U.S. for Election-Spending Record', *Reuters*, 9 March 2014.

[2] E. Sridharan and Milan Vaishnav, 'India', in *Checkbook Elections? Political Finance in Comparative Perspective*, eds, Pippa Norris and Andrea Abel van Es (New York: Oxford University Press, 2016), 64–83.

We devote special attention to recent developments, including new election finance initiatives implemented by the Bharatiya Janata Party (BJP) government of Prime Minister Narendra Modi in 2017. We also discuss possible areas of reform, including the regulation of political parties, which can lead to increased transparency and help the country break out of a corrupt equilibrium.[3]

THE POLITICAL AND ECONOMIC CONTEXT OF PARTY FINANCE IN INDIA

Before getting into the details of India's political finance regime, it is worth taking stock of India's broader political and economic evolution. This evolution, after all, has had a direct bearing on how money in politics has been regulated (or not).

Broadly speaking, the evolution of the Indian party system can be readily divided into three main phases.[4] The initial phase, which began with the first general election in 1952 and ended in 1967, was characterized by simultaneous Lok Sabha (lower house of Parliament) and state assembly elections—both of which were dominated by the hegemonic Congress party. Drawing on a deep well of popular support flowing from its role in the Independence movement, Congress

[3] In this chapter, we build on earlier work including Sridharan and Vaishnav, 'India'; E. Sridharan, 'Reforming Campaign Finance to Tackle Corruption in India: Possible Options from the International Experience', in *Fighting Corruption*, ed. Samuel Paul (New Delhi: Academic Foundation, 2013), 43–70; M.V. Rajeev Gowda and E. Sridharan, 'Reforming India's Party Financing and Election Expenditure Laws', *Election Law Journal* 11, no. 2 (2012): 226–40; E. Sridharan, 'Electoral Finance Reform: The Relevance of International Experience', in *Reinventing Public Service Delivery in India: Selected Case Studies*, ed. Vikram K. Chand (New Delhi: Sage, 2006), 363–88; E. Sridharan and Peter Ronald de Souza, 'Introduction: The Evolution of Political Parties in India', in *India's Political Parties*, eds. Peter Ronald de Souza and E. Sridharan (New Delhi: Sage, 2006), 15–36; E. Sridharan, 'Toward State Funding of Elections in India: A Comparative Perspective on Possible Options', *Journal of Policy Reform* 3, no. 3 (1999): 229–54.

[4] E. Sridharan, 'Why are Multi-Party Minority Governments Viable in India? Theory and Comparison', *Commonwealth and Comparative Politics* 50, no. 3 (2012): 314–43.

regularly won a majority, sometimes even a two-thirds majority, of parliamentary seats on the basis of a plurality of votes (typically ranging between 40–45 per cent).

This period of dominance came to an abrupt end in 1967, when the Congress lost assembly elections in half of India's then 16 major states. This widespread upheaval allowed opposition parties to consolidate, leading to a new phase in the party system that would last for more than two decades. Duvergerian—or two-party—dynamics played themselves out in both national and state assembly elections from 1967 to 1989, and this trend persisted even after 1989.[5] This pattern led to either a two-party (or two-coalition) system or a bipolar party system with the non-Congress opposition consolidating behind a particular party (with a few exceptions, such as the state of Uttar Pradesh).[6] However, the precise configuration of the bipolarities varied considerably across time and space; for example, the competition was between the Congress-Jana Sangh (the precursor of the present-day BJP) in some states; Congress-Left in others; and Congress versus a regional party in yet others.[7]

In the third phase, bookended by the elections of 1989 and 2014, the party system fragmented considerably, due to three major trends: the decline of Congress, the rise of the BJP, and the rise of regional parties. The net result of these dynamics was a fractured Lok Sabha in which no single party obtained a majority in the seven consecutive elections from 1989 to 2009, until the BJP's narrow majority in 2014. With the pan-Indian resurgence of the BJP following the 2014 general

[5] In the field of political science, Duverger's law holds that plurality-rule elections (such as India's first-past-the-post system) that are structured within single-member districts lead to the establishment of a two-party system. See Maurice Duverger, *Political Parties: Their Organization and Activity in the Modern State* (New York: Wiley, 1954).

[6] For detailed accounts, see Pradeep K. Chhibber and Geetha Murali, 'Duvergerian Dynamics in Indian States', *Party Politics* 12, no. 1 (2006): 5–34; E. Sridharan, 'The Fragmentation of the Indian Party System 1952–1999: Seven Competing Explanations', in *Parties and Party Politics in India*, ed. Zoya Hasan (New Delhi: Oxford University Press, 2002), 475–503.

[7] More accurately, these regional parties could be called state-based parties, as they were almost all based in a single state.

election results, it is possible that India has entered a new, fourth phase. However, it is too early to deliver a conclusive verdict on that score.[8]

These political transitions occurred against the economic backdrop of a heavily regulated economy. After gaining independence, India adopted an import-substitution industrialization strategy led by the public sector. Many industries were reserved for the public sector, nationalized, or forced to adhere to detailed state regulations concerning the setup, expansion, and import of inputs—such as coal, petroleum, steel, and power. The government wielded myriad instruments of control over the private sector, including a vast thicket of mandatory licenses and permissions, a monopoly over most of the banking system, and significant leverage as a consumer. Economic liberalization, beginning in the mid-1980s and picking up steam after 1991, has primarily taken the form of freer private sector entry into industries hitherto reserved for the public sector, combined with trade and foreign investment liberalization. But, there are still overarching state regulations in many areas, as well as an undesirably high level of state control over most of the banking system. Discretionary state regulation pervades environmental clearances, land use, and natural resources—both at the central (federal) and state levels—even as the old system of industrial licensing is no more.[9]

THE EVOLUTION OF INDIA'S POLITICAL FINANCE REGIME

India's political finance regime has also evolved in three broad phases, broadly tracking the country's overall political and economic history. The first phase began in 1947 and ended around 1990, which saw the emergence and consolidation of a corrupt, opaque equilibrium. The second phase, 1990–2003, witnessed the early beginnings of reform.

[8] Milan Vaishnav and Danielle Smogard, 'A New Era in Indian Politics', Carnegie Endowment for International Peace, 10 June 2014, accessed 17 October 2017, http://carnegieendowment.org/2014/06/10/new-era-in-indian-politics-pub-55883.

[9] Kanchan Chandra, 'The New Indian State: The Relocation of Patronage in the Post-Liberalisation Economy', *Economic and Political Weekly* 50, no. 41 (10 October 2015): 46–58.

The third phase, from 2003 to 2017, saw the emergence of greater transparency but very few—if any—structural changes. Given recent legislative changes introduced by the government of Prime Minister Narendra Modi in 2017, the overriding focus of reforms appears to be on curbing the use of cash at the expense of transparency. We elaborate below on the key developments of each of these phases.

The Emergence of a Corrupt Equilibrium: 1947–90

Internationally, we can identify four major features of political finance regulation: limits on expenditure, limits on contributions, public subsidy of elections and political parties, and reporting and disclosure requirements.[10] The evolution of political finance in India in these terms yields the following picture.

Under the 1951 Representation of the People Act (RPA), the foundational law that governs elections in India, there are strict limits on candidate spending. In terms of contributions, the then-dominant Congress party depended initially on membership dues, but rapidly shifted to private business as membership dues proved inadequate in keeping pace with the cost of increasingly competitive elections. This shift was encouraged by the fact that the government was heavily regulating businesses by licensing both capacity creation (and expansion) as well as imports. Businesses, therefore, gave money to parties and politicians in exchange for regulatory favours. This behaviour became rapidly institutionalized as part of the overarching, highly regulated, import-substituting industrialization strategy that characterized India's economic management. In this climate, businesses evaded taxes and 'donated' black money to political parties in exchange for policy or regulatory favours until engaging in such activities became an intrinsic part of running a business, rather than a choice.

During the decade of the 1960s, the first murmurs of political finance reform began to emerge as the broad contours of this new equilibrium became widely known. Indeed, the nexus between black money and political fundraising was mentioned as early as 1964, in the

[10] For a comprehensive survey of political finance across the world, see Reginald Austin and Maja Tjernstrom, eds., *Funding of Political Parties and Election Campaigns* (Stockholm: International IDEA, 2014).

reports of the Santhanam Committee on Prevention of Corruption, and again in 1971, in the Wanchoo Direct Taxes Enquiry Committee.

A key turning point in the history of political finance in India occurred in 1969, when the Indira Gandhi-led Congress government banned corporate donations to political parties. Gandhi pushed the move because a weakened Congress faced a credible challenge from conservative forces on its right flank, especially after it sustained heavy electoral losses in 1967. Congress feared that the pro-business Swatantra party, along with the Hindu nationalist Jana Sangh, would increasingly attract corporate donations, so banning the latter would deal a fierce blow to these rising challengers. However, Gandhi did not create any form of state funding or subsidy to political parties for elections to fill its place—a sharp contrast to the rise of public funding for parties in European democracies in the 1960s and 1970s.

The net result of this development was that, with company donations banned, there was no legal source of adequate finance for political parties. This inevitably meant a consolidation of the nexus between black money and politics. This tendency was reinforced by the policy shift from the late 1960s, engineered by Indira Gandhi, towards intensified government control of the economy. Beginning in 1969 and continuing through the first half of the 1970s, Gandhi tightened government control over the private sector, leading to a political economy of business financing ('donations') in exchange for regulatory and allocative favours. Newly imposed controls included the nationalization of 14 major private banks in 1969; the Monopolies and Restrictive Trade Practices (MRTP) Act of 1969, which intensified regulation of big business; the Foreign Exchange Regulation Act (FERA) of 1973, which tightly controlled foreign investors; and the nationalization of coal mining, petroleum, and general insurance in the early 1970s. In hindsight, the banning of company donations in 1969—without adequately substituting for it with public funding—was a key moment in the path-dependent evolution of political finance because it strengthened ties between political parties and the black economy, while driving the funding of political campaigns further underground. The Congress, controlling most of the levers of power, stood to benefit in relative terms.

The next key development was the delinking of party and independent supporters' expenditure from candidate and candidate-authorized expenditure for the purpose of calculating a candidate's election spending. In other words, parties and independent supporters could spend unlimited funds on a political campaign without being subject to the strict limits on candidate expenditure. In 1974, the Supreme Court eliminated this loophole, ruling in *Kanwar Lal Gupta v. Amar Nath Chawla* that party spending on behalf of candidates would, in fact, be attributed to the candidate and, therefore, subject to the strict limits in place.[11] To circumvent this judgment, the government amended the RPA in 1975, introducing Explanation 1 to Section 77(1), which clearly stated that any spending by parties or independent supporters not authorized by the candidate would not count towards the spending limit. In effect, it removed any ceiling on party spending, rendering the candidate limit farcical. The end result was not surprising: the move touched off spending arms races in increasingly competitive elections.

The situation was altered slightly in 1979, when political parties were exempted from income and wealth taxes on the condition that they file annual tax returns.[12] Then, in 1985, Rajiv Gandhi's relatively liberalizing (delicensing) and pro-business government re-legalized company donations to political parties. Reversing Indira Gandhi's outright ban, the government amended the 1956 Companies Act to allow companies to donate up to 5 per cent of their average net profit over the prior three years, subject to board approval and declaration in their profit-and-loss accounts. However, there was no tax incentive for businesses to do so. In the end, the re-legalization after a gap of 16 years did not succeed in bringing donations above the table. Not only were there few incentives for shedding anonymity, there were actually positive *disincentives*. For instance, a company that openly supported a particular party, even the ruling Congress, would alienate opposition parties that might be ruling in states where the company had business interests. By the mid-1980s, there was simply too much water under the bridge; the system of opaque donations to parties and politicians in exchange for regulatory favours had become too deeply entrenched in a highly state-controlled business environment.

[11] *Kanwar Lal Gupta v. Amar Nath Chawla & Ors* decided on 3 October 1974. Citations 1975 AIR (308), 1975 SCR (2) 269.

[12] These annual tax returns, like most other income tax returns, were not subject to public disclosure.

The Beginnings of Reform, 1990–2003

The 1990s saw the beginning of a number of reform initiatives and proposals on political finance, emanating both from government and civil society. Minority governments, including minority coalitions and non-Congress parties, became more outspoken on the issue. Despite the increased chatter, many of the suggested changes never actually saw the light of day. And those that did operated at the margins, unable to fundamentally dislodge the corrupt equilibrium that prevailed.

The year 1996 saw two Supreme Court orders and one legislative change that had a bearing on the regulation of political finance. The first move occurred in January 1996, when the Supreme Court, in response to a public interest litigation (PIL) petition by the non-governmental organization (NGO) Common Cause, ordered political parties to file their annual income tax and wealth tax returns. Although parties were required to file annual returns since being granted tax-exempt status in 1979, no party had regularly done so. The ruling broke new ground, although it had serious limits. Thanks to the court ruling, parties were compelled to file returns, but they were often doctored and remained under wraps until 2008.

In April 1996, just prior to the general election, the Supreme Court again issued a landmark decision on political finance by ordering the second major legislative change of the period. The court ruled that party expenditures would once more count towards candidate spending ceilings if parties did not file audited accounts of income and expenditure. In effect, problematic Explanation 1 would no longer exempt party expenditures from the spending limit if such accounts were not filed. This reinforced the earlier court order and led to parties filing their tax returns and, thus, reporting their incomes and expenditures. However, the ruling did not mandate these returns be subject to independent audit and, hence, they remained the handiwork of crafty party-appointed auditors.[13]

In 1998, the government introduced the first significant state subsidy for elections: free airtime on state-owned television and radio.

[13] In addition, in July 1996, Parliament amended the RPA to shorten the campaign period from 21 days to 14 days, thus potentially reducing the scale of campaign spending.

The move built on the informal system in practice since the late 1970s, which had evolved with the consent of the ECI, parties, and government. The length of time each party had was based on a given time slab, with additional time based on past electoral performance for significant parties, which included seven national and 34 state parties. The same system was replicated at the state level for assembly elections.

In addition to these Supreme Court orders and legislative changes, there were a number of proposals for political party reforms in the 1990s. However, most of these reform blueprints went nowhere fast. We briefly mention them because they illustrate the fact that many prominent figures in Indian political life—from diverse quarters—recognized the knotty political finance predicament as far back as a quarter century ago.

In 1990, the Janata Dal-led National Front government of V.P. Singh set up the Dinesh Goswami Committee on Electoral Reforms. The committee's report recommended limited public subsidy in the form of vehicle fuel (the main campaign expenditure then), but left Explanation 1 intact and recommended a ban on company donations. But, much like in 1969, the committee did not propose to substitute the loss of corporate donations with a system of public funding.

Indian industry also became increasingly concerned about the issue of political funding during the 1990s. This concern was a result of the economic reforms of 1991—particularly trade and foreign direct investment (FDI) liberalization—which increased foreign competition and eroded profit margins, at a time of mounting political demands on Indian companies. In response to the concerns of its member companies, the Confederation of Indian Industry (CII) set up a task force which recommended state funding of elections.[14]

Although the CII proposal did not gain traction, the government continued to dabble in this area by setting up new reform commissions. The 1996–8 United Front government set up the Indrajit Gupta

[14] The funds were to be raised either by a cess (earmarked tax) on excise duty or through contributions by industry to a fund pool managed by the ECI. The money would then be distributed to parties by a transparent formula, creating, in effect, an election tax on industry. It also recommended that company donations to parties be made tax-deductible, and that shareholder approval be required for such board decisions.

Committee on State Funding of Elections. In its 1998 report, the Gupta committee recommended only partial state funding, including free television and radio broadcasts on state-owned channels, vehicle fuel, paper, and other campaign paraphernalia, up to certain limits.[15] It also said that parties that failed to maintain audited accounts for the ECI or submit income tax returns should be denied state funding. Parties would be required to receive all donations above Rs 10,000 by cheque/bank draft, so that all significant donations could be traceable.[16]

In 1999, Lok Satta, an NGO founded by activist-cum-politician Jayaprakash Narayan, proposed the introduction of tax-deductible political contributions, both for companies that were not government contractors and for individuals. That same year, the 170th report of the Law Commission of India recommended deleting Explanation 1 and imposing minimum standards of transparency and internal democracy in parties as conditions for state funding of parties. In 2002, the National Commission to Review the Working of the Constitution also recommended dropping Explanation 1. However, it did recommend providing state funding only after a comprehensive reform of political parties to ensure internal democracy and transparency, which would include requiring candidates to disclose their assets and liabilities. None of these proposals were implemented with the exception of free airtime on state-owned television and radio channels.

From 2003 to 2017: Greater but Limited Transparency

2003 marked the beginning of a series of significant, if still incomplete, steps forward in improving the transparency of political finance. The story of the first of these reforms dates back to November 2000, when the NGO Association for Democratic Reforms (ADR) filed a public interest petition demanding greater transparency on the backgrounds of aspirant candidates. The Delhi High Court responded by directing

[15] On state funding, the committee recommended a separate election fund pool to which the central and state governments would contribute together Rs 6,000 million annually (then $166 million) to enable partial state funding.

[16] The Gupta committee also left Explanation 1 standing and said nothing specific about company donations.

the ECI to collect and make public the criminal records, educational qualifications, and financial assets and liabilities of candidates (as well as their spouses and dependents). All parties resisted this move, but the judgment was reaffirmed, and the ECI issued an order making the above disclosures mandatory on 27 March 2003.

Arguably the most important legislative reform in campaign finance during this period was the Election and Other Related Laws (Amendment) Act passed in September 2003 by the BJP-led National Democratic Alliance (NDA) government. The law made corporate and individual donations to political parties 100 per cent tax-deductible under Sections 80 GGB and 80 GGC of the Income Tax Act respectively.[17] This created an incentive, for the first time, to contribute openly by cheque. The law also made it mandatory under Section 29C of the RPA for parties to list all donations received of Rs 20,000 and above to the ECI on an annual basis, with the names of the donors and amount received, thus introducing a limited degree of transparency.

The law also tried to close the loophole Explanation 1 opened up, by making it mandatory for candidates to report spending by parties and independent supporters towards their election, and stipulating that these expenditures would have to be counted for the purpose of the spending limit. However, the fine print undercut the larger stated objective. The law exempted the travel costs of the top leaders of recognized parties as well as party and independent supporters' spending on propagating the party's programme, as long as it does not favour any particular candidate. This last move, in particular, watered down the overall impact of the change.

The 2005 passage of the Right to Information Act (RTI), analogous to the Freedom of Information Act (FOIA) that operates in the United States, helped reshape the fight for greater transparency in India. Its impact on political funding, however, has been mixed. ADR used this new power to request that the Central Information Commission (CIC) make the income tax returns of political parties publicly available. Unsurprisingly, all parties resisted the demand, but in 2008 the

[17] Company contributions remained subject to the ceiling of five per cent of average net profit over the prior three years under Section 293A of the Companies Act.

CIC ruled in ADR's favour. This judgment forced political parties to publish their incomes and expenditures going back to 2004–5, thus providing a measure of transparency to party finances. This transparency is still incomplete, however, since the CIC did not insist on an independent or third-party audit, as recommended by the ECI.

The net effect of the candidate disclosure requirements introduced in 2003, the introduction of tax deductibility in the 2003 law, and the CIC's 2008 ruling under the RTI of 2005, is a modicum of transparency in party finance where there was virtually none before. However, these changes helped mainly on the margins. Parties still did not have to disclose the identities of donors if they were under the Rs 20,000 threshold. As it turns out, these anonymous donations constitute nearly 75 per cent of the income of six national parties.[18]

Despite the illusion of hyperactivity, the opaque political finance system, with roots in the 1969 decision to ban corporate donations without introducing an effective substitute, was still very much in place. Since 2013, there have been two noteworthy developments. First, in 2013, the Electoral Trusts Scheme allowed for the setting up of 100 per cent tax-exempt electoral trusts by companies, provided they disburse 95 per cent of their annual receipts (including surplus brought forward) to political parties. Also, under Section 182 of the Companies Act of 2013, the contribution limits for companies to parties was raised from 5 to 7.5 per cent of their average net profit over the prior three years.

The second notable development was the ECI's new transparency guidelines of August 2014, under which parties must identify all donors and amounts—with the exception of petty sums raised at rallies. However, these guidelines do not yet have the full force of law since, apart from the extraordinary step of derecognizing a party's symbol, the ECI has no power to fine or deregister a party that violates the new guidelines.[19]

[18] Only a relatively small fraction of national party donations comes from identified donors and in specified amounts, a pattern that also holds true for state parties.

[19] S.K. Mendiratta (legal adviser to the ECI), in conversation with one of the authors, 5 November 2014.

2017: A POSSIBLE INFLECTION POINT?

In 2017, Parliament legislated several changes to the country's political finance regime—the first time since 2003 that political finance appeared on the national policy agenda. This was likely a direct result of the public debate that ensued in the wake of the government's November 2016 decision to abruptly invalidate or 'demonetize' all high-value currency notes in circulation.

In the immediate aftermath of the dramatic demonetization announcement, many analysts pointed out that the manoeuvre alone was unlikely to have a sustained impact on India's black economy unless it was accompanied by complementary reforms in areas such as tax, administration, and regulation. For demonetization to have a lasting impact, overhauling the regulation of political finance is arguably one of the most critical areas for future reform. Indeed, the government came under criticism for stating, on the one hand, that demonetization would attack cronyism and corruption while, on the other hand, failing to articulate any new measures especially designed to address political corruption. The outcry was initially sparked by a statement made by the union revenue secretary (later reiterated by the finance secretary) that deposits of newly invalid currency notes into the bank accounts of political parties would not attract tax scrutiny. In narrow legal terms, this statement was innocuous; under Section 13A of the Income Tax Act, political parties have long been exempt from paying tax, provided that they adequately maintain their books.

But the outcry that followed forced ministry officials and subsequently even Union Finance Minister Arun Jaitley to address the issue, stating, 'The legal and taxation regime with regard to political parties remains absolutely what it has been in the last 15–20 years. There is not a single change that has been brought about nor is any change at the moment contemplated.'[20] The government's position was less than credible; arguing that one is constrained by decades-old law rang hollow when it had just implemented a draconian measure such as demonetization at a moment's notice.

[20] 'No Plan to Reprint Entire Demonetised Amount, Says Arun Jaitley', *Times of India*, 18 December 2016.

In an unusual New Year's Eve address to the nation, Prime Minister Modi noted that the public had spoken and the time had come for the country to consider how best to cleanse the financing of politics. 'Political parties, political leaders and electoral funding, figure prominently in any debate on corruption and black money. The time has now come that all political leaders and parties respect the feelings of the nation's honest citizens, and understand the anger of the people,' Modi said. While the prime minister stopped short of articulating a blueprint or roadmap for reform, he urged that all parties and leaders give up their 'holier than thou approach' to jointly discuss how to 'free politics of black money and corruption.'[21]

In principle, the government seemed to live up to its rhetoric and introduced several political finance reform measures in the 2017 Finance Bill. The core of the government's approach centred on three objectives—strengthening limits on cash giving, tightening income tax provisions, and introducing a new instrument known as 'electoral bonds'.[22] As with any new legislation, assessing their impact on political funding will depend on the quality of implementation and the details found in the fine print (which, in the case of electoral bonds, had yet to be issued at the time of writing). Nonetheless, we provide a preliminary analysis of the government's measures.[23]

Contributions

The first group of provisions strengthened limits on cash giving by changing the nature and limit of contributions to political parties. Under the status quo ante, no single anonymous contribution

[21] 'Full Text: PM Narendra Modi New Year's Eve Address to the Nation', *Indian Express*, 31 December 2016, accessed 6 June 2017, http://indianexpress.com/article/india/full-text-pm-narendra-modi-new-years-eve-address-to-the-nation-4453587/.

[22] Milan Vaishnav and Rebecca Brown, 'Crafty Indian Politicians Can Game the New Political Funding Rules Even in Their Sleep', *Quartz*, 1 February 2017, accessed 6 June 2017, https://qz.com/900922/budget-2017-why-arun-jaitleys-new-rules-to-clean-up-indias-political-funding-simply-wont-work/.

[23] Milan Vaishnav, 'Finance Bill Makes Funding for Political Parties More Opaque Than Ever', *Hindustan Times*, 29 March 2017.

to political parties could exceed Rs 20,000. Any donation over this threshold required the individual or entity making the donation to disclose their identity. The changes enacted in the bill modified this in several ways. For starters, the act instituted a new Rs 2,000 threshold for cash donations. Going forward, any donation above Rs 2,000 must be transferred via check or digital payment (interestingly, however, the act did not alter the Rs 20,000 limit for public disclosure). In addition, the act tied the new cash threshold to an individual rather than to any single contribution. This is an important detail because donors in the past regularly split their large contribution into many smaller donations (each below Rs 20,000) to avoid disclosure. This, of course, also allowed parties to obscure the identity of the vast majority of their donors.[24]

Under these new provisions in the Finance Act, anyone who donates more than Rs 2,000 *in aggregate* will have to disclose their identity. The final adjustment requires that corporations make all contributions via check or digital payment, rather than cash. Shortly before the bill was to come up for a vote on the floor of the Lok Sabha, the government attached two further amendments to the Finance Bill with little advance notice. The first eliminated the cap on corporate giving (which previously stood at 7.5 per cent of a corporation's average net profits over the previous three years) while the second dropped the requirement that firms must declare their political contributions on their profit and loss statements.

The government's proposals to limit cash in politics are notable and consistent with demonetization and the general move to curb the use of cash in the economy. Cash transactions, as many of the contributions in this book demonstrate, are rampant in electoral politics, difficult to observe and, therefore, hard to trace. Unfortunately, the government's measures do not provide adequate disincentives when it comes to cash. For instance, the government could have abolished cash contributions altogether, as opposed to simply placing a ceiling on cash donations at Rs 2,000. Whenever an arbitrary limit is imposed (whether it is 20,000 or 2,000), there is an incentive for those who want to game the system

[24] Interestingly, if donors choose the alternative route of electoral bonds that has been introduced (see section below), then disclosure of identities can be completely avoided.

to report amounts just below the threshold. While it is technically illegal for any one individual to donate more than Rs 2,000 without disclosure, it is not clear what will stop parties from claiming they have received multiple small donations from anonymous individuals since they do not have to keep records of those who give less than the limit in any case.[25]

Perhaps the most surprising omission was to require the simplest and most obvious form of identification be linked to any cash donation of any size: the contributor's *Aadhaar* number. For a government so committed on leveraging Aadhaar in an ever-increasing number of government programmes, this was clearly deliberate. And for many in civil society who have pressed for greater transparency in electoral finance, their opposition to Aadhaar meant they could not press for it in this case.

Tax Scrutiny

Beyond altering the fine print around donations, the legislation also aimed to tighten provisions of the Income Tax (IT) Act as they relate to political parties. While political parties in India are tax-exempt, under prevailing law, political parties are required to keep updated financial accounts, maintain records of the names and addresses attached to large contributions, submit their accounts for audit, and file their income tax returns on an annual basis (in exchange for receiving tax-exempt status).[26] The Finance Act stipulated that

[25] As one politician remarked to one of the authors, the biggest winner of this reform will be chartered accountants, who will be able to demand bigger pay cheques in return for their expanded financial jugglery. Indeed, as one journalist noted, 'Earlier, if a person had to give Rs 1 lakh in cash, they would make five receipts by breaking it up and keeping it under Rs 20,000. Now, they would have to make 50 receipts. It's a logistical nightmare but it still doesn't prevent the party from accepting cash donations.' Meghnad S., 'Why Jaitley's Political Funding Reforms Won't End Anonymous Donations', *The Wire*, 6 February 2017, accessed 6 June 2017, https://thewire.in/106262/jaitley-political-funding-reforms-budget-anonymous-donations/.

[26] In January 2017, the Supreme Court reconfirmed that the exception made to keep parties out of the tax net was one of executive determination, claiming that parties needed money to propagate their beliefs.

these tax returns should be submitted within the time prescribed. Previously, many parties did not submit their tax returns on an annual basis, while others failed to do so at all. This new provision ostensibly sought to close this loophole.

The lack of independent audit scrutiny and meaningful enforcement makes the new provision much better in theory than in practice. ADR has warned in the past that 'there is a lack of frequent and complete scrutiny of financial disclosures of political parties' by tax authorities.[27] If tax officials do not scrutinize party accounts, it will make little difference if the documents are submitted on time or with substantial delay. Equally, there is no categorical schedule of penalties if parties fail to file their accounts 'within the time prescribed'. Indeed, under the Companies Act, all private companies in India must file tax returns within 60 days of their last annual general meeting, and there is a clear escalating schedule of financial and penal penalties the longer the delay in filing returns.[28] Clearly, the ramifications for the public if a political party fails to file returns in time are substantially greater than if a private firm fails to do so. Yet the bite of the law is much stronger on the latter compared to the former.

Electoral Bonds

The third and final innovation in the Finance Act is the introduction of a new instrument, the 'electoral bond.' At the time of writing, the government has not fully elaborated the details of how this bond would operate, but a few basic principles seem clear based on government

[27] 'Additional Views of ADR/NEW on Political Finance and the 255th Report of the Law Commission of India', Association for Democratic Reforms and National Election Watch, April 2015, accessed 6 June 2017, http://adrindia.org/sites/default/files/Additional_views_ADR-NEW_political_finance_255th_Law_commission_ECI.pdf.

[28] Under Section 92 (5) of the Companies Act, 2013, if a company fails to file its annual return, 'the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees *and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months* or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.' (emphasis added)

documents and statements made by various finance ministry officials. Electoral bonds are time-limited bearer bonds that corporations can purchase from scheduled banks and subsequently transfer to a registered bank account of a political party. The fund flow would proceed entirely through the formal banking system, allowing for a step-by-step paper trail. However, the identity of the corporation purchasing the bond would not be publicly revealed (although, since the transaction is taking place via the banking system, regulators presumably would have access to this information). When the corporation deposits these bonds into a specially designated bank account of a registered party, the party would know who the donor is, but neither the party nor the corporation is required to disclose this information.

The upside to the new scheme is that corporations will now have a legitimate channel through which they can contribute funds to parties, as opposed to indulging in under-the-table transactions, while protecting their anonymity (which they greatly prize). But the upside is also the downside: transparency, as far as the public is concerned, is arguably the biggest victim; this is ironic considering the government explicitly framed the proposal under the heading of improving 'transparency in political funding'. Taking into account the elimination of the cap on corporate giving, the dropping of the requirement that firms disclose political giving on their financial statements, and the introduction of electoral bonds, 'corporations can now legally give unlimited sums to political parties who, in turn, can accept unlimited sums of money—all without having to disclose a single rupee'.[29] Advocates of the new changes rightly point out that there will be a digital paper trail (as there is with all banking transactions), but this trail will not be on public display, which means that electoral bonds will not change the opaque status quo for the better in the foreseeable future.[30]

[29] Vaishnav, 'Finance Bill Makes Funding for Political Parties More Opaque than Ever'.

[30] To be clear, corporations have good reason for wanting to donate anonymously: given the discretionary authorities that are vested with the state, any firm that publicly donates funds to one political party fears retribution if a competing party comes to power.

Net Assessment

The net effect of the recent changes in the rules could be an increased flow of funds to political parties by digital or cheque payments but absent disclosure of donor identities. Indeed, as the finance minister himself has said, part of the government's objective was to protect donor anonymity; the banks will know who bought electoral bonds but not to which party they were given. The question of who gave how much to which party will not be in public view. This is a far cry from transparency and disclosure of donor identities and amounts—standard in most developed democracies—but will boost (opaque) fund flow to parties over the next two years, something about which both parties and donors feel comfortable. We can expect an arms race in fundraising over the next two years before the 2019 election with the ruling party having an edge.

In the absence of public funding and/or increased tax deductibility, there is little incentive for donors to become more transparent. In fact, in a highly regulated political economy, there is no incentive to donate transparently to parties simply to support democracy without a *quid pro quo*. In a poor country with a regulated economy, there is a problem of donor self-interest that militates against the achievement of full transparency unless some system of adequate public funding is put in place. However, this system requires internal democracy and accountability in parties, something that most parties are loath to consider.

As of mid-2017, the push for further transparency of political parties and their finances remains stalled.[31] In June 2013, the CIC ruled that India's six national political parties (Congress, BJP, Communist Party of India [Marxist] [CPI(M)], Communist Party of India [CPI], Nationalist Congress Party [NCP], and Bahujan Samaj Party [BSP]) were 'public entities' that should be subject to disclosures under the RTI Act, and repeated this in March 2015. However, these parties have consistently failed to comply and the CIC, lacking any coercive or punitive powers, has thrown up its hands. In May 2015, the Supreme Court, in reaction to the non-compliance of political parties to the repeated orders of the CIC to make disclosures under RTI, asked the six national parties

[31] For the information in this paragraph, see Krishnadas Rajagopal, 'Can't Bring Political Parties Under RTI, Centre Tells Supreme Court', *Hindu*, 24 August 2015.

and the central government to respond as to why they could not be more transparent. The central government, for its part, stated that the CIC had erroneously concluded that parties are public authorities. To the contrary, it argued that parties are not established under the Constitution or any law made by parliament, and that there is already transparency of their finances under the reporting requirements of the 1951 Income Tax Act and the RPA.

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Political finance reform is ultimately a collective action problem among political parties and between parties and donors that requires the right alignment of incentives. And there are some positive examples of such collective action in the past. The Model Code of Conduct, a mutually agreed upon code among parties, that governs election campaigns is an example. What are the incentives to break out of a corrupt and opaque equilibrium that is the long-run path-dependent outcome of banning company donations without substituting them with state funding?

Any viable reform of political finance not only has to be in the public interest, but it must also serve the interests of existing political parties. Until 1989, when the one-party dominant era came to an end, the conditions for collective action did not exist because the Congress party had no incentive to constrain its superior fundraising potential. The changes to the party system that began in 1989 and led to the emergence of a multi-party system have arguably created some of the enabling conditions for collective action on political finance reform, including full transparency and possibly state funding too. We do not discuss possible reforms here as they are discussed in detail in the concluding chapter by Kapur, Sridharan, and Vaishnav. However, we note that whether the solution is full transparency of donations and donor identities, or this combined with state funding of parties for elections or for general purposes, the key is some form of regulation of parties that requires internal democracy, transparency, and accountability; indeed, adoption of these principles should be made mandatory before any system of state funding is instituted. However, any such regulation of parties should also bear in mind that while they are performing public functions and overlap with the state when in power, they are ultimately private organizations representing citizen interests, and this character should not be destroyed by regulation.

From a broad comparative perspective, many aspects of India's political finance architecture are broadly shared. 40 per cent of countries (for which there is data) have limits on candidate spending.[32] 70 per cent of countries (including India) do not have any ceiling on spending by political parties. Likewise, another 40 per cent of countries have some form of limit on donations (although in 2017, India eliminated limits on corporate giving). Two-thirds of countries have direct public funding for parties and/or candidates. India and a collection of fragile democracies, including some Middle Eastern, African, and post-Soviet states, do not.

Taken as a whole, India's political finance system is heavily regulated on paper. In practice, however, loopholes and lax enforcement create a de facto laissez faire regime—especially when compared with developed democracies. India lacks any effective ceiling on party spending, effective limits on donations, public funding (except for limited time on state-owned electronic media), and a practical system of reporting and disclosure. Clearly, despite steps in the direction of transparency and curbing the deployment of cash in politics, India has a very long way to go.

[32] See Austin and Tjernstrom, *Funding of Political Parties*, for the data cited in this paragraph.