UNIT 5 STATE PLANNING AND MARKETS: POLICY CHOICES

Structure

5.0 OBJECTIVES

After reading this unit, you will be able to:

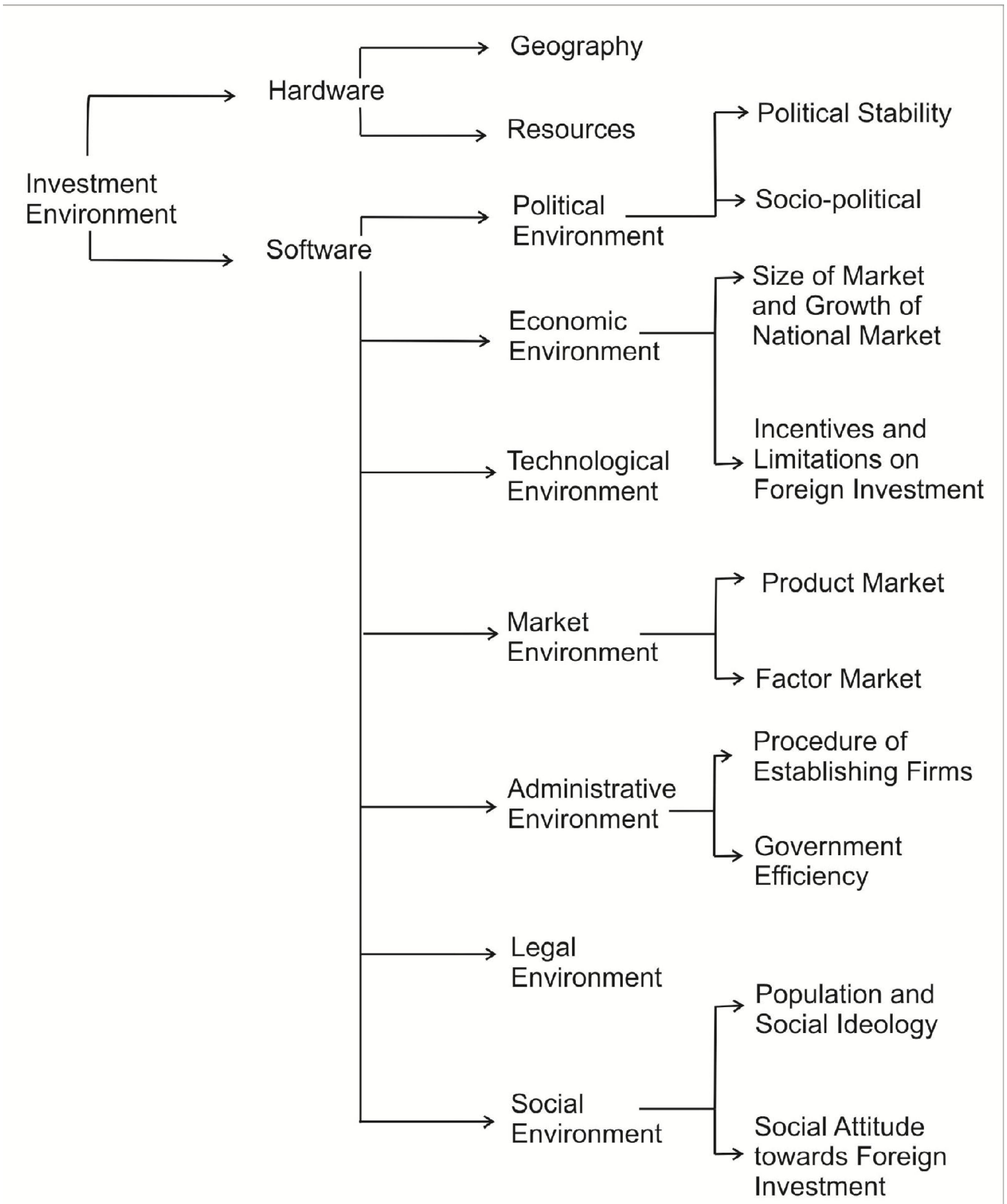
- appreciate the role of the state in the process of the economic development;
- identify the forms of intervention by the state in economic activity;
- discuss the shortcomings from which the state suffers and the cause of state failure;
- identify the areas in which markets can perform better than state;
- state the meaning and need for economic planning in an emerging economy;
- distinguish between the nature of economic planning in a free market economy and a controlled economy;

- spell out the functions of a state in a market-oriented economy;
- explain the role of state in the different phases of economic planning in India; and
- work out the role of the planning commission in the changing economic environment.

5.1 INTRODUCTION

The current economic thinking about the process of economic development has evolved during the last six decades. Starting from the 1950s, when the simple relationship between investment in physical capital and growth reigned supreme, our understanding of determinants of growth and distribution of income and output has been enriched both by developments in theory and, more importantly by the empirical experiences of the developing countries themselves.

Economic development is conditioned by a multiple number of institutions which can be collectively described as 'environment'. Broadly, these various institutions can be identified as 'hardware' and 'software' as follows:



Source : Jinghan Chen: The Environment of FDI and Characteristics of Joint Ventures in China, Development Policy Review, Vol.II, No.2, June 1993.

However, the mere presence of one or more of all these factors may only define the 'potential' of an economy. The actual rate of growth will fall short of the 'potential' rate of growth if the 'management' of the economy is found to be less than appropriate. It is only through appropriate policies initiated and executed by the State that the actual rate of development can be brought closer to the potential rate over the time.

5.2 ROLE OF THE STATE AND ECONOMIC PLANNING

The debate among economists on the role that a government can usefully play by manipulating market forces had been going on at least since Adam Smith divined the working of an 'invisible hand' in the market.

5.2.1 Arguments in Support of State Intervention

The principal arguments in support of State intervention in economic system arise basically from market failures and can be summed up as follows:

1) **Ignorance and Lack of Information:** This will be especially important for investment decisions where the lifetime of capital goods is long and where the indivisibility of capital makes for 'lumpy' investment.

2) **Obstacles and Bottlenecks:** A free market gets confronted with different types of obstacles. For example, system of market prices may, because of the economic structure of a developing economy, require large and destabilising price changes to achieve useful results. Such changes can only be administered by the State and cannot be left to the market forces.

3) **Inadequacy of Social Overhead Capital:** Government would be able to create favourable conditions by increasing investment in social capital, which would provide base for private enterprise to invest in directly productive activities.

4) **Divergence between Social Costs and Benefits:** There often exist divergences between the private and social costs and benefits of investment projects. The private entrepreneur is quite naturally concerned only with the cost incurred by him on a project, and with the income received in his decision whether or not to embark on it. He is not expected to, nor does he in practice attach any weight to what are called 'externalities' of his activities, namely, the side-effects (positive or negative) of his operations on the rest of the economy.

   The government can attempt to deal with externalities either by taxes and subsidies (taxing the pollution, subsidising pollution abatement); by regulation (prescribing certain activities); or within a legal framework (letting those injured sue and possibly taking action that lower the costs of such private suits).

5) **Environment:** In many cases, market mechanism is incapable of adding to efficiency. Making the polluter pay will not rectify the damage already done to the environment. Environment, in fact, constitutes the weakest point in the discourse of market led growth and state withdrawal. One cannot let natural resources be freely exploited endlessly, especially when the market system does not even provide ways of internalising the costs — present or future.

6) **Monetary Control:** No progress can be made without a sound monetary and banking system. Savings have to be mobilised and credit controls manipulated to suit the changing conditions. Only the State can undertake this task.

7) **Mobilisation of Resources:** Only the State can mobilse the resources – domestic and external – required for financing the various development needs on such a big scale. This may be beyond the capacity of individual entrepreneurs.

8) **Skill Formation:** Development requires a high level of skill formation. Skills can be developed only by investing in the SOC and building up the infrastructure consisting of different services. No individual can provide this type of investment. The responsibility devolves upon the State.

9) **Balanced Development:** It is the State which can lay down a balanced development programme of agricultural, industrial and other economic activities with a view to bring about the maximum welfare of the largest number of people.

10) **Poverty and Deprivation:** The State may be called in to deal with poverty and deprivation. Further, the state may be looked upon as an agency that acts paternalistically to ensure certain basic rights to its citizens such as the right to basic education and primary health. By the same token, the paternal role of the State may be extended to encompass strict legislation and enforcement against drugs and liquor. The State may also intervene to protect the interests of the future generations in terms of issues like environmental degradation and global warming, a concern that is simply unlikely to be addressed by the market.

11) **Welfare State:** The concept of State has undergone a radical change. The modern State is a Welfare State. This contemplates a reduction in inequalities of income and wealth, a redistribution of land ownership and property ownership by fixing land ceilings and urban property ceiling, provision of employment, participation of labour in the management of industry, etc. All these and many similar functions can be performed only by the State. These cannot be left to the decisions of the private enterprise.

In short, the dominant view has been that the modern State is an indispensable instrument of economic development and that it should undertake activities that would compensate for "market failure". Market failure is perceived as the inability of markets to allocate optimally resources over time, that is, for investment because of the 'miopic' nature of markets. What the modern State can achieve through a process of aggressive and judiciously selective intervention is amply demonstrated by dramatic success stories in East Asia. The East Asian governments provided political stability, stable macroeconomic conditions, appropriate legal systems, a high level of human capital, attractive enabling environments for business, and a basic infrastructure that fostered growth. Governments intervened in markets to create economic rents. Rents were reallocated by the governments to participants on the basis of performance-based criteria.

There is a remarkable similarity between the government activities undertaken by the East Asian countries and those undertaken by the United States in a comparable period of its development. There are few examples on the other side of success without government involvement.

5.2.2 Forms of State Intervention

Government intervention is needed. The debate is not over 'Whether state intervention' but 'how much' and 'what type' of the role. We may distinguish between four different types of roles of a modern State, viz., (i) regulatory role, (ii) promotional role, (iii) entrepreneurial role, and (iv) planning role.

i) The regulatory role of government may include

— determination of the conditions under which individuals or groups would be permitted to enter certain lines of business to avail of public facilities and scarce resources;

— regulating the conduct of industrial or business ventures in operation through legislation or laying down rules and standards for management to abide by;

— controlling the accrual and disposal of business income;

— regulating the relationship between different segments or interest groups in the economy so as to protect legal rights or resolve conflicts of interest;

— preventing environmental degradation.

ii) The promotional role of the government may include (i) promoting education, (ii) promoting technology, (iii) supporting the financial sector, (iv) investing in infrastructure, and (v) creating and maintaining a social safety net.

iii) The entrepreneurial role of the government may consist in its participation in business through public ownership and management of industrial and commercial undertakings.

iv) The planning role of government involves allocation of scarce resources according to national priorities, and is exercised through the instrumentality of economic planning.

Economic Planning is believed to be an answer to the inability of the price mechanism to ensure growth, efficiency and equity, although the ability of an economy to draw an 'optional' plan has been widely debated.

5.2.3 Government Failure

Economic planning has had its heyday during the fifties and the early sixties of the last century among the development economists the world over and the policy-makers. Drawing up of a five-year plan became the norm for developing economies; donors of foreign aid as well World Bank almost insisted on such plans. It came to be said, "we are all planners now". The seventies saw the world economy in crisis. Stagflation and intense social distortions became the destiny of the first world. The second world was unable to maintain its pace of growth as planning faced difficulties in coming to grips with an intensive phase of development which needed fine-tuning in many ways. During the same period, the third world's development dream too was seen to have turned sour. All these developments were treated as failures of planning and intervention, or what came to be known as 'government failure'.

Causes of Government Failure

Major causes of government failure have been identified as follows:

i) Individuals may know more about their own preferences and circumstances than the government.

ii) Government planning may increase risk by pointing everyone in the same direction — government may make bigger mistakes than markets.

iii) Government planning may be more rigid and inflexible than private decision-making since complex decision-making machinery may be involved in government.

iv) Governments may be incapable of administering detailed plans.

v) Government controls may prevent private sector individual initiative if there are many bureaucratic obstacles.

vi) Organisations and individuals require incentives to work, innovate, control costs and allocate efficiently; the discipline and rewards of the market cannot be easily replicated within public enterprises and organisations.

vii) Different levels and parts of government may be poorly coordinated in the absence of the equilibrating signals provided by the market, particularly where groups or regions with different interests are involved.

viii) Markets place constraints on what can be achieved by government, for example, resale of commodities on black markets and activities in the informal sector can disrupt rationing or rather non-linear pricing or taxation schemes. This is the general problem of "incentive compatibility".

ix) Controls create resource-using activities to influence those controls through lobbying and corruption — often called rent-seeking or directly unproductive activities in the literature.

x) Planning may be manipulated by privileged and powerful groups which act in their own interests and further, planning creates groups with vested interests, for example, bureaucrats or industrialists who obtain protected positions.

xi) Governments may be dominated by narrow interest groups interested in their own welfare and sometimes activities hostile to large sections of the population. Planning may intensify their power.

xii) Some industries are more attractive at different points of time. But governments have proven to be singularly incompetent in targeting winning horses. The Japanese lost billions of yens in a government inspired programme to enter into mainframe computers, Europeans lost millions in an EU attempt to create competitiveness in high definition television. It is best to leave these decisions in the hands of private sector managers.

5.3 ON-GOING DEBATE ON STATE VS. MARKETS

The debate that began in early 1970s seems to have been resolved with the following conclusions:

a) A system of detailed central planning in a huge diversified economy is counter-productive.

b) Market forces free from government action, are the necessary means to promote economic growth and efficiency in resource allocation and utilisation.

To talk of the State intervention began to attract the same kind of disdain "as would a person playing a 75 rpm record with 1920s music at a party". *The Economist* called it a "bloodless revolution".

But this disdain for state intervention (and-corresponding trust in free markets) was short-lived. The global economic crisis of 2008-09 dealt both a death-blow. The crisis brought to forefront in one stroke both the state-failure and the market-failure.

Simultaneously, it has also been realised that the free markets were not magically solving the problems of the poor or of development. Free markets have weak institutional foundations in UDCs and thus tend to malfunction or not even exist. Peasants and the poor did not benefit from the numerous economic reforms undertaken in the 1980s and 1990s.

This realisation found expression in the idea that the state and the market have to work in a complementary way — each supplementing the effort of the other.

This type of synthesis has been considered necessary for avoidance of both "government excesses" and for ensuring more equitable distribution of the fruits of economic growth. The ultimate goal is the joint maximisation of the people's welfare reconciling and satisfying the interests of all sections of the economic players. These include not only the consumers but also producers, traders and wage-earners as well as non-wage earners.

As we march ahead in the 21st century, the case for active state intervention is becoming more assertive and definite, in view of the various challenges being faced by an economy.

The various functions of the state can be briefly summarised as follows:

1) ***Minimal Functions:*** These can be further split up into two groups, viz. (a) Addressing market failure, and (b) Improving equity.

   a) The former includes the responsibility of providing pure public goods, like (i) defence, (ii) law and order, (iii) property rights, (iv) macro-economic management, and (v) public health.

   b) The latter involves extending protection to the poor. This calls for (i) anti-poverty programmes, and (ii) disaster relief.

2) ***Intermediate Functions:*** These can be identified as follows:

   a) addressing externalities, like (i) basic education; and (ii) environmental protection;

   b) regulating monopoly, like (i) utility regulation, and (ii) anti-trust policy protection;

   c) overcoming imperfect social information, like (i) financial regulation, and (ii) consumer insurance;

   d) providing insurance, like (i) redistributive pensions, and (ii) unemployment benefits.

3) ***Activist Functions:*** These involve (a) coordinating private activity by (i) fostering markets, (ii) cluster initiatives; and (b) asset redistribution.

As we march ahead in the new millennium the debate on the respective roles of the state and the market thus goes on, as Deepak Nayyar puts it: "We have not yet reached the end of the history. There is much appeal in the proposition that neither the market nor planning are complete in themselves nor are the two irreconcilable foes, which are mutually exclusive." Their respective roles should be determined by the comparative advantage of each, besides the relationship between the two has to be highly supportive and non-antagonistic.

Much of the growth in the Indian economy during the first decade of the present century can be explained by pro-growth strong role played by the government. Analysis of episodes of sustained growth over time and across counties overwhelmingly supports the view that the state will play a role in it. Efforts are on to find the ways in which the role of the state can be constructive and facilitative rather than being a hindrance.

Check Your Progress 1

1) Give four arguments in favour of state intervention in economic activity.

....

....

....

2) Examine the different forms of intervention by the state in economic activity.

....

....

....

3) Mention three examples of government failure.

....

....

....

5.4 MEANING AND SIGNIFICANCE OF PLANNING

Notwithstanding all the cliches like market-friendly state, consumer-friendly markets, etc., economic planning continues to be the foundation stone of economic policy-makers all over the world. It is a symbol of independence, and it provides a medium through which the society or its representatives can articulate a view of the country's economic situation, its problems and projects and goals, or as one scholar observes: "It reflects the determination to take charge rather than be driven by economic forces."

5.4.1 What is Economic Planning?

Economic Planning is defined as "a continuous process which involves decisions, or choices, about alternative ways of using available resources, with the aim of achieving particular goals at some time in the future." The planning is done by a central authority, like the State, possessing the powers of implementation. A development plan may contain the following features:

i) a survey and diagnoses of the present economic situation,

ii) policy objectives, especially as related to the future development goals of the country concerned,

iii) a set of strategies by which the objectives should be achieved,

iv) a macro-economic projection for the whole economy.

In this type of orthodox planning, the review of the recent trends of the economy, and its main factors such as output, investment, saving, consumption, government expenditure, balance of payments, and the population is the starting point of planning. The growth path to attain certain objectives is determined on the basis of this decision.

5.4.2 Nature and Scope of Economic Planning

The nature and scope of planning is largely determined by the type of the economic system within which it is practised. Economic planning can be and is practised alike in a capitalist, i.e., a free market economy, socialist, i.e., a centrally-controlled economy and mixed economies. However, its role differs in each of these systems.

Planning in a Capitalist Economy

In this system, planning is more of an indicative type. It is democratic in nature. In this type of planning, the sphere of State intervention is limited to (a) formulation of a plan, and (b) adoption of indirect controls. The state can only issue guidelines, and not directives, leaving it to the market forces to decide their course of action. The absence of policy instruments that are able to ensure that overall and individual industry target growth rates and firm shares are met, limits the effectiveness of this type of planning.

Planning in a Socialist Economy

In this system, planning is of an imperative type. It is totalitarian in nature and works on the basis of directions. It is made imperative on the production units to follow the plan and to fulfill the targets.

Planning in a Mixed Democratic Economy

In this system, planning is a more difficult task. It may have to bear the strains and stresses of the other two systems. On the one hand, economic planning to be meaningful cannot be merely of an indicative type nor can it be, in the absence of a monopoly control over means of production, of an imperative type. It is to be a judicious mix of the two. The State has to adopt a proper mixture of direct and indirect controls. Whereas, on the one hand, it cannot give the impression of its being non-existent, on the other, it cannot afford to be too rigid either.

5.4.3 Significance of Planning

For a UDC planning has a manifold significance.

1) Since resources, whether natural, material, capital or human, are severely limited, planning provides a method of rational and considered choice for securing the optimum combination of inputs.

2) Planning helps to identify those deficiencies in the economy and the social structure which demand the largest attention from the standpoint of economic growth.

3) A plan for mobilising resources and savings is a necessary counterpart of the scheme of investment. By posing various critical problems in development and attempting to give them a quantitative dimension, planning is calculated to lead to a higher degree of capital formation than might otherwise be attainable.

4) By drawing attention to the social prerequisites of growth, planning also paves the way for the acceptance of large institutional changes. The very processes associated with planning and the implementation of plants enlarge the scope for public participation and co-operation.

5) It may be found desirable to weigh more heavily than the market does the interest of future generations. Indeed, many people themselves might be willing individually to make sacrifices for future generations, but are discouraged from doing so because of their belief that many others would not voluntarily do likewise. A role for government planning is thus called for to ensure that potential free riders play their part. The Galenson-Leibenstein criterion for investment, named for the economists who developed it, illustrates how a planner might choose to illustrates and extract higher investment now to promote a more rapid rate of growth later.

6) As planning techniques improve and more precise statistical data become available, the inter-relationship within the national economy can be seen more clearly and to that extent, the effects of different policies and measures can be traced more systematically.

However, practical success in planning is often limited by a variety of factors, more specifically inadequate statistical, economic and technical data, weaknesses in the social structure, lack of trained personnel, and inadequacies of organisation and management, particularly in large public sector enterprises. A large number of remedial measures may be required to correct the situation.

5.5 ECONOMIC PLANNING IN INDIA

India has completed about six decades of economic planning (1951-2011). India's experience with economic planning is a unique one as she has been practising economic planning within the framework of a democratic mixed economy. In this type of system, as already seen, planning is confronted with manifold strains and stresses. India too had its share of these strains. Another feature of India's scene is the diversity and heterogeneity of this country, which presents special challenges for development. It is in this background that the Indian economic planning makes an interesting study.[1] We shall begin our review of Indian planning with a study of the circumstances in which the adoption of economic planning was almost an imperative necessity. We shall also examine the broad features of India's plans and provide an assessment of the failures and achievements of planning.

[1] The rise of development economics as a serious sub-discipline of economics coincided with the formulation of India's first three Plans. Almost all major contemporary economists who took an interest in problems of development had occasion to interact with India's planners and policy-makers in the 1950s and the early 1960s. The result was a process of two-way interaction. Dominant ideas of contemporary development economics influenced the logic of India's plans, and, correspondingly, development theory was for a while greatly influenced by the Indian case.

5.5.1 Why Planning?

In the wake of independence, India was faced with an uphill task of overcoming the legacy of the colonial policies.

India sought to reverse the 'historical process'. Given the nature of a highly fragmented and distorted economy and the low level of infrastructure, human resource development and living standards, the primary objective of economic and social policy has to be developmental. The big and unique character of development made it imperative that the State could no more stand as a silent spectator of the economic scene. The early pioneers of development economics such as Simon Kuznets, Rosenstein Rodan, Ragnar Nurkse, Hans Singer and Arthur Lewis were nearly unanimous in recommending a leading role for the State in the development process; their work provided a powerful intellectual case for central planning.

The National Planning Commission was established in March, 1950. Planning commission was set up as a non-statutory, non-constitutional body, it was brought in by an executive order. It was charged with the following functions:

- To make an assessment of the material, capital and human resources of the country.
- To formulate a plan for the most effective and balanced utilisation of country's resources.
- To define the stages, on the basis of priority, in which the plan should be carried out and propose the allocation of resources for the due completion of each stage.
- To indicate the factors that tend to retard economic development.
- To determine the conditions which need to be established for the successful execution of the plan within the incumbent socio-political situation of the country.
- To determine the nature of the machinery required for securing the successful implementation of each stage of the plan in all its aspects.
- To appraise from time to time the progress achieved in the execution of each stage of the plan and also recommend the adjustments of policy and measures which are deemed important for successful implementation of the plan.
- To make necessary recommendations relating to current economic conditions, policies, measures or development programmes.

From a highly centralised planning system, the Indian Economy is gradually moving towards indicative planning where the Planning Commission concerns itself with the building of a long-term strategic vision of the future and decides on priorities of the nation.

The major function of the Commission was to "formulate a plan for the most effective and balanced utilisation of the country's resources". The Planning Commission prepared the First Five Year Plan for the period 1951-56. India, thus, entered the era of economic planning with the First Five Year Plan beginning on 1st April 1951.

5.5.2 Objectives of Economic Planning

The major objective of earlier plans in India was 'rapid economic growth with social justice' so as to build a self-reliant egalitarian economy. Within this broad objective, the early plans laid emphasis on the following: (i) securing increase in national income, (ii) pushing up the rate of investment, (iii) ensuring social justice and equity, (iv) providing additional employment, (v) adopting measures to alleviate bottlenecks in three high-priority areas, viz. agricultural production, the manufacturing capacity and the balance of payments.

While the broad objectives of planning remained the same, the relative emphasis and priorities underwent a change as the process of growth marched ahead.

Removal of poverty was accorded a high priority in the First Five Year Plan. The subsequent plans reiterated this objective. The Sixth Five Year Plan explicitly, for the first time, mentioned the objective of modernisation of the economy. Modernisation implies a shift in the sectoral composition of production, diversification of activities an advancement of technology and institutional innovations so as to transform a feudal and colonial economy into a modern and independent economy.

Subsequently, two other major objectives were added primarily to complement the earlier objectives: (i) Maximising the usage of resources by areas, and (ii) achieving price competitiveness and price stability by lowering protection and reducing the gap between demand and supply of commodities and factors.

All along, beginning with the First Plan well till the present times, while rate of economic growth picked up slowly and gradually but surely, social justice eluded us, as did the objective of self-reliance. In view of this perception, the Eleventh Plan introduced the objective of achieving faster and more inclusive growth. Inclusive growth is a process in which economic growth, measured by a sustained expansion in GDP, contributes to an enlargement of the scale and scope of the following four dimensions:

i) ***Opportunity:*** The economy should generate more and varied ways for people to earn a living and increase their incomes over time.

ii) ***Capability:*** The economy should provide the means for people to create or enhance their capabilities in order to exploit available opportunities.

iii) ***Access:*** The economy should provide the means to bring opportunities and capabilities together.

iv) ***Security:*** The economy should provide the means for people to protect themselves against temporary or permanent loss of livelihood.

It is apparent that the concept of "inclusiveness" goes beyond the narrow objective of poverty reduction. It encompasses a much broader approach to distributional objectives. Distributional objectives are not viewed as an "add on" to a dominantly growth-oriented strategy. Rather, inclusiveness is an integral part of the growth and indeed the structure of growth sought to be achieved is one which is most likely to achieve inclusiveness. In view of changes in emphasis on different objectives, the strategy to achieve these objectives underwent a change.

Check Your Progress 2

1) State the minimal functions of a government in the modern times.

....

....

....

....

2) State the intermediate functions of a government in the modern times.

....

....

....

....

3) State the activist functions of a government in the modern state.

....

....

....

....

5.6 STRATEGY OF THE PLANS

The primary problem to be identified in developmental planning in an emerging mixed economy is to establish a system of ends that may be pursued with a definite technique. This type of exercise is known as the strategy of planning. Any strategy for development consists of three components: resource mobilisation, priorities for the allocation of resources mobilised, and a policy framework to ensure an efficient deployment of resources into the priority sector.

5.6.1 Evolution of Strategy in India's Plans

It was during the First Five Year Plan (FYP-1) period itself that the Planning Commission had started doing 'home work' relating to the formulation of the FYP-2. A series of studies, under the general guidance of Prof. P.C. Mahalanobis, were prepared by a group of both Indian and foreign economists and statisticians. These contributed to the writing of the Mahalanobis' Plan Frame (which was hailed as the most radical Plan outside Communist countries) which became the foundation of the FYP-2 and, for that matter, all long-term planning in future. The strategy aimed at building a self-sufficient economy.

Mahalanobis' Plan Frame

Even though the Mahalanobis model, which was used as the analytical construct for the Second Five Year Plan was not even an original contribution – it was adapted from the Feldman model of the 1920s – it inspired the tradition of using theoretical models for practical policy planning. This represents the core of Mahalanobis' contributions — to cull out the relevant knowledge and put it into action.[2]

Mahalanobis divided the economy into two sectors: producing capital goods and consumption goods respectively, and the policy decision was – the share of total

[2] Ashok Rudra: Prasanta Chandra Mahalanobis: A Biography (OUP, New Delhi, 1996).

investment to be allocated to each sector. His key assumption was that the Incremental Capital Output Ratio (ICOR) is technologically determined by each sector, i.e., his model is an extension of the Harrod-Domar model to two sectors. For each sector the growth in output from one period to the next depends upon how much new investment occurred in that sector and the productivity of the additional capital. The change in output of the capital goods industry is

$$I_t - I_{t-1} = \beta_k . I_{t-1} \qquad ...(1)$$

where β_k is the ICOR of the capital goods sector, T is the share of total investment allocated to the capital goods sector, and the I subscripts refer to time periods. Similarly, the change in output of the consumption goods industry is:

$$C_t - C_{t-1} = \beta_c . T_c . I_{t-1} \qquad ...(2)$$

where T_c is the share of investement allocated to the consumption goods sector and is the change in output per unit change of investment in that sector.

Current production of capital goods can be related back to the level of investment at any time in the past. From Eqn. 1, current investment is equal to investment in the previous period multiplied by ICOR(β_k) and investment in the previous period is related to investment in the period before that in the same way. If β and T coefficients are constant (in this model, the former is technologically determined and the latter policy determined), then capital goods output is related to the investment level and the choice of T in some base period, time O, by

$$I_t = I_O (1 + \beta_k . T_k)^t \qquad ...(3)$$

Becuase, the output of consumption goods also depends upon the production of capital goods in the previous period, it too can be related to investment in the base period:

$$C_t - C_{t-1} (\beta_c . T_c / \beta_k . T_k) I_O . [(1 + \beta_k . T_k)^t - 1] \qquad ...(4)$$

and then, using the C+I identity, total output can be related to output and investment in the base period.

The conclusion from the Mahalanobis model is that the long-run growth of both consumption and GNP is dominated by the expression ($1+\beta_k.T_k$). Since this is raised to the power t in equation (3) and (4), it will become the asymptotic growth rate, i.e. the rate to which growth will tend in the long run. Because the β values are technologically given, the policy rule is to maximise T_k, the share of investment going to the capital goods sector. Diverting investment away from the consumption goods sector must reduce consumption in the short run, but, by sacrificing current consumption, the stream of consumption goods available over the long run will be higher.

Mahalanobis' underlying viewpoint is clearly 'structuralist'. The line between capital goods and consumption goods is rigid, and once capital goods are produced, they define the aggregate investment/output ratio. Given the allocation of new capital goods between the two sectors, future output is then mechanically determined by the given ICOR. There is no room for demand; people consume the consumption goods which are produced, and, because they cannot eat or wear or otherwise consume capital goods, output of capital goods determines the savings rate.

International trade is not mentioned, importing capital goods would break the link between consumption and last investment allocation decisions. Altogether, technological and behavioural flexibility are ruled out, and prices have no role as signals to influence economic decisions.

i) The basic constraint on development was seen as being an acute deficiency of material capital, which prevented the introduction of more productive technologies.

ii) The limitation on the speed of capital accumulation was seen to lie in the low capacity to save.

iii) It was assumed that even if the domestic capacity to save could be raised by means of suitable fiscal and monetary policies, there were structural limitations, preventing conversion of saving into productive investment.

iv) It was assumed that whereas agriculture was subject to secular diminishing returns, industrialisation would allow surplus labour currently underemployed in agriculture to be more productively employed in industries which operate according to increasing returns to scale.

v) Another assumption was that if the market mechanism were accorded primacy this would result in excessive consumption by the upper-income groups, along with relative under-investment in sectors essential to the accelerated development of the economy.

vi) While unequal distribution of income was considered to be a ‘bad thing’, a precipitate transformation of the ownership of productive assets was held to be detrimental to the maximisation of production and savings.

The planners decided to pursue a policy of deliberate industrialisation. In other words, long before Gunder Frank and others wrote about dependent underdevelopment and the development of underdevelopment, we had already implemented policies that would make India an independent, metropolitan power.

This type of strategy assumed that the state would have a predominant influence on economic policy and all investment decisions, even in private sector, would be dictated by the requirements of the plan. The private enterprise would have little or no say in formulation of economic policies.

It was realised from the past experience that a necessary condition for reducing poverty effectively would be to improve efficiency in the use of resources. This would help increase the producer’s surplus which would then appropriately be deployed for poverty alleviation. This resulted in the initiation of a large number of schemes for increasing the productivity of capital via improved technology and generation of assets largely for the poor. To develop this strategy and, at the same time, to protect against centralised decision-making, mass participation in the planning process was warranted.

5.6.2 Shifts in Strategy

It was realised that an increase in the GDP growth and a high rate of accumulation *per de* might not provide a sufficient condition for improving the standard of living and consumption needs of the people, nor help in attaining economic self-sufficiency in fulfilling different demands.

Possibly in response to this, the strategy changed later and the investment mix began to be chosen on the basis of the demand pattern for final consumption. This new strategy was, in turn, reflected in the modelling area through a choice of appropriate inter-sectoral consistency models – close to Leontief's input-output families. This strategy primarily covered India's Fourth Plan.

By the 1970's it had become clear that the benefits of growth had not percolated to the masses. As a corrective measure, development strategy shifted therefrom towards providing the necessary consumption benefits to the poor directly. Accordingly, in the modelling area, a large number of new economic and non-economic variables were chosen to identify poverty and incorporated in the model frame in order to build explicit redistributions strategy in planning. This policy got largely reflected in the Fifth Plan.

Incorporation of productivity with redistribution became an important element of plan strategy pursued in more recent plans. To develop this strategy and, at the same time, to protect-against centralised decision-making, mass participation in the planning process was warranted. It was, therefore, felt that the quality of human stock needed improvement at all levels, down to the blocks and villages.

Certain past strategies of the development plan are now seriously questioned. Among these, the more important are:

- The almost exclusive reliance on the generation of new investment as the only input in accelerating growth;
- The excessive emphasis on the need for self-sufficiency, leading to an indiscriminate protection granted to domestic activities, almost in complete deference to efficiency and incentives;
- The attempt to solve the problems of poverty mainly by subsidy-oriented compensatory fiscal measures, very often leading to unproductive employment and underutilised capital.

5.7 NEW ECONOMIC POLICY (NEP) AND PLANNING IN INDIA

The new economic policy envisages rapid industralisation with modernisation for attaining faster growth of GDP. The conditions which the NEP introduces for this kind of industrialisation and growth are as follows:

i) Substitution of the market and of private enterprise for planning and public sector leadership in industry.

ii) Orientation towards exports production in place of import substitution.

iii) Removing the capital goods bias in resource allocation and letting the market do the allocation.

The NEP finds its origin in the growth of neo-liberalism during the 1980's and the 1990s. The neo-liberalism affirms the economic decision-making; correspondingly, it limits the role of the state to rule-setting and contract upholding.

5.7.1 NEP and Efficiency

The thrust of the NEP is towards creating a more competitive environment for improving the system's productivity and efficiency.

This is to be achieved by removing the barriers to entry and restrictions on the growth of firms. While the industrial policy seeks to bring about a greater competitive environment domestically, the trade policy seeks to improve international competitiveness subject to the protection offered by tariffs. Competitiveness implies:

- production of goods and services based on new technologies,
- capacity to increase market shares in the world trade which implies advantages in export markets,
- a move towards trade surplus,
- an increase in the level of per capita income in the country.

The private sector is being given a larger space to operate in, with some areas earlier reserved for the public sector being thrown open to the private sector. In these areas, the public sector will have to compete with the private sector even though the public sector may continue to play the dominant role. What is sought to be achieved is an improvement in the functioning of the various entities whether in the private or in public sector by injecting an element of competition.

5.7.2 NEP and Role of State

There is nothing in the NEP which takes away the role of the State or the public sector in the system.

Government will have the primary responsibility for the development of the physical infrastructure such as irrigation, energy, transport and communication and social infrastructure sectors such as literacy, health, population control and environment. It will continue to have the responsibility for initiating and administering special programmes to take care of the poor and the disadvantaged for growth by itself will not take care of the problems of these groups. Public sector investment has, however, to become more focused and its role clearly defined.

The recent plans have clearly identified the principles governing public sector investment. These are:

i) The public sector should make investment only in those areas where investment is infrastructural in nature and where private sector participants are not likely to come forth to an adequate extent within a reasonable time perspective.

ii) The principle of market economy should be accepted as the main operative principle by all public sector enterprises unless the commodities and services produced and distributed are specifically for protecting the poorest in the society.

5.7.3 NEP and Indicative Planning

Planning in India has to take into account the changing roles of government and market and bring about a blend that ensures better growth through greater efficiency. The role of economic planning should be:

- To provide a long-term perspective of the economy.
- Identify thrust areas of development where the country has strengths or where it needs to build up strengths.
- Evolve appropriate policy measures to achieve the desired goals. In a more

deregulated environment, policy formulation and coordination will assume greater importance.

- To ensure that all markets function efficiently.
- To plan public action in areas where externalities create natural monopolies and where costs of public action are less than costs of regulation.
- To lobby for the poor in economic policy making: (a) plan programmes for income transfers that are non-regressive, non-subvertible and self-liquidating, and monitor them to ensure that they fulfill social objectives, (b) plan programmes that result in better distribution of assets including environmental ones, and (c) increase the value of the asset that the poor have, namely, labour through human resource development.
- To maintain macroeconomic stability so that the real incomes of the poor do not go down suddenly.

In view of these considerations, planning in India will be increasingly "indicative".[3]

Aims of Indicative Planning: The economy benefits from the indicative planning in the following ways:

- Clear prioritisation of goals leads to the reduction of production bottlenecks making possible higher rates of growth. If each industry can plainly see what it should achieve, each industry would gear up to meet that target.
- Channelisation of necessary funds to the crucial sectors considered essential for future economic development.
- The information provided by the indicative plan aids decision-making for Government as well as business. The plan provides clear picture of the effects on the entire economy of any change in implications of any contemplated change in government policies, the indicative plan leads to more rational decisions and more coherent policies.
- The informational effects of indicative planning also increase the overall rate of expansion in a more general way. Uncertainties about the future demand tend to reduce the rate of investment and expansion in the private sector. Indicative planning reduces such uncertainties, thus, providing a climate conducive to higher investment and more rapid expansion.
- It needs to be noted that so long as public sector investment is a significant proportion of the total investment, planning, so far as it relates to public sector, has to be detailed and specific. This is analogous to corporate planning. For the rest of the system, however, the plan will be indicative outlining the broad directions in which the economy should be growing.

Requisites of Indicative Planning: All this calls for very different kinds of expertise and organisations than are currently available. Besides building up capability at the state level—where a goods part of planning for agriculture, electricity, roads etc. – has to be done – the government has to play an active role.

---

[3] Also dubbed as non-centralised, weak and non-directive planning which essentially makes a none-too-large coordinated and effective intervention to overcome known limitations of market mechanism.

- creating an atmosphere conductive to the growth of specialised organisations;
- bringing the industrial enterprises (irrespective or whether they are in the public or private sector), industry associations, private design and engineering organisations, universities and research institutions into an effective interaction, facilitating wider, quicker diffusion of knowledge about existing and prospective technology;
- promoting technology assessment and development keeping in view the needs and constraints of the country;
- promoting close interaction between sectoral enterprises, enterprises in related sectors: design engineers, technologies and research insitutions.

5.7.4 Redefinition of the Role of Planning Commission

There may be a redefinition of the role and functions of the Planning Commission, but it will have to be given a stature that it deserves as a major instrument of federal resources transfer and the development process.

A Federal Agency: It should function as a federal agency and be neutral between the Centre and States. It must be professional in its approach and cease to swing to the tune of the Central political leadership. The NDC must meet often and the plan strategy must be endorsed by the Council, which must also be involved in periodical monitoring of the performance of the economy.

An Allocational Body: The Commission has the role of an allocational body. In the new context, its allocational role has to be in areas like infrastructure and environment, besides in encouraging the private sector. This will require the Commission getting involved in promotional exercises.

Investment Planning: In light of the emerging situation, sectoral investment planning continues to form an important component of the planning process. Individuals and entrepreneurs are frequently unable to assess the areas of opportunities and anticipate likely problems. Investment planning is a methodology to bridge this gap.

Resource Augmentation: The planning process also needs to take stock of the resources for development and to indicate methods by which these resources can be augmented in a sustained manner. Since planning is done for the entire nation, the strategies for resource augmentation need to cover not only the government at all levels but also those which would be available to other sections of people.

Identification of Vulnerable Areas: The other principal task before the Planning Commission in a market oriented economy is to identify the areas of emerging vulnerabilities and to suggest measures to address them. Although the specific policies would need to be worked out by the concerned ministries or the states, the broad directions would have to be provided by the planning system. Unless such problem areas are placed within the wider macro-economic context, short-run fire fighting measures can lead the economy in undesirable directions.

Monitoring Authority: There is the need for a strong monitoring authority to regulate and control the movement of economic variables thereby preventing waste of resources.

It is also necessary to establish priorities in terms of alternative uses of resources. This again brings in the question of prioritisation in expenditure that is the task of the Planning Commission.

Responsibility of Long-range Planning: The most important role for the Planning Commission is to get involved in long range planning. The emphasis should be on in-depth exploration into alternative scenarios in respect of vital sectors, like energy, telecommunications, transport, social sectors and technology.

Further, the various programmes contained in what has come to be known as "the new post-Washington Consensus programmes of reform" have to be properly co-ordinated and sequenced, maintaining inter-sectoral and inter-temporal consistency and designed for implementation with transparency and accountability and public debate. These responsibilities would devolve on the Planning Commission.

These will require the Planning Commission to shift its focus to "planning for policies". The commission is one medium the government has which intermediates between states and the centre, ministries, departments, etc. Involved in the country's development planning, it is the bridge between today and tomorrow and even day after'. The commission should, therefore, be a nodal agency for planning for policies.

Development Fund: A recent study suggests that the Planning Commission should work as a Fund for Public Investment (FPI) for both the Centre and States. The FPI, like a development bank, should advance long-term development bank, and long-term development finance by borrowing domestically and abroad. It will appraise the projects for their feasibility, economic and social returns and also for the soundness of the borrower.

In view of the various considerations mentioned above, it is likely that the planning machinery may be made broader to provide adequate representation of the business enterprises as is the case in France. The advantage would be that the formulation of a plan would take into account the information supplied on the views expressed by the private sector. This would make it easier for the plan projections to influence the production decisions of private enterprises.

Check Your Progress 3

1) State in brief the role of the state in the Mahalanobis model of growth.

....

....

....

....

2) What is the principal feature of growth strategy in India?

....

....

....

3) What do you mean by 'indicative planning'?

....

....

....

5.8 LET US SUM UP

Adam Smith's invisible hand' was perceived as omni-potent and omni-present. This idea influenced economic thought through generations of economists and policy-makers. This thought was challenged when the discussion on economic planning took the centre-stage of economic discourse. The early successful experiments with economic planning as a smoother route to economic prosperity and growth attracted many more devotees to this deity. This phase lasted as long as the weaknesses and the limitations of this process came in limelight and invited severe criticisms. There was a rush of apologies from the think-tanks that were hitherto devotees of economic planning. But this phase also could not last long. Since then, the debate on relative effectiveness of state and market has gone more intense, with the state finding new opportunities for intervention and the markets yielding ground to it.

5.9 EXERCISES

1) Contrast the economic policies that emerge from the Mahalanobis' model of development with those that form the corpus of the New Economic Policy.

2) "Indian economic environment has undergone dramatic changes with a shift in development strategy." Recount these changes.

3) Account for the transition from central planning to indicative planning in India.

4) "Relationship between the state and the market needs to be highly supportive and non-antagonistic." Comment.

5) Analyse the changing nature of the role of state in the light of the globalisation measures adopted in India since 1991.

5.10 KEY WORDS

State : It commonly refers to either the present condition of a system or entity, or to a governed entity (such as a country) or sub-entity (such as a province or region).

Market : A market is one of many varieties of systems, institutions, procedures, social relations and infrastructure where by parties engage in exchange.

Plan : A plan is typically any diagram or list of steps with timing and resources, used to achieve an objective.

Planning : It implies the working out of sub-components in some degree of elaborate detail.

Indicative Planning : It is a form of economic planning.

5.11 SOME USEFUL BOOKS

Dhingra Ishwar C. (2012): *The Economy, Environment and Policy* (Sultan Chand, New Delhi, 27th edition 2012).

Alfaro Laura and Charry Anusha (2009): *India Transformed?,* National Bureau of Economic Research.

Basu Kaushik (ed.) (2010): *The Oxford Companion to Economics in India*, Oxford, New Delhi.

Deepak Lal, (2006): Reviving *The Invisible Hand, The Case for Classical Liberalism in the Twenty-First Century*, Princeton University Press.

Mookherjee Dilip, (2006): *Market Institutions, Governance and Development*, Oxford, New Delhi.

5.12 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See Sub-section 5.2.1

2) See Sub-section 5.2.2

3) See Sub-section 5.2.3

Check Your Progress 2

1) See Section 5.3

2) See Section 5.3

3) See Section 5.3

Check Your Progress 3

1) See Section 5.6

2) See Sub-section 5.7.1

3) See Sub-section 5.7.3