Does Market Provide Better Solution For Growth Than The INDIAN PLANNING PROCESS?

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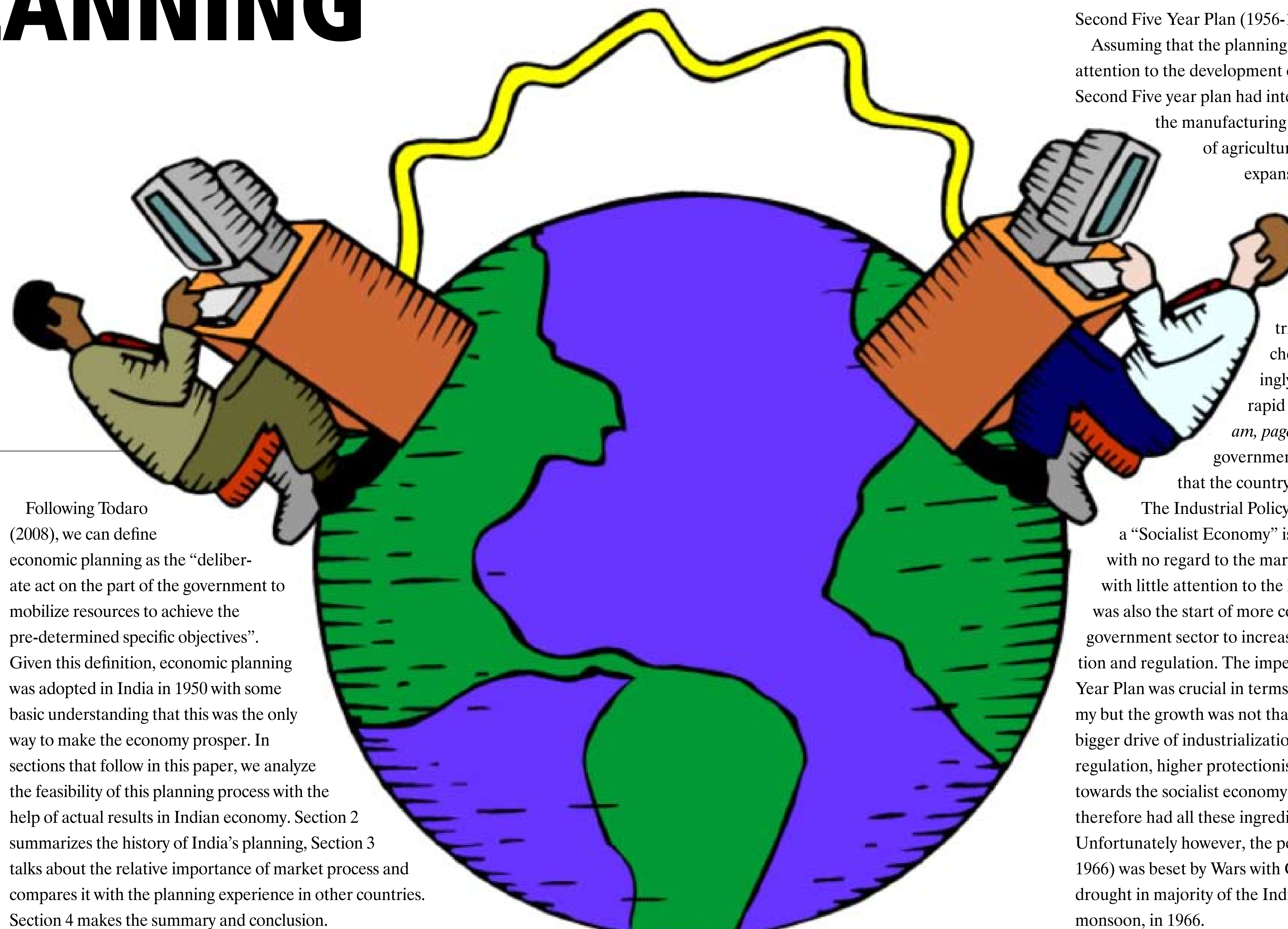

Introduction

There has been an interesting and mixed evidence of the feasibility of planning process in India. The most prosperous sector of Indian economy in last 20 years has been the software industry, which has mostly unregulated, unplanned, and in a way, unorganized. On the other hand, the regulated and planned sectors such as construction, infrastructure, and legal (law) sector have shown depressingly laggard growth and the unsatisfactory performance. While some years have shown a remarkable growth in these areas, the general feeling is that too much regulation has led to slower progress in construction of highways, supply of utilities such as electricity, water and public sanitation. So, the main question as the title of this paper suggests, is to find out if the economic planning is really a better way or not. This paper evaluates that question with the help of theoretical arguments for and against the market solutions for economic growth.

Following Todaro (2008), we can define economic planning as the "deliberate act on the part of the government to mobilize resources to achieve the pre-determined specific objectives". Given this definition, economic planning was adopted in India in 1950 with some basic understanding that this was the only way to make the economy prosper. In sections that follow in this paper, we analyze the feasibility of this planning process with the help of actual results in Indian economy. Section 2 summarizes the history of India's planning, Section 3 talks about the relative importance of market process and compares it with the planning experience in other countries. Section 4 makes the summary and conclusion.

History of Indian Planning Process:

In 1951, when the Indian planning process began the immediate need of the economy was the agriculture sector which provided 70% of GDP and kept 70% of the population occupied, if not employed, in that sector. Plus the country was coming back from the loss of resources due to the War with Pakistan, the Republic was newly established, and the planning process was dominated by the economic planners (such as Mahalnobis) who were trained in the Keynesian tradition of socialist inclination. Therefore the first plan established three main objectives: rehabilitation of refugees, rapid agricultural development to achieve food self sufficiency and control of inflation. While it succeeded in terms of moderate growth in agriculture sector and reduction in prices, it brought in more enthusiasm to establish even more aggressive targets for Second Five Year Plan (1956-1961).

Assuming that the planning process can now turn its attention to the development of heavy and basic industries, the Second Five year plan had intentions of a Big Push towards the manufacturing sector without losing the sight of agricultural growth. Plus the 1956 expansive Industrial Policy launched by the Nehru Government made it clear that major economic growth will not be possible with out the focus on the heavy and basic industries such as iron, steel, cement, chemicals and fertilizers. Accordingly, the Second Plan aimed at rapid industrialization (*Datt-Sundharam, page 270*). However, the increased governmental outlay necessarily meant that the country would sway towards socialism. The Industrial Policy of 1956 made it clear that being a "Socialist Economy" is the goal of the Indian economy with no regard to the market clearing process and with little attention to the Neo-classical prescription. This was also the start of more control and ownership by the government sector to increase the bureaucracy, administration and regulation. The impetus received in Second Five Year Plan was crucial in terms of the growth of Indian economy but the growth was not that impressive. This led to even a bigger drive of industrialization with more control and more regulation, higher protectionism and increased leaning towards the socialist economy. The Third Five Year Plan therefore had all these ingredients in its implementation. Unfortunately however, the period of the Third Plan (1961-1966) was beset by Wars with China and Pakistan and a severe drought in majority of the Indian States due to unfriendly monsoon, in 1966.

Due to the changing priorities, and realization that the growth is not even close to the one expected, the first draft of Fourth Plan as prepared by Dr. Ashok Mehta (and his Commission) had to be abandoned. The Planning Process was declared to have three years of "Plan Holidays" to be replaced by Annual Plans from 1966-1969. Fourth Plan period (1969-1974) set before itself two principal objectives, "growth with stability" and "progressive achievement of self reliance". The Plan also aimed at having a 5.5% growth rate of GDP, and removal of poverty. It realized none of those objectives. Instead the higher inflation, started with OPEC's oil price increase made the matters worse. The economic situation got even more dramatic, and somewhat depressing, in the Fifth Five Year plan period (1974-1979). The government faced a major political upheaval leading to the era of emergency, the inflation became a runaway inflation. The main objectives of Fifth Plan were however, a greater income distribution (with the help of heavy taxation) and removal of poverty with attainment of self reliance which also meant more isolation of the economy from international trade. While these objectives now sound to be weird and unattainable, the means to adopt them were even more dramatic and ruthless. The increase in government interference required to achieve these objective was of a degree that was unsustainable as well as harmful to the every man and woman's life. The excesses applied to control the population were partly responsible for India Gandhi government losing elections in 1977 leading to the abandonment of the Fifth Five Year Plan in 1978 by the Janata Party. This was replaced by Sixth Five Year Plan period (1978-1983) which had two separate and unrelated versions.

Excesses applied to population control were partly responsible for India Gandhi government losing elections in 1977

"The Janata Party Sixth Plan openly praised the achievements of Planning in India, but held the Nehru model of growth responsible for growing unemployment, for the concentration of economic power in the hands of a few powerful business and industrial families, for widening of inequalities of income and wealth, and for mounting poverty. The Janata Sixth Plan sought to reconcile the objectives of higher production with those of greater employment, so that millions of people living below poverty line could benefit there from. The focus of the Janata Sixth Plan was enlargement of the employment potential in agriculture and allied activities, encouragement to household and small industries producing consumer goods for mass consumption and to raise the incomes of the lowest income classes through minimum needs program." (*Datt-Sundharam, page 271*) However, the Janata party lost the elections in 1980 and the newly re-elected Indira Gandhi government not only rejected the Janata Sixth Plan, but also replaced it with the one (1980-1985) that had aims of direct attack on the problem of poverty by creating conditions of expanding economy. About this time a reasonable growth in the Indian economy was registered by favorable monsoons and agricultural growth that was pushed harder by the Green Revolution. Hence the Seventh Plan (1985-1990) emphasized policies and programs which could accelerate growth in food grain production, increase employment opportunities and raise productivity. Just about this time there was a drastic change in the economic planners in India. While the failures of the very planned process were somewhat evident and obvious, there appeared the will and readiness to try something new in the international trade area especially about the loss of economic welfare created by heavy protectionism up to that point of time.

Hence the approach of the Eighth Plan was not only different but also was embraced by all the parties that put a claim on the government. In fact the approach to the Eighth Plan was initially approved in September 1989 and the actual plan was to be introduced in April 1990. However changes in the government necessitated constant re-constitution of the Planning Commission. "Finally the fourth version of the Eighth Plan (1992- 1997) was approved at a time the country was going through a severe economic crisis caused by a balance of payments crisis, a rising debt burden, ever increasing budget deficits, mounting inflation and recession in the industrial sector" *(Datt-Sundharam, page 271)*. This prompted the government to announce a path-breaking new plan (in June 1991) that involved not only reducing tariff rates substantially but also devaluating the Rupee by approximately by 25%. The Eighth plan also reflected these changes in its attempt to accelerate growth and improve the quality of life of

the common man. The subsequent Five Year Plans have been set in the background of the neo-classical arguments of further freeing up of international trade and also more market oriented Indian economy. The regulations, especially for the foreign direct investment have come down substantially. The Information Technology industries and alike have been regulated in a much more friendly way, and the infrastructure investment has been increased, the auto industry as well as the aviation industry is open for freer competition and similar market oriented policies were adopted from 1995 onwards. The results have been stupendous. The economy has progressed in an impressive manner. So, the main question is what went wrong in the strict planning period from 1951 to 1991? Here are some arguments to answer this question:

1) The reduction in poverty was an ambitious project, even for the 1980s era, as 33% of the Indian population still earns less that $1/day: which is an usual measure of counting the poverty. In 1987 Chakravarty pointed out three main failures of Planning Process until then. First, there was a gross inefficiency in production in many of the public sector enterprises. There was no apparent reason why these firms would produce below 50% of their capacity, and why there was such a low level of management practices used in the productions of steel, power, fertilizers, transport etc.

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Second, the manufacturing sector has not been as labor intensive as the agricultural sector leading to growth with out employment. This put even more pressure on rising unemployment in India, leading to further inventions on the part of the government to come up with other employment schemes. Third, the planners apparently did not comprehend the logical implications of the big and unachievable goals that could not be fulfilled. They set themselves for a major failure by being over ambitious. While the low ambition was seen as unpatriotic, the high ambitions were out of the realm of possibility. The planning process, therefore, has become almost meaningless as the economy got used to the high failure rates. The negative externalities of the strong preference to planning process has led to high bureaucracy, increased controls, more licensing, inefficient use of resources, and a dense network of regulation. In economic sense the opportunity cost of the planning in India is a huge burden on the resources. This point is made clearer by the experience of Indian economy from 1991 onwards. As the market process was given more chance to operate, and as the open international trade has made competition from external sectors more plausible, the Indian economy's performance has improved tremendously. Helped by the freer sector of computer and information technology related companies, the Indian economy has been progressing in an impressive manner ever since it was allowed to be dictated by more market oriented policies. To convince ourselves that the Indian economy's experience is no exception, we can briefly investigate the evidence form some other economies in the next section. In the meantime, one can easily observe a drastic change in Indian economy's performance in pre- and post 1991 era in the graphs listed in Appendix .

Experience From Other Countries

Over the past half-century, there has existed a movement toward the liberalization of markets in several other centrally planned economies as well as other democratic economies. From Japan, Taiwan, South Korea and Singapore, who experienced average economic growth rates of eight percent during the 1960's and 1970's, to China's economic liberalization in 1978, which was followed by many years of double-digit growth, to India's own economy, which has experienced growth rates as high as 9.8 percent after liberalization reforms in 1991. The data for other countries have consistently suggested that in the developing economies of Asia, the more liberal and market driven economies consistently outperform those of their centrally-planned counterparts. The question in this case is why, and to what end?

Albert Waterston studied early development planning in 55 countries, and claimed that "the great majority of countries have failed to realize even modest income and output targets in their plans except for short periods. What is even more disturbing, the situation seems to be worsening instead of improving as countries continue to plan." (*see Waterson in the Bibliography*).

This is a glaring example of one of the most obvious problems with development planning; for a planning body, observing and determining the short-run weaknesses and opportunities in a market or economy are not as difficult as possessing the flexibility and responsiveness required to adapt to continuously changing market conditions. Even at its most flexible, the planning body cannot possibly adapt with the same efficiency that a market otherwise could, on its own. The long-run strategy of maximizing economic growth requires the ability to change at the same rate that the factors of production and the demands of consumers change, which can only be optimally performed by the market itself.

With regard to the separation between short-run and long-run growth strategies, it can also be shown that government reaction to short-term weaknesses and opportunities in the economy actually amplify long-term reductions in growth. Assuming that the government is not acting as a player in the market, and not becomes a subject to market prices, then theoretically, government subsidization of the production of a certain good gives incentives for the use of resources to produce that good. Even if the economy in question possesses a relative abundance of the factors required to produce that good, the opportunity costs lay in the sacrificed development that the rest of the economy would have seen had the resources (whether subjective or tangible) not been redirected to the subsidized good. While the production of the good may be in the short-run best interests of the economy, the waste of resources that occurs as a result of their redirection generates less than optimal growth rates in other sectors of the economy. Except in the case of capital intensive production or infrastructure projects, where government facilitation is necessary, the open market directs resources most efficiently, which allows an economy to take advantage of strengths without wastefully appropriating resources.

As it pertains to those economies that have transitioned from central planning to a more market oriented economy, there is no better evidence of the market's ability to correct for inefficiencies than that which took place in China over the last thirty years. As described by Naughton (1995), the entry of private firms to the market eliminated at least a portion of the price distortions that had been created by state firms producing inefficiently. "Competition eroded initially high profit margins for state firms, and induced the government, as owner of the firms, to become more concerned with profitability." In this case, the introduction of the "invisible hand" subjected the state-run enterprises to the same forces that are felt in the market and that drive markets toward equilibrium prices and production levels. In this case, the government did not "facilitate" the market, but instead became a part of it and subject to its demands.

And supposing the state-owned enterprises were subject to the demands of a more liberalized economy, Sachs and Woo (1997) show that even after the "dual-track" process had begun—with both state-owned and non-state sectors in operation— the non-state sectors "account for more than 70 percent of total growth during 1979-94." This suggests that even when compared side by side, and without the support of a monopolistic pricing model, the state-owned interests still lacked the adaptive abilities required to maintain competitiveness in the long run. Though this may be the result of an actual desire to promote the private interests, the state-owned enterprises made up 18 percent of all employment in China as of 1993— the same percentage that existed in 1978—suggesting that this was not the case.

Another example of the correcting capabilities of the market came from Chile. Though a great deal of the political and economic circumstances were different in Chile, their structural market reforms beginning in the mid-1970's moved them from almost complete isolation in the world economy to one of the higher ranking countries in free-trade policies. Bergoening, Hernando and Repetto (2006) of the Central Bank of Chile show that these liberalization policies allowed for the entry of new participants to domestic industrial production, and showed that at the plant level since 1980, "almost 90% of total growth is explained by efficiency gains." They go on to explain that while new entrants in the marketplace were not as efficient as incumbent units of production, the new entrants quickly became equally efficient and they replaced those market participants that were not as productive and were forced to exit the market. This conclusion is extremely important because it suggests that under a central planning or state-owned production environment, the less productive plants that would have otherwise been replaced by more efficient firms or perhaps by plants producing substitutes, are instead subsidized to meet the goals of the planning body. Without the supply-side turnover that increases net productivity, the planning body cannot possibly expect to see competitive rates of overall economic growth.

Bergoening, Hernando and Repetto (2006) also examine the role of increased access to external financing on productivity and show, once again, that the interaction between deepened capital markets and productivity is positive, and more so in those industries and firms that are credit constrained. The deepening of credit markets caused an increase in private credit by deposit banks of nearly 40 percent (relative to GDP) and resulted in growth rates over the full sample of industries of 2- 2.5 percentage points. This is specifically as a result of increased access to capital that would not have existed if state-imposed restrictions of access to the financial markets were still in place.

This is not to say that all public involvement is bad. Certainly, the establishment and enforcement of property rights and commercial law provide the minimum degree of systemic integrity necessary for market operation, and the public development of infrastructure that supports increases in the mobility of goods, services and ideas can definitively serve as drivers of economic growth. But while government support of these particular necessities may establish the foundation that allows a market to function and develop efficiently, excessive central planning introduces a variable that places additional (often unnecessary) bounds and limitations on an economy.

Summary and Conclusion

The main conclusion from the above story is that economic planning has rarely been successful. It has not only been unsuccessful, it has been harmful to the economy in terms of channeling resources to inefficient and unproductive productions. It has increased bureaucracy and corruption. It has managed to increase the controls by administrators. On the other hand, market process is not a panacea for very economic problem. It has its limitations because the real growth appears only when the aggregate supply is increased. This is achieved only by better working conditions, innovations, positive technological change, non-destructive policy changes, improved enterprise and the zeal of the population to do better for itself in future. Without these changes the economic growth is unattainable and unsustainable. Hence if markets can make mistakes too the government can make even bigger and more hurtful mistakes and coming back from the increased regulation is much harder than getting into it.

References and Additional Thinking

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(The views expressed in the write-up are personal and do not reflect the official policy or position of the organization.)

Appendix: Data For India's Economy

Table 1. Exports Of Goods And Services (% Of GDP)

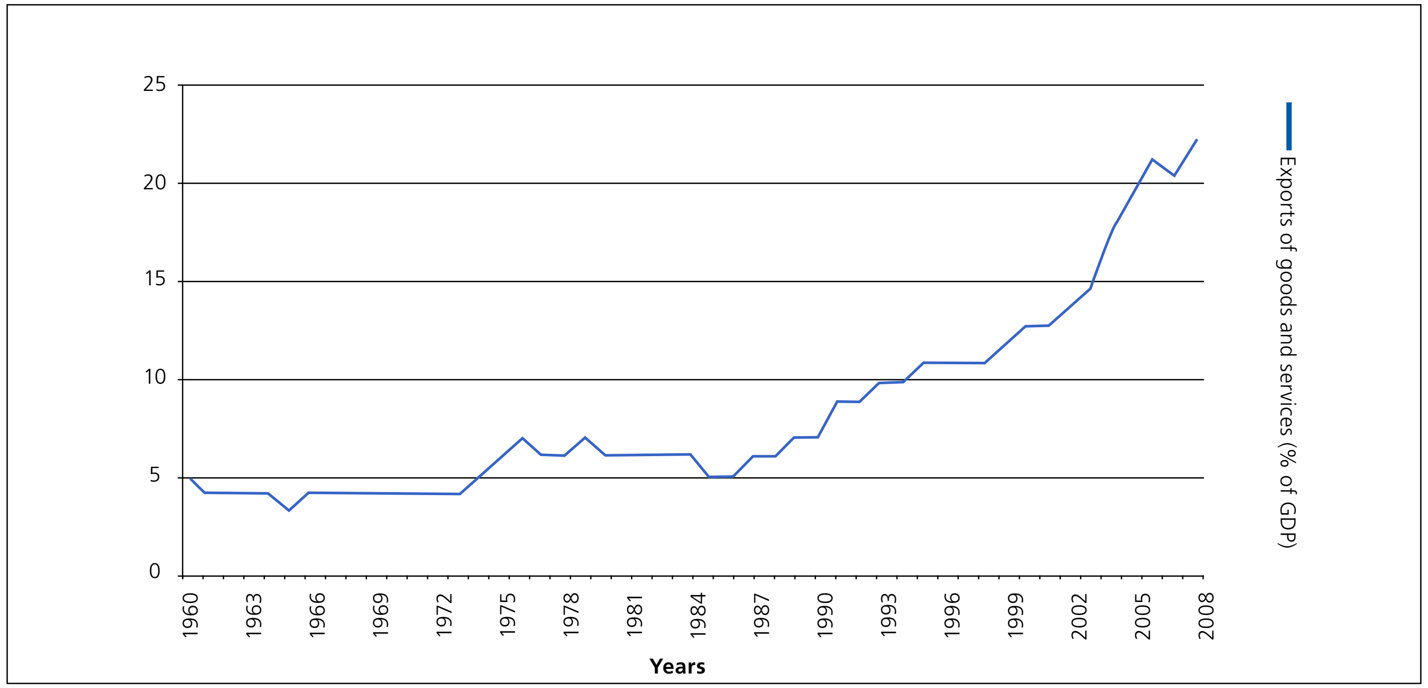

Table 2. GDP Per Capita (Constant 2000 US$)

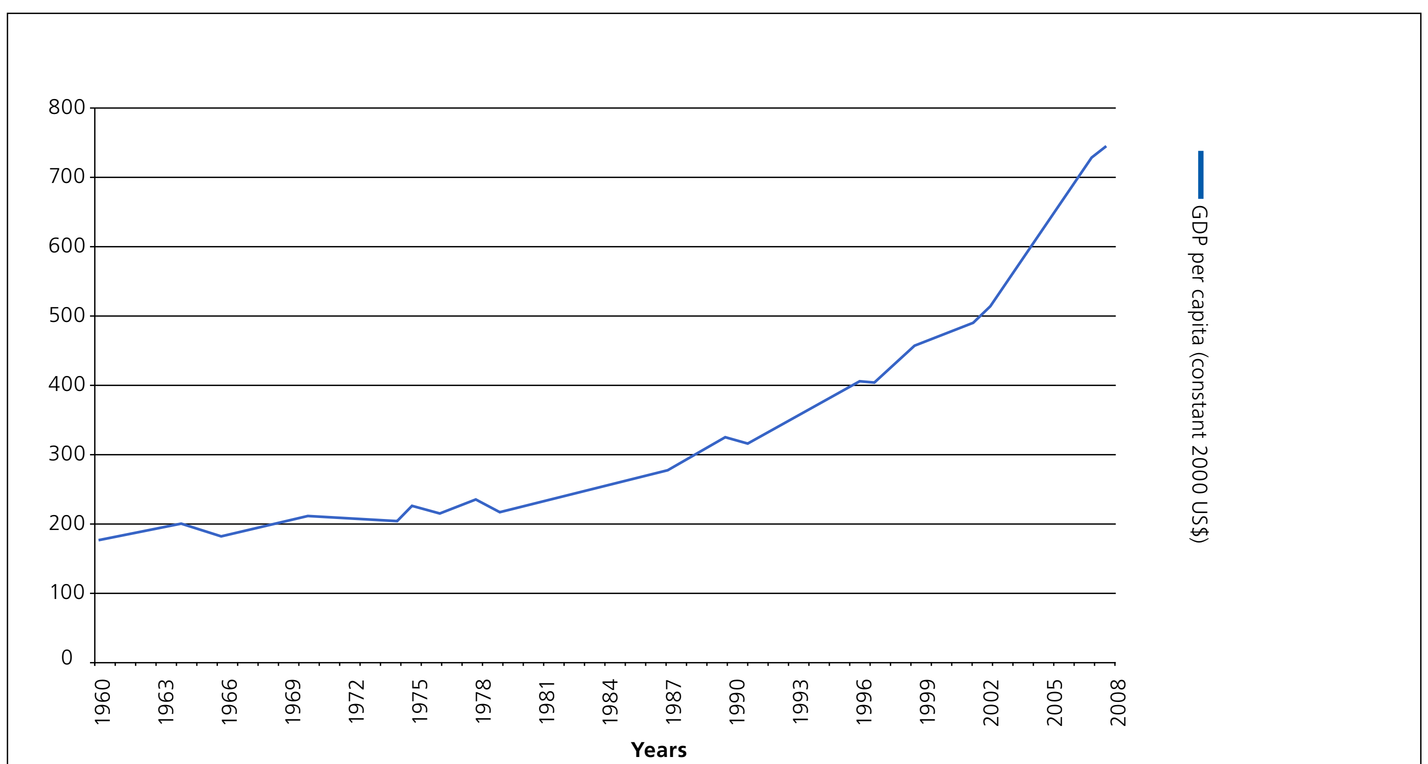

Table 3. Trade (% Of GDP)

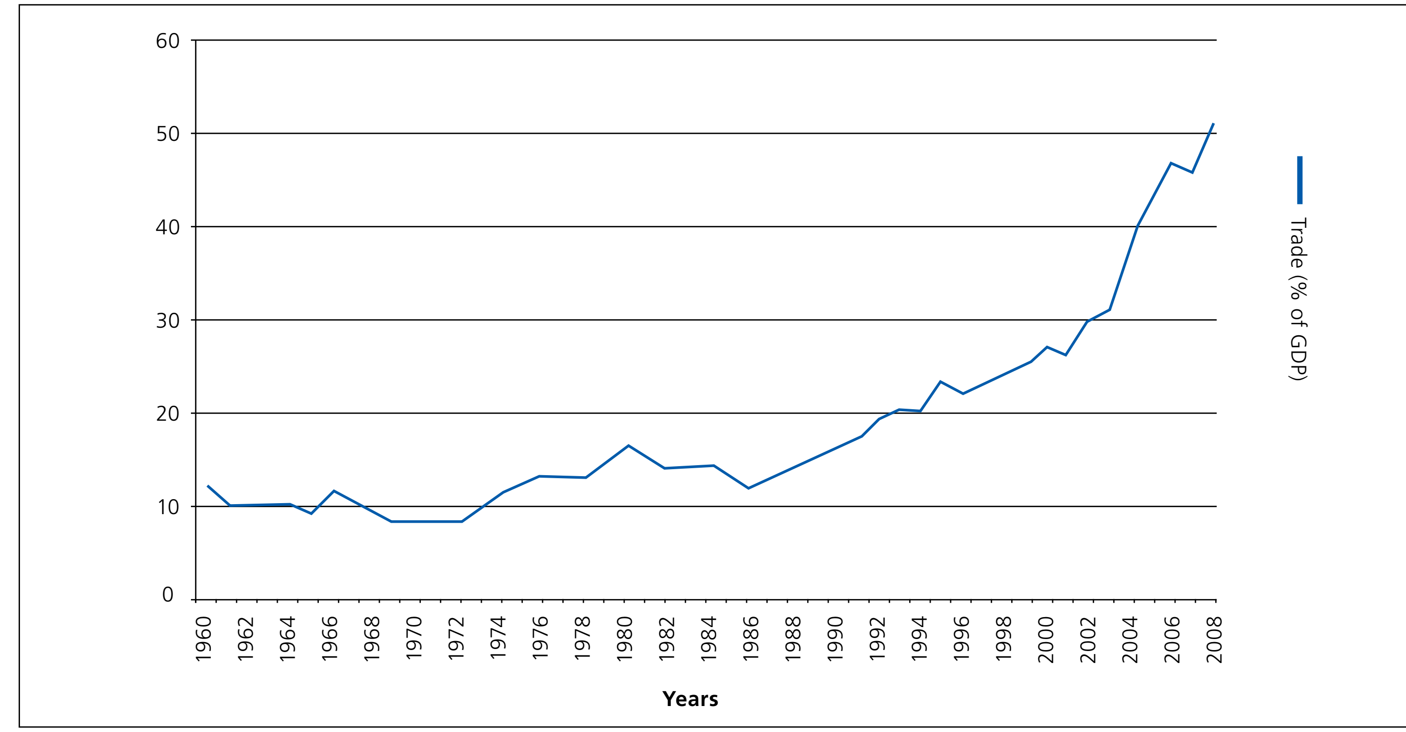

Table 4. Tarrif Rate, India (%) (Applied,Simple Mean, All Products)