UNIT 1  ECONOMIC POLICY: AN INTRODUCTION

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1.0  OBJECTIVES

After going through this unit, you shall be able to:
• state the need and objectives of economic policy;
• explain the various instruments of economic policy;
• examine the dynamics of formulation of economic policies in India; and
• identify the causes of failures of economic policies in India.

1.1  INTRODUCTION

Economic policies are statements of aims and ideals to be achieved through various instruments outlined by the Government to guide the process of economic development. In a way, it can be termed as a structural response to correct economic imbalances (and inequality). Government, by manipulating economic and social variables, influences the process of resource allocation to achieve desired level of economic development with social justice and stability. An economic policy essentially relates to either or all of the three basic economic decisions viz., ‘what to produce’, ‘how to produce’ and ‘for whom to produce’ at macro level.

Generally, it is believed that economic policy-makers are guided by economic considerations supported by economic theories in framing various subsets of economic policies. However, in the democratic countries like India, the decisions about public policy in general and economic policy in particular are taken by the elected representatives at different levels. Hence, these are essentially political decisions. Apart from legislators, different shades of public opinion, through mass-media, bureaucracy, judiciary, trade
organisations, experts’ bodies, voluntary organisations (NGOs), and other interest groups exert ‘pulls and pressure’ to influence the process of economic policies formulation. Hence, comprehension of the interaction between politics and economics can help us to gain insight into the key questions of ‘making, implementation and failure’ of economic policies and programmes. This unit aims to introduce you to economic policy formulation process wherein apart from interaction between economists and politicians, a large number of institutions/organisations influence the policy formulation process. To begin with, let us discuss the need and importance of economic policy and its various instruments.

### 1.2 NEED FOR ECONOMIC POLICY IN INDIA

Why do we need economic policies (outlined by governments)? Seemingly naive but it is an important question. The answer to this question leads us to the most exciting and ceaseless ideological debate in Economics and is beyond the scope of this unit. However, a brief discussion on this topic will help you to develop a perspective about economic policies and plans of the Government of India.

Market system is an institutional arrangement that has persisted and evolved over the past few hundred years because it has contributed greatly to our economic well-being. It is not perfect, however, and in some situations, our economic well-being can be raised by regulating it or even by side-stepping it altogether. Failure of market is the most important reason behind “making of” an economic policy.

Economic literature says that competitive markets generate a Pareto optimal solution and an economy that reaches a Pareto optimal solution is commonly said to be efficient. Pareto optimal solution is based on certain assumptions. You might have learnt about these assumptions in Unit 14 of MEC-001 course. If one or more of these assumptions does not hold good, the market system does not give rise to an efficient outcome. These inefficient outcomes are called ‘market failures’.

Choices through time, under-provision of public goods, presence of externalities, existence of common property resources, imperfect competition, asymmetric information, etc., are some of the well-documented reasons for ‘market failures’. These need some sort of Government intervention in the form of ‘economic policies and programmes’. Further, even if under Pareto optimal solution resources are efficiently allocated, the distribution may not be ‘equitable one’. State through participation in the production activities can give a direction to the resource allocation in more efficient manner in the larger public interest. It can directly own and manage various public utility services (also called social consumption of public goods). Competition is wasteful in such industries, and, hence, these can be best entrusted to the state. The state itself can undertake the production and distribution of public goods meant by collective consumption. Production of public goods is necessary not only for itself but also for generating new opportunities to secure the goal of full employment. The state may engage itself in production of such services that are beneficial but which do not attract private enterprise either because they are too risky or because the rate of return on capital employed is too low. There are certain goods of strategic importance that cannot be left in the hands of the state. The state can also act as a countervailing power to private monopolies. The state may: (i) prevent consumption of noxious products, and (ii) protect the consumers against fraudulent practices.
Further, if certain well-specified conditions are met, the Government can shift the economy from one Pareto optimal solution to another by redistributing purchasing power and then allowing people to trade in competitive markets. The need for ‘redistribution that takes the economy to any desired Pareto optimal solution’ underlines the need of economic policy.

Moreover, India at the time of independence was socially and economically backward. In order to solve these problems, the framers of the Constitution provided certain Directive Principles. Under ‘directive principles’, it is the duty of the state to ensure to all its citizens the right to an adequate means of livelihood; to ensure a fair distribution of the material resources of the country for the common good; and to distribute the wealth in such a way that the wealth is not concentrated in the hands of a few people.

All such constitutional obligations can be fulfilled by a sound economic policy.

### 1.3 AIMS OF ECONOMIC POLICY IN INDIA

The principal goal of economic policy in a developing country like India is to accelerate the process of economic development and thereby ensuring swift economic development. It is worth to mention here that the concept of economic development is distinct from the concept of economic growth as traditionally defined. You will find details on this issue in Unit 3. The goals of economic development are listed below:

1) **Rapid Economic Growth:** In a developing economy, the principal goal of economic policy is to ensure rapid economic growth. Growth, i.e. increased output of goods and services, helps to build up backward and forward linkages that are so essential to ensure trickle-down and other spread effects.

2) **Full Employment:** Linked to the growth objective is the goal of full employment, i.e., to find productive use for all available resources in the economy. The economic gains from full employment are enormous. Full employment yields the individual security, which, in turn, promotes progress, contributes to human dignity and weakens non-functional discrimination.

3) **Better Distribution of Income:** Market mechanism left to itself promotes inequalities in the distribution of income and wealth. Inequalities lead to misallocation and misutilisation of resources. They lead to a serious breach of social welfare. Economic policy can be so designed as to achieve a somewhat better distribution of income and wealth.

4) **Human Development and Decent Work:** Human development as an indicator of improvement in the quality of life is considered an important objective of economic development. Several factors like education and illiteracy rate, life expectancy, the level of nutrition, consumption of energy per head etc. are involved in the measurement of such qualities. With the growing concern of human development, decent work has emerged another goal of economic development. There are four dimensions of decent work: work and employment itself, rights at work, security, and representation and dialogue.

5) **Stability of Prices and Rates of Foreign Exchange:** Monetary instability adversely affects both the growth process and the welfare. Fluctuations in the rate of foreign exchange affect international trade and introduce an
element of uncertainty into the economic life of the country. Economic policy is a powerful instrument to ensure stability.

6) **Maintenance of Fair Competition:** Competitive conditions are essential for welfare maximisation. These can be ensured by an effective antimonopoly policy.

7) **Avoidance of Cyclical Fluctuations:** An essential feature of free market economies is what we call business cycles or trade cycles. These refer to regular cyclical fluctuations in economic activity with attendant consequences. An important goal before economic policy is to rid the economy of these ups-and-downs.

Having discussed the major objectives of economic policy, let us know what are the weapons available in the state’s armoury to address the targets, i.e., the instruments of economic policy.

**Check Your Progress 1**

**Note:**

i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) What do you mean by the term ‘Economic Policy’?

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2) Why do we need state intervention in the economic affairs of a country? Give two reasons in support of your answer.

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3) Why is ‘full employment’ included among the objectives of economic policy?

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**1.4 INSTRUMENTS OF ECONOMIC POLICY IN INDIA**

Though there is no theoretical framework about the necessary components of an economic policy, based upon our historical experience, we can outline a few of them.

Properly defined targets, explicitly outlined strategy to achieve those targets, specific programmes for implementation and objective methods of evaluating outcomes are some of the basic ingredients of a ‘sound economic policy’. Further, a good backup of statistical data helps to generate alternate options, to
set targets in quantitative term to determine the best course of action(s), i.e., strategy to achieve these targets. Many a time, it is observed that ‘failure to achieve desired outcomes’ is due to errors on ‘estimation front’.

Good use of statistical techniques to analyse public policy problems and policy options are quite imperative in a complex modern world. Some of the techniques employed are use of simple and general linear regression modeling, use of intercept-dummy variables and interaction variables, linear probability model and the probit model of discrete choice, and simultaneous equation models. You might have learnt all these techniques in MEC-003 course on ‘Quantitative Techniques’.

The instruments of economic policy vary between the types of economic policies. Broadly speaking, we can distinguish between two types of economic policies, viz., (i) macro-economic policies (or aggregative policies), and (ii) micro-economic policies (or sectoral policies).

1) **Macro-economic Policies** are designed to address the big aggregative macro variables, like national output, employment, general price level, investment, saving, rate of exchange, etc.

2) **Micro-economic Policies** are sectoral policies and are designed to direct and contribute to the growth in the individual sectors of the economy, like agriculture, industry, services, etc.

1) **Macro-economic Policies**

It is in the macro-economic arena that the state finds its full flow. It encompasses the whole spectrum of economic activity. The state has to employ different weapons to achieve the targeted goals. Before we attempt to prepare a brief catalogue of these weapons, we need to reiterate that these different weapons cannot be seen in isolation; these have to be employed in an integrated manner to achieve a balanced growth.

The principal instruments of macro-economic policy can be identified as follows:

i) **Fiscal Policy:** The foremost among the instruments of macro-economic policy is the fiscal policy, also called the budgetary policy. As the name implies, the policy operates through the budgetary operations. A budget is an annual financial statement of the Government’s transactions. Public revenue and public expenditure form the core constituents of budget. The principal sources of public revenue are taxes of different kinds. Besides, governments can and do raise large sums of money by way of borrowings, both internally and from external sources. On the expenditure side, subsidies, economic and social sector, etc. constitute the principal heads. Each of the items on the revenue side and the expenditure side has the potential to affect the course of economic activity, both in aggregative sense and in the sense of individual sectors.

ii) **Monetary Policy:** Monetary policy deals with the volume and price of money in an economy. Volume of money refers to the amount of money in circulation in the economy. While an inadequate quantity of money in an economy may fail to provide the required liquidity for the growing volume of transactions in the economy, and may, thus, adversely affect the process of economic growth, an excessive supply of money, on the other hand, may prove inflationary, and, hence, in turn, may adversely affect the process of economic growth. Therefore, the state (or the monetary authority, i.e., the Central Bank of the country) would have to exercise
judicious control over the creation of money (both by the Central Bank and Commercial Banks) in the economy.

Domestic price level also affects the external value of currency. Fluctuations in the external value of currency, i.e., the rate of exchange, may, in turn, have adverse effect on the domestic economic activity. This becomes another important reason why too-little or too-much of money cannot be created in an economy.

The total supply of money (along with its demand) also affects the rate of interest, i.e., the price of money. Rate of interest, in turn, is an important determinant of various macro variables, like consumption, saving and investment.

iii) **Commercial Policy**: A third important component of macro-economic policy is commercial policy. Commercial policy defines, broadly speaking, the Government’s attitude towards the external sector of the economy, i.e., policy towards investment by foreign capital in the host country (both in the form of portfolio investment and direct investment), policy towards inflows and outflows of foreign exchange, goods and services. A state may opt for a total open-door policy; another extreme could be when at every entry or exit, a call is to be made to the state. A mild protection may be a middle way. Which of the policies, absolute free trade or protection, or mild protection comes to be selected is determined by obtaining economic environment, both domestic and international.

2) **Micro-economic Policies**

The state need not be content with restricting itself to broad macro-economic aggregates. The state can and does define its attitude towards activity in different individual sectors of the economy, like agriculture, industry, and services of different types. The state may permit and promote certain lines of activity in agriculture, industry and services. On the contrary, the state may prohibit and discourage certain lines of action. The different instruments of micro-economic policies may be identified as: (i) industrial licensing, (ii) quota-permit system, (iii) import control, (iv) export control, (v) competition or anti-monopoly policy, (vi) procurement policy, (vii) policy of minimum support prices, (viii) policy of buffer stocks, etc. These are only a few illustrations of micro-economic policy, by way of examples.

### 1.5 PROCESS OF ECONOMIC POLICY FORMULATION

As hinted in section 1.1 above, the process of formulation of economic policy in India involves people of different inclination and interest. Legislatures as political institutions are primarily responsible for policy-making. Policy-makers in a democracy like India are accountable to the electorate either by direct election or by appointment by elected officials. Thus, in the Indian context, the political decision-making is supreme. However, the political parties and the members of Parliament have little professional and research support to articulate alternative (public) choices.

Normally, the Government picks up a clue (or a problem) from public domain, constitutes a committee or a task-force to generate policy options, makes ‘necessary political changes’ in those recommendations, and, then, announces its decision at appropriate forums either in the form of an executive order or a legislative resolution.
The character of political system plays a crucial role in identifying and prioritising problems. As we observe, democracy in India has evolved from a formal democratic system of 1950s to more meaningful and participative democracy after 1990s. This led to an environment of ‘more consultative and responsive’ process of policy formulation. It is being reflected in changing ‘policy rhetoric’. Nowadays, no political party talks of setting up of ‘big Public Sector Enterprises’. Instead they are speaking about creating ‘village business hubs’.

Further, role of mass-media and non-governmental organisations advocating new policy options got acceptance in policy-making process. Creation of National Advisory Council (NAC) consisting of non-governmental activists and headed by chairperson of the ruling coalition is one such example of widening of consultative process.

Notwithstanding the fact that formulation of economic policies is a political process, economists and experts play very important role in the deliberative processes. They are incorporated in Government institutions to make an ongoing consultation possible. They generate policy options based on ‘rational economic and technocratic criterion’. We have in India a large set of technical, scientific, development organisations/institutions to provide for an institutional forum for expert advice. The task of detailing the policy documents still lies with the bodies consisting of specialists and bureaucrats within administration. Some of such bodies/agencies involved in preparation of policy documents for consultation are as follows:

1.5.1 Planning Commission of India

Planning commission is one such organisation. The Planning Commission was set up by a resolution of the Government of India in March 1950 in pursuance of declared objectives of the Government to promote a rapid rise in the standard of living of the people by efficient exploitation of the resources of the country, increasing production and offering opportunities to all for employment in the service of the community. The Planning Commission was charged with the responsibility of making assessment of all resources of the country, augmenting deficient resources, formulating plans for the most effective and balanced utilisation of resources and determining priorities.

1.5.2 Central Statistical Organisation

The Central Statistical Organisation is responsible for coordination of statistical activities in the country, and evolving and maintaining statistical standards. Its activities include National Income Accounting; conduct of Annual Survey of Industries, Economic Censuses and its follow up surveys, compilation of Index of Industrial Production, as well as Consumer Price Indices for Urban Non-Manual Employees, Human Development Statistics, Gender Statistics, imparting training in Official Statistics, Five Year Plan work relating to Development of Statistics in the States and Union Territories; dissemination of statistical information, work relating to trade, energy, construction, and environment statistics, revision of National Industrial Classification, etc. It has a well-equipped Graphical Unit. The CSO is headed by the Director-General who is assisted by 2 Additional Director-Generals and 4 Deputy Director-Generals, Directors & Joint Directors and other supporting staff. The CSO is located in Delhi. Some portion of Industrial Statistics work pertaining to Annual Survey of industries is carried out in Calcutta.
1.5.3 **Indian Council of Social Science Research (ICSSR)**

ICSSR was established in the year 1969 by the Government of India to promote research in social sciences in the country. The Council was meant, inter-alia, to advise the Government of India on all matters pertaining to social science (including economics) research as may be referred to it from time to time; and take such measures generally as may be necessary from time to time to promote social science research and its utilisation.

The Indian Council of Social Science Research (ICSSR) with 27 research institutes is established to provide regional orientation to research that can be used for policy purposes. All these institutes receive state grants and, therefore, act according to the requirements of the pay-master.

Subsequently, few private funded research organisations have come up, viz., National Institute of Public Finance and Policy, Centre for Science and Environment, Tata Energy Research Institute, Tata Institute of Social Sciences, etc. Apart from conducting research, these institutes play an important advocacy role by publicising their studies in the media and holding seminars for the relevant policy-makers. Time to time, the Government also constitutes committees and task forces in which social and other scientists play major roles.

1.5.4 **Lobbyists**

There are other forms of organised advocacy by private interests in the formulation and implementation of public policy. Organised labour (Trade Unions) and their counterparts Trade Associations (FICCI, ASSOCHAM, CII) also influence the policy process through representation and collective actions. These private organised interest groups are normally well-connected to different political parties as latter depend upon their support for funds and workers during elections. The cost of elections has become almost obscene, requiring candidates to raise hundreds of thousands of rupees just to seek a legislative seat. The only ready source for such huge sums of money is ‘special interests’. They, of course, have a very direct stake in economic policies.

1.5.5 **Non-governmental Organisations (NGOs)**

Recently, with the adoption of economic reform policies in 1991, there has been explicit recognition of the role of markets and non-governmental organisations (NGOs). In fact, the Eighth Plan made a strong plea for greater role of the voluntary organisations. This resulted into mushrooming of non-governmental organisations, popularly known as NGOs. Most of these NGOs are registered under the Societies Registration Act, which gives them legal recognition to raise funds from Government and non-government sources. The numbers of such NGOs run into thousands. They also try to influence policy using their micro-level experience as a basis of suggestions for policy options.

1.5.6 **International Politics and Multilateral Lending**

In the guise of guidance based upon ‘cross-country experiences’ the external forces also influence the policy formulation in India. We have observed ‘socialistic’ influences during 1950s; and have been feeling ‘pressure for privatisation and liberalisation’ since 1990s. There has been constant pressure of developed countries to open up fast growing Indian economy for multinational corporations. The subsequent shift in ‘policy framework’ in recent years may be viewed in this perspective.
Anyway, on the record, it is the departments and ministries of Government of India headed by political functionaries (ministers) who supervise the making of economic policies in their respective domains. Normally, these policies are announced with approval of the Union Cabinet. Occasionally, these policy statements are approved by the Parliament in the form of Resolutions/Acts.

### 1.6 DISAPPOINTING OUTCOMES

With above discussion, you must have got a fair understanding about the process of policy formulation. You should also have an idea about the process of implementation, as it is equally important for the purpose of ‘evaluating outcomes’.

We have democracy in India. The economic policies of local and national governments (and parties) set the direction and parameters for the formulation of laws, governmental programmes and budgets. After the policy is finalised and programmes are launched, the role of bureaucracy i.e., the implementing agency becomes important. The task of implementation of Government’s economic policies and programmes is delegated to the bureaucracy. The bureaucracy (agent) is the instrument for implementing the policy laid down by the political leadership (principal). Bureaucracies are necessary for policies to be carried out with some predictability, equity, and due process.

The Government could seldom meet the policy targets in the past. Earlier, we have argued that the way to rein in “market failures” is to introduce Government intervention, i.e., policies and programmes. But we have experienced that there also is such a thing as “Government failure”.

The outcomes of policies enunciated by the Government were invariably disappointing due to more than one reason. The failure is so widespread and the success is so rare that pointing the finger at any single component is futile.

At formulation stage, the political interests get precedence over economic reasoning. The policy-makers might settle for or even prefer deliberate vagueness as a momentary expedient to finalise a plan (or programme), thus, authorising a policy which often proves unworkable, unsatisfactory, or even contradictory to other policies. The failure to articulate precise and operational goals, objectives, procedures, and plans leaves enough scope for task ambiguity for implementing agencies.

At times, it happens that the ‘policy-makers’ have poor information on the effort the ‘bureaucracy’ is making. In other words, policy-makers have no mechanism to monitor performance of ‘implementing agency’. The bureaucracy may, then, be tempted to shirk. You will find more details about the issue in Unit 21 and 22.

The policy-makers, including economists, do not have time to seek access to information about the performance or suitability of implementing ‘agents’. This may result into under-achievement of the policy goals.

Another hurdle encountered is the large structure of bureaucracy. In a federal structure, there is enough scope for buck passing. Moreover, within administration, there is no proper system of ‘reward for extra efforts and/or penalty for non-performance’.
Multiplicity of similar type of schemes is another important reason responsible for failure of schemes. Due to lack of inter-ministry or Centre-State co-ordination, similar kind of ‘benefits’ compete to reach to same segment of ‘beneficiaries’. Success of one programme leads other programmes to failure.

For successful undiluted outcomes of economic policies in India, the policy-makers, particularly economists, shall have to prepare policy by taking into account all the above mentioned ‘influences’ so that immediate benefits from deviating becomes negligible. The policy-makers have to develop tools and technique to check ‘performance and suitability of implementing agencies.’ In other words, policies and programmes should be outlined in such a manner that ‘deviations’ are easily and instantly observed. Moreover, economists have to devise ways to enhance ‘technical expertise’ of politicians on economic issues. In other words, process reform should go hand-in-hand with policy reform.

Check Your Progress 2

Note:  
i) Space is given below each question for your answer.  
ii) Check your answer(s) with those given at the end of the unit.

1) State the principal instruments of macro-economic policy.

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2) Do you think that economic policies are essentially political decisions?  
Give two reasons in support of your answer.

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3) How is CSO useful in policy formulation process?

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4) State any two disappointing outcomes of Indian Economic Policy.

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14
1.7 LET US SUM UP

Economic policies are statements of aims and ideals to be achieved by various instruments outlined by the Government. Due to several ‘market failures’, state intervention manifested in the form of economic policies is needed. Insuring swift economic development is the principal objective of economic policy. Rapid economic growth, full employment, human development and decent work, stability of prices and exchange rate, maintenance of fair competition and avoidance of cyclical fluctuations constitute the important objectives of economic policy. Broadly, economic policies can be classified under two categories: (i) macro-economic policies, and (ii) micro-economic (sectoral) policies.

Economic policies in India are political decisions. However, economists and technocrats play major role in the process of formulation of economic policy. Further, the policy-makers have to take into account opinions expressed by mass-media, trade unions, trade associations and NGOs. Even international politics and Multinational Corporations (MNCs) influence the process of making of economic policy in developing countries including India.

Over the period, several indigenous institutions have come up to generate macro level policy options. Most of them are funded and/or financially supported by the Government. The task of implementation of economic policies and programmes in India is delegated to bureaucracy.

There are many reasons for failure of economic policies and programmes in India. Although, major responsibility for under achievement (or failures) lies upon inflexible bureaucracy, a few of these reasons can be traced to flaws at formulation stage.

By articulating precise workable goals, operational procedures and ‘inbuilt mechanism for performance monitoring’, the policy-makers can improve the chances of meeting the development goals.

1.8 EXERCISES

1) ‘Economic Policy in India is a purely political process’. Comment.

2) Examine how different shades of public opinion influence the process of economic policy formulation. Give illustrations in support of your answer.

3) Discuss the various disappointing outcomes of the poor implementation of economic policies.

4) Suggest some measures to improve implementation of economic policy and programmes in India.

1.9 SOME USEFUL BOOKS

Buchanan, James M. and Tullock, Gordon (1962); The Calculus of Consent.


Leach, John (2004); A Course in Public Economics, Cambridge University Press.

Samuelson, Paul and Nordhaus, William; Economics (latest edition).
1.10 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1
1) See Section 1.1
2) See Section 1.2
3) See Section 1.3

Check Your Progress 2
1) See Section 1.4
2) See Section 1.5
3) See Sub-section 1.5.2
4) See Section 1.6