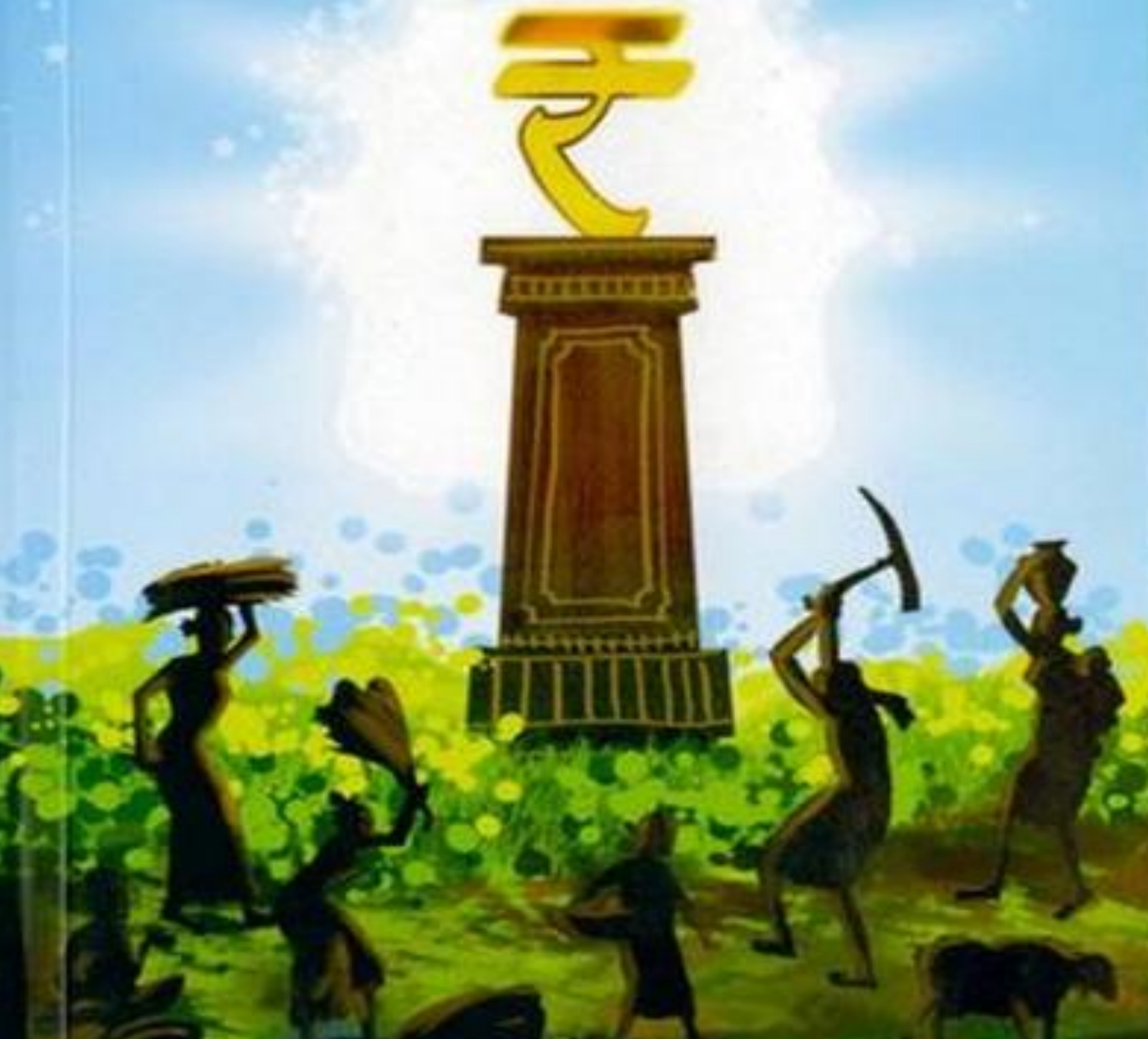
WEALTH and ILLFARE

An Expedition into Real Life Economics

C T Kurien



An Expedition into Real Life Economics

WEALTH and *ILL*FARE is intended for readers who do not have much knowledge in economics, but are eager to know how economic systems function. In particular, it deals with the phenomenon that many find disturbing, the soaring affluence of the few and the continuing misery of the many that is increasingly becoming evident globally and in our country. Ownership and control over resources, different forms of mediation and asymmetry of information are identified as clues for any interested reader to develop skills to study real life economic problems. It is a unique and timely contribution by a reputed practitioner who, over the past half a century, has influenced generations of students and through his earlier writings the general public as well.

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About the Author

Dr. C. T. Kurien is one of India's senior economists. He was Professor in the Madras Christian College (1962-78) and Director of the Madras Institute of Development Studies (1978-88). His books include: *Poverty and development* (1973), *Poverty, Planning and Social Transformation* (1978), *Dynamics of Rural Transformation* (1980), *Growth and Justice* (1991), *The Economy: An Interpretative Introduction* (1992), *Global Capitalism and the Indian Economy* (1994), *Rethinking Economics: Reflections based on a study of the Indian Economy* (1996). His most recent essay was on the international financial crisis titled *Inter-Planetary Economics: The Meltdown and Beyond* (2009). Through his many books, professional papers and newspaper articles he has influenced generations of economists and the reading public. He has retired from active academic life and now lives in Bangalore.

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"Ill fares the land…where wealth accumulates and men decay"

Oliver Goldsmith

C. T. Kurien

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INTRODUCTION

Dear Reader,

You have picked up this book, I imagine, because you recognize that economic events both in your immediate surroundings and elsewhere are impacting your life as also of society as a whole. If you are a home-maker you know that the rising prices of daily necessities are related to the happenings in the farms in the rural areas, the policies within the country and outside that determine the price of petrol, and may be because of all the developments in the much talked about 'global economy'. If you are an IT professional you are acutely aware that your progress in life depends much more on the changes and chances of the world outside than on your own skills. If you are a social worker involved in poverty alleviation programmes, you are convinced that the people whose welfare you are concerned with are not largely responsible for their present plight. But you do not find it easy to explain the phenomenon of the continuance of mass poverty even as a few in the country quickly make their way to the top.

We are all aware of many more issues of this kind. What is perhaps missing is an understanding of how such things hang together. That is what the discipline of economics is supposed to do – to provide the interconnections of the many puzzling economic problems that are part of our everyday experience.

I have had a long engagement with economics for about six decades – as student, teacher, researcher, author and commentator. I turned to economics because I was seeking explanations for real life issues, specifically for the prevalence of mass poverty in the country. From my acquaintance with the subject I can tell you that while there are many "schools" within it, most of them professing to deal with practical issues, they can

be broadly divided into two basic approaches. Let me refer to them as 'logic-centred' and 'life-centred'.

The former creates an abstract economic system (a make-believe world, if you like) concentrating on what is *a prioiri* determined to be the central principle coordinating the decisions of its different participants and thus leading to what may be thought as the ideal set up. But, of course, the participants must behave as 'theory' expects them to. Internal consistency and universal applicability are claimed to be the features of such a system. If the real world throws up situations different from the ideal, the inference then is that some conditions required for the ideal have not been adhered to. Removing these external impediments through 'policy instruments' can get the real world closer to the ideal is the claim. Exposition of economics, especially in class room teaching turns out to be enumeration (rigourous or otherwise) of the conditions required for a smoothly functioning and (internally) self-adjusting economic system.

In the second approach the emphasis is on contextuality, temporal and spatial, of economic phenomena as they arise from and reflect the ever-changing social processes. The basic premise is that the economy is not a self-contained closed entity governed by its own laws but part of and greatly contributing to larger social relationships. Hence economic problems must be probed keeping in mind such social factors as the ownership of resources, the manner of control over them, divisions and power configurations that arise from them and much more. Real human beings in the variety of social contexts are the actors that shape the economy.

A familiar 'riddle' may bring out the essential difference between the two approaches.

Ten birds are perched on the branch of a tree. A hunter comes and shoots one and it falls down. How many birds are left on the branch?

The common sense answer to this 'riddle' is known to everyone – or nearly everyone. Have you tried out this riddle on any of our smart urban kids who have not seen birds, except in cages or TV, but are otherwise very well-schooled? I have, and the answer is not rarely, "*Nine"*. In one instance, a youngster thought that this riddle was an insult to his knowledge of arithmetic and so added, "*No big deal"*!

Why does this smart youngster give 9 as answer to the above trick question? Obviously because it comes naturally to him that 10 – 1 = 9, or to make it a little more sophisticated, $10x - 1x = 9x$, no matter what the x is -- apples, oranges or birds or whatever-- a case of trained logical thinking. But note that when you give the answer to the riddle as *'None'*, instead of *'Nine'* you are also relying on sound logic, but modified by your knowledge of the behaviour of birds. You have to concede, then, that logic is not always "pure and simple", and two forms of it will have to be recognized. *Abstract context-independent* logic, and logic *based on the realities of life.* This distinction is not always made, but is of crucial significance when dealing with societal matters. In one of my writings I have referred to these distinct, but related forms of reasoning as *'formal or syntactic logic'* and *'substantive logic'.* Please note that when you deal with real life situations, there are instances where 10 – 1 = 0!

Let me give you an example of substantive logic in application. Two strangers run into each other in an isolated desert area. Let me call them A and B.

A says to B: *"Are you by any chance looking for a lost camel?"*

"*Yes",* replies B and also asks excitedly, *"Have you seen it?"*

"No", says A, *"but tell me, is its right leg a little lame and the left eye almost blind?"*

"Sure enough, that's my camel", cries B, "please tell me where you saw it"

A answers, *"Let me tell you once again that I have not seen your camel".*

B loses his cool and shouts back at A, *"Stop your nonsense! If you have not seen my camel, how do you know so much about it?"*

"Cool down my friend" says A, *"I noticed the foot prints of a camel and a man in the sand for a long stretch of the desert. After a while only the footprints of a camel could be seen. So I inferred that the animal had been separated from the man. I noticed too that the footprints of the right hind leg were not very clear and that led me to think that it must be lame. I also observed that the camel had eaten leaves only from the right side of its path and I concluded that the vision of the animal on the left side must have* been *impaired."*

The story illustrates what substantive logic is.

I rely a great deal on substantive logic to take you through the economy using economics as the guide map. And you have rightly inferred that I am taking the second alternative mentioned above! My training, initially in Madras and subsequently at Stanford University, United States was via the first alternative, what has come to be known as 'Neo-Classical Economics'. The Department of Economics of Stanford at that time (late 1950s and early 1960s) was arguably the best centre in the world rigorously expounding that tradition in economics. Kenneth Arrow whose mathematical exposition of the logical structure of Neo-Classical Economics at that time was a great novelty (and for which he received the Nobel Prize subsequently) was one of those from whom I learned the subject. Initially I was quite excited about the integrating power of that approach. On one occasion I raised the question about the relationship between the abstract logical system whose properties and claims one was intellectually appreciating and the practical issues that one comes across in any actual economy and the answer was that

mastery of the logic would make that possible. However, when I started using it to make sense of real life problems from the Indian context I began to see its limitations. I took up the matter with Arrow too. He admitted that the logical system was far removed from reality, but that an ideal system would enable one to see how far the real was from the ideal and thus help in initiating corrective action. I did not think that this was the best way to understand reality, but the priority at that time was to complete my doctoral work, which I did!

Back home, while I was passing on the logic to undergraduates as "Principles of Economics" and to post-graduates as "Advanced Economic Theory", but was also dealing at some depth with practical economic problems, I began to realize that at best the logical approach could only deal with what **it** recognized as economic problems. One of my earliest professional writings was bringing out the limitations of the Neo-classical tradition to provide rational explanations for the dominance of household production units in India.

Subsequently I was at Yale University (in the late 1960s) which then had a 'Growth Centre' trying to apply economic theory to the development problems of underdeveloped countries. The 'models' that were being churned out there were based on assumptions whose validity was never seriously examined and I was not enthused about such exercises. Instead, I devoted the best part of the year to a careful study of the 'classical' writings in economics. I became convinced that what was required to deal with concrete economic problems was an appropriately modified approach of the classical writers whose basic concern was the practical economic problems of their times. From the early 1970s I started cultivating such an approach. Issues related to the measurement of poverty in the country were the widely discussed theme among economists at that time, but I worked on an adequate conceptualization of poverty as a societal aberration. My book on poverty written while I was a National Fellow of the University Grants Commission and which came out towards the end of the decade was

the first of my writings using the new approach. The critical acclaim that it received showed me that I was on the right track. When I turned to full time research concentrating on deeply rooted Indian economic problems, it became increasingly clear to me that the logic that was claimed to be universal by Neo-classical economics was not raising the relevant questions. I decided to pursue the path I had become convinced about, though it did not find much favour within the profession. As we go along we will have occasions to make references to both the "Classical" and "Neo-classical" approaches.

I need to refer to one more matter, not on approach or method, but on substance. I have made references to both 'economics' and 'the economy'. Obviously the term 'economy' is used under different circumstances with different meanings such as Indian Economy and Global Economy which are quite common, but also as 'Market Economy', 'Open Economy', and even 'Paddy Economy' and so on. A more definitive understanding of the term is required when it is claimed that 'the Economy' constitutes the field of study of economics as the material world forms the field of study of physics or the animal kingdom the field of zoology. You will be hard put to come across a treatment of the economy in that sense. I have found it necessary to indicate explicitly what that expression conveys. The Economy can be thought of as society's arrangement to provision the material needs of its members. It is a narrative of the social relationships and structures that emerge in that process. Elsewhere I have spell it out in greater detail : *The Economy is a structure of relationships among a group of people in terms of the manner in which they exercise control over resources, use resources and labour in the production of goods and services, and define and settle claims of members over what is produced.*

Your reaction may be that this field of study is not similar to those of physics and zoology which exist *out there* whereas the Economy appears to be a rather vague entity. That need not be much of a problem because there are other academic disciplines such as

mathematics and philosophy where it is equally true and yet they are useful to understand the real world.

The description I have given of the Economy brings out two of its essential features. The first is that the economy is primarily *about human beings and their social relationships* and not about materials and money ("things") as it is often made out to be. Of course, if resources form an important aspect of the economy it cannot be denied that materials, and money which is command over resources, feature significantly in it. But the human beings and the social arrangements to deal with resources are the central concern of the economy.

Secondly, if there is no such thing as the economy out there, it must be thought of as a mental construct, a carving out for more thorough enquiry from the larger (and even more difficult to identify) entity, 'society'. To put it differently, the economy exists 'within society' or is 'socially embedded' to use a slightly technical expression. At the same time, it is not merely a figment of the imagination because it is something *experienced* by people at all levels in the course of their daily lives.

Economics as an academic discipline, then, should help one to probe into such a complex entity, at once a matter of experience and a mental construct. That is supposed to be the role of economic theory although frequently it takes flights into fantasy! To prevent that from happening, I suggest a matter of fact procedure of enquiry. When I was teaching economics, I used to tell the students that there are three key questions that help one to probe into any economy: "Who *owns* What?", "Who *does* What?", "Who *gets* What?" We shall soon see how to use these 'clues' to study the basic features of any economy and to go into the specific problems of the Indian Economy.

To help you follow this procedure let me provide you an outline of what is to follow. Think of the whole exercise as an exploratory expedition into a territory that is not quite

familiar to you and accept me as your guide. The first three chapters constitute something of an indoor orientation to brief you about the terrain. They are in the nature of *thought experiments* -- a devise resorted to quickly sum up the early stages of economic evolution and to introduce you to basic economic activities, production, product-sharing and barter. These thought experiments may appear to be over-simplifications and somewhat unrealistic or arbitrary representations. But then, all experiments are arbitrary in the sense that to focus on a particular issue, you remove from real situations what you consider to be not relevant for your purpose. Some disciplines, for instance chemistry, can do experiments in laboratories with controlled conditions. That is not possible for those who deal in social issues such as economic matters. So, we have to conduct thought experiments. What we do is to strip a real life situation of many of its ingredients so that we can discover some basic inter-connections. That is the thrust of Part I consisting of three chapters. The treatment is simple but if you become impatient with that simplicity, hold on. No edifice can come up without foundations that are simple in design and won't be seen after the superstructure comes up. That is the nature of Part I.

With Part II we step out into the real world of markets, money, banks and finance. What these have in common is *intermediation* which consists of some players taking over the economic tasks from the real actors and becoming controlling agents. We shall see that an understanding of the role of the intermediaries and the process of intermediation is the key to unravelling many of the complexities that characterize modern economies.

Part III deals with production units in the economy at the ground level first. We then move on to the aggregation of production at the national level. The last chapter in this Part deals with the collection of national economies, what is increasingly referred to as the 'Global Economy'.

Part IV is a treatment of the Indian Economy, our reality which draws on the insights from all the earlier chapters. It deals with the evolution of the Indian economy both during the pre-Independence and post-Independence periods. It takes up for careful scrutiny the glaring divide that is rapidly emerging – the vulgar display of massive increase of wealth in the hands of a few and the growing vulnerability that is the daily experience of the many.'

Don't forget that a good guide is **not** one who tries to teach you; rather he must give you enough guidance and confidence to enable you to explore the territory on your own. That will be my aim.

I hope you are now ready to start our explorative expedition!

Part I

BASIC ECONOMIC ACTIVITIES AND RELATIONSHIPS

Imagine a family (or tribe) next to nowhere – either on an island or in the middle of a forest – and with no neighbours around. You will agree that survival will be the primary concern of its members. And to survive they will have to exert themselves. Even if 'manna' is daily available from above they will have to gather it. In fact, anthropologists will tell you that for long human beings were 'gatherers', gathering from nature their requirements for survival. That is where economics begins, in the concerns of human beings for survival. This is not a relic of the past either. Even in the twenty-first century the primary activity of the vast majority of human beings, including most of the citizens of our country is ensuring survival which is a matter of daily concern. This fact may not have occurred to you at all because your concerns and those of your peers are certain to have crossed this first step. Understanding survival strategies is the first step in learning economics. You master it from observing real life situations. Look around.

Note that survival is primarily a matter of interaction between nature and human beings which, when translated into the real life experience of the majority of people even today is working on land to produce the requirements of survival. Let us convey this idea a little more formally – after all we will be dealing with economics, a prestigious academic discipline – production results from labour (of human beings) applied to land.

Production has two aspects, technological and organisational. The former is about the possibilities of combining land, labour, tools etc. to produce output such as paddy. This aspect has implications even when there is only a single family or tribe. When there are more such units the organisational aspect emerges which are based largely on the manner in which land is owned and controlled. There are different possibilities which give rise to relationships of production. A major part of economics is tracing and

understanding of the variety of relations that arise, which also decide how the product gets distributed among the participants. Another relationship that emerges is when there are neighbouring families involved in production, but of different goods, bananas in additional to paddy for instance. The rudimentary form of this relationship is barter which over time and with additional conditions later turn out to be the general form of exchange which occupies a very prominent position in contemporary economics.

The treatment of these basic economic activities and relationships through a set of thought experiments is taken up in Part One consisting of Chapters 1, 2 and 3.

Chapter 1

Economics of a Single Household

Did you know that the word 'economics' is derived from the Greek words 'Oikos' which means household and 'Nomos' meaning rule or law? So, translated from Greek, 'economics' means the 'management of the household'. Hence it is quite legitimate and proper that we use the household as the starting point of our expedition.

Households

Households play a tremendous role in any economy, ancient or modern. Of late, of course, it doesn't get much prominence because other units in the economy, particularly business corporations of various kinds have come to the foreground. But think of the many ways in which households become relevant, in fact crucial for the working of an economy.

First, households are *solely* responsible for supplying the work force for the economy. Workers (including human beings who may consider it below their dignity to be described as 'workers'!) are born in households, receive their early training there and even after they step out into the wide world beyond the walls of their households, it is into them that they regularly return for nourishment and rest. In this sense the households are the roots from which the visible parts of the tree, its stem and branches, leaves, flowers and fruits all emanate. Don't underestimate the role of the households simply because they are not very visible always.

But households are visible too. Who do you think is responsible for 'consumption' in the economy? A great share of consumption that constitutes 'demand' in the economy is

done by households. Actually, if all the cooking that goes on in the households is also taken into account, the households' visible role in the economy is quite significant.

There is an important third area where too the households have a prominent role. In the final analysis households own all resources and all incomes accrue to them. Governments and corporations may come into the picture, but they are proxies for the real owners, aren't they? The households decide too how much of the income of a given period is consumed during the same period and how much of it will be 'saved' for the future so that incomes and wealth will grow over time. Here, again, the corporations and other agencies and the government may play their proxy role.

If all these aspects are taken serious note of the households can be claimed to be the core of any economy.

But what are these households? Quite simply households are 'natural' human communities forming the basis of the economy, polity and society at large. 'Community' implies interactions and relationships. The household is a 'natural' human community in the sense that the relationships are not derived from any formal specifications, defined by rules and regulations, or to be more general by any 'memorandum of association'. Household relationships are natural because they are based on what may be referred to as 'bonds of flesh and blood'.

Let us try to understand what that means. The composition of the household is biologically decided. There is the biological distinction based on sex, some are female and others are male. Some are young and others are adult, some among the adults are old and some possibly infirm. The household, thus, is a naturally heterogeneous group of individuals held together by practices of caring and sharing.

There is also a natural division of labour within the household arising from the differential capabilities and inclinations of its members. The females have the responsibility of bearing children and nurturing them in the early stages. The females, therefore, have a greater role in the reproduction of the community. Consequently the males may have greater responsibility in production that sustains the community.

Another basic function of the household is that it serves as an information generating, sustaining and interpreting unit. Think of a child learning language. Initially a lot of what she hears is just noise. It is because there exists within the household a body of noise already converted into meaningful information that she is able to make sense of the noises that she hears. Information gets codified in the household: it continues to receive 'noises' or bits and pieces of information from outside, interprets them in the light of the information it already has and continuously builds up the corpus. A child has the innate capacity to join this on- going process, but she is able to actualize it only in the context of a human community which is what the household is.

Another feature of the household is that it has a decision-making process. Before taking any decision the various aspects are considered, the pros and cons are evaluated and finally a decision is arrived at. Sure enough, these are all informally done, but in moving on from deliberations to decision there is an exercise of authority. The member exercising authority is usually referred to as the 'head of the household'. Here again, there is little that is formal. The head may function in a 'benevolent', 'democratic' or 'dictatorial' manner. Very often the 'head of the household' is a senior male, but not invariably or necessarily so. There have been and still there are households and collections of households that constitute a social order where the senior female has been the 'head'. Quite simply, the head is the one who is recognized by other members as the 'head'. It is not necessary that authority must be vested in a single person. What it implies is that there is an informal, but quite recognized locus of authority even in a small community such as the household. The larger the community – a tribe, for instance

– and more differentiated its members are, the greater is the need to have the locus of authority identified and accepted. At one stage it might have been the 'Chief'. Its equivalent informal counterpart now is the 'Boss'. In the absence of such authority the resulting situation is likely to be chaos or anarchy. So no matter how you approach it, for a household **sensitive guidance and authority there must be.**

Not a word has been said so far to suggest that the basic features that have been enumerated above refer to an 'economic unit' identified as the household. That is quite deliberate, though. The point it emphasizes is that the 'economy', the field of study of *economics*, is set within a *non-economic* mould. As we move on we shall see what this 'social embeddedness' of the economy means. You will see also how each of the features we have enumerated has its bearing on the economy. You will note too that the distinction between the economic and non-economic aspects implied here won't be seen in real life situations. That distinction is the first step in our 'thought experiment' and its rationale is that it helps us to enter into our (mental) laboratory to study the one area of reality that we are interested in. Reality is far too complex to analyse and understand in its entirety. We can see only in part: we can understand only in part. But the parts, if carefully examined and understood may give us a glimpse of that complex reality.

The economy as a whole is complex too. We can examine it also only in parts! Where do we begin?

Production

Let us start with production. The justification for doing it is that of all the major activities that can be described as 'economic' production is the basic one because survival is the prime human concern. Exchange is another basic part, but only secondary, though

because of its greater visibility in our present context sometimes it appears to be more important.

In order to concentrate on production we shall take the next step in our thought experiment – consider a totally isolated household which will have to produce all that it requires for its survival (and more if its members so desire) and has no contact with any other human community so that exchange is ruled out.

To provide the rationale for our 'first step' let us note that production is a 'within' activity of an economic unit whereas exchange is a 'between' activity of two or more units. You will be able to appreciate this distinction more clearly in the next chapter and beyond.
One more preliminary observation is called for. An isolated household is not something totally removed from reality. Its real life counterpart is a self-contained community such as a tribe, and we do have such communities in our country even now. So the situation that we have set up is neither a case of "long, long ago" nor "far, far away"!

Alright. Let us now enter into our thought experiment. What must we first examine about the isolated household? I suggest that we first consider its demography, not so much the total number as the composition of its members. We know that they are not alike. There is the female-male distinction, the adult-child distinction, and let us say, the able-disable distinction also as we have already noted. Let us note the total by 'P'. Of special significance to us is the distinction between those who work, 'W' and those who are non-workers, denoted by 'NW' who are dependent on the former. Thus we have

$$P = W + NW$$

Production is the activity of the W members for the benefit of all members. What does that activity involve? In the early nomadic stages of human history, it must have been the gathering of the fruits, roots and leaves around them, that is, from the bounty of

nature. In the more settled stage of agricultural production (starting just about 15,000 years ago) it was putting land to use. That continues to be the form of production involving vast numbers of workers even today. Later still, there was something of a shift from land to machines and generated power (just about three centuries back) but the role of nature in production is prominent even today; think of the oil, the metals and the raw materials that go into 'industrial' production. So we can generalize and say that *production is human interaction with nature.* We shall use the more contemporary terminology and state that production involves human beings (workers) and *resources*. Thus resources will stand for all that human beings use to sustain their survival. The human element in production will be represented by the letter 'L' standing for labour, the capacity of workers to convert resources into products to meet their needs and wants.

Let us assume that what our isolated household produces is paddy for which the main resource required is land. We shall use the letter 'D' to refer to land (as L has been used for labour). Since we have already used 'P' for people, let us represent paddy by 'C' noting that the early writers in economics used 'corn' to stand for grain in general.

To enter into the economic aspect of production, we first need to assess how much paddy the household will produce. This may appear to be an irrelevant question at this stage because we have not so far specified the extent of land the household can use or the number of workers available for the production of paddy. However, even without knowing those facts, we can indicate some limits that will apply. At a *minimum*, the household would try to produce what is required for its members to survive. That means they must cultivate as much land as required for this purpose. The minimum *output* is, therefore, constrained by the availability of land for cultivation of paddy. On the other hand, *the maximum* of the product is the extent to which the workers in the household (W) can exert themselves to produce paddy using the land available for cultivation of paddy. So the maximum is constrained by labour. The *actual output* will be decided by

what the household determines it needs, which might well be somewhere between the minimum necessary and the maximum possible. This is termed *demand,* which also therefore, plays a role in determining the actual extent of production. The role of demand in determining the level of production may not be easily recognized at this stage of our thought experiment, but its significance will become obvious when we deal with real life economies of a larger society such as a nation.

Substitution

The previous paragraph implied that it is possible to produce the same amount of paddy with different combinations of the extent of land 'D' and the number of individuals 'W' working the land to produce paddy. That has been an over simplification of the activity described as production. But it enables us to raise some meaningful questions about production. Using the analogy of industrial production, one may consider that engineers rather than economists should make these decisions. But since economists are also concerned about production which involves human beings, they also must have their say. We must recognize, of course, that the perspectives of the engineers and economists differ.

Of special interest to economists is whether a given quantity of output can predictably be produced by differing combinations of labour and the means of production that are used such as land that we have already considered. If that is not possible it is indicative of *fixed coefficients* of production. However, we know from real life experience that such is not always the case. Some flexibility exists, perhaps two or three combinations, which permit instances of *variable or flexible coefficients* in production. Probably such a limitation of the variability of coefficients is most likely in real life situations. Since economists tend to seek ease of analysis, they tend to work with the two extremes of *totally flexible coefficients* and *fixed coefficients of production*. If you were to object to this approach on the basis of real life experiences, you would be right to do so. But let us

recall that the 'thought experiment' we are doing to facilitate analysis calls for such simplifications and are legitimate as long as they lead to a better understanding of complex real life situations. Already for the sake of simplicity we have brought together all natural resources, including water, sunshine and natural fertilizers under the term *land* and all human factors, such as manual labour, supervision as well as others under the term *labour.*

The case of fixed coefficient of production is a widely used procedure known as *input-output analysis* which tries to separate out the different *inputs* into production as much as possible. This is called *disaggregation* of inputs. In the case of paddy production, the inputs other than labour itself will then consist of seeds, land, water, fertilizers and many other elements involved in the production of paddy. You will immediately recognize that some of these inputs, fertilizers, could themselves be outputs from other instances of production. Hence we use the term, *input-output analysis.* Even this widening of analysis fails to make the representation fit exactly with real life complexities. Engineers involved in *production* will maintain that even the most elaborate of *input-output tables* will fall short of concordance with actual experience in the real world. Engineers and economists deal with different aspects of production and we will return to concentrate on how economists look at ways of understanding *production.*

What lies behind the economists' concern about the combination of inputs in production? In the example of the single household we have been considering, we have not so far discussed the extent of land available to it, or the number of workers. It will therefore be helpful to know whether and to want extent land and labour, D and L as inputs can be altered to keep production constant or to increase it. Suppose that available labour is limited: can an increase in land accessible for cultivation keep the output of paddy constant? Can the output of paddy be increased by adding more labour while accepting that the land available cannot be increased? Or can the same end be achieved if labour is limited by increasing the land available for cultivation? These are

legitimate queries for which the answer must be sought by the household in its effort to survive and to make life meet the ideal of an ordered household. These questions and the answers to these queries form the basic *field of economics.* Put differently, the enquiry into the nature of the coefficients of production, fixed or variable and if the latter by how much and the answers obtained determine the extent to which substitution is possible in production.

We can exclude by our thought experiment one extreme, namely that of *perfect substitutability*. If such a possibility existed in real life, all paddy demanded by a single household could be produced by applying labour to the 'land' in a flower pot or by one person cultivating thousands of hectares of land! We recognize that such a 'theoretical' calculation is an absurdity in real life. The other extreme of total non-substitutability is not quite realistic either.

If substitution is possible but limited, there is one other inference we can make. As you substitute one of the inputs for another incrementally, output will also increase, but at a diminishing rate. Or to reformulate in general terms: In production, an attempt to increase output by varying only one of the inputs keeping the other(s) constant will lead to a less than proportionate increase. This observation is widely used in economics and is known as the "Law of Diminishing Returns". Actually, since only one of the many inputs is varied, there is no reason to expect a *proportionate* increase in output, so it is not much of a *law.*

When we look back into the historical development of economics as an academic discipline, it can be recognized that in the early days of the development of economic theories, the observation of *diminishing returns* was based on real life experience, though the procedure for coming to conclusions was very different. The early writers were very insistent about observing real life situations to derive conclusions and few conducted theoretical *thought experiments.* They observed that with ever increasing

extent in the land under cultivation, the increase in output was less than proportional to the amount of land added. Initially this was considered to be due to a specific characteristic of the land, less fertile land being mixed in with the more fertile areas under cultivation. The phenomenon was first designated "decreasing returns to the land". Subsequent observations based on uniform quality of land showed that equal increase in output could not be achieved for equal additions of land, while holding the quantity of labour at the same level. Therefore the observation of "diminishing returns" was accepted as a general principle or *law* relating to the nature of production.

Division of Labour

Let us look at some other aspects of the production of paddy. It is not a one-step operation. It is a process involving several aspects: preparing the land for cultivation, sowing the seed, transplanting, weeding, harvesting, threshing, winnowing etc. till paddy the product is obtained. Then there is the husking, cleaning and cooking before it finally becomes food. We do not need to go through each one of these steps, except to point out that the variety of tasks involved makes it possible to introduce division of labour, some of the members of the household who form the worker group W specializing in each of the operation, thereby creating advantages to the household as a whole. There are other decisions to be made also: how much paddy should be used as food and how much should be set aside as seeds for the next season of sowing. All we need to notice at this rather simplified stage of our thought experiment is that while the physical process of production is the major economic concern of the household, there are more decisions to be made, even in a simple social structure as a *single* household.

Capital Formation

Next, let us extend our thought experiment into another area. The required output of the paddy or the *demand* to use its technical term, is not only for the needs of the

worker members W in the household, but also for the NW members who do not take any part in the physical activities of production. Further, if labour power is still available after allocating enough of it to produce calculated demand for output, what is to be done with it? They could organize a festival or allow for relaxation time through meditation though these activities are *non-productive* in relation to paddy as an output. Or they might utilize such unused labour *this* year to dig a well that can increase production of paddy *next* year through irrigation. It will then become a *productive* use of labour power, even though it does not increase current production. It is the use of labour power, not for the purpose of increasing production *now*, but to augment both production and *productivity* (that is product per unit of labour) in the future. In the thought experiment we are undertaking now, the well becomes *capital.* If a decision is made to make a tool, such as a plough, which again does not increase production *now*, but does so in the *future,* that also becomes part of the capital. We will have more detailed discussion of capital formation later.

Distribution

We have so far dealt with the manner in which members of the household use their labour power and resources they have access to, to produce the paddy they need. Now they have to decide how the product will be *distributed* among the members of the household which also we noted as one of their economic decisions. They can, of course decide that the total product will be equally divided among members, though that is unlikely. They have to decide whether the Working members W and the nonworking members NW should be treated differentially. The household has to take into account the special needs of the children and the aged. They may decide that the *ideal* principle of distribution is*, "To each according to his (her) needs: from each according to his (her) ability".* These are the *within or internal* decisions of a single household and there is not much we can say about that until we consider a multi-household society.

Before we take leave of the single household of our *thought experiment,* there is one more important aspect that requires examination. Who makes the production and distribution decisions? In the case of production we noted that there are some operational factors to be taken into account. Distribution may be based on custom or moral principles. But none of these happens automatically. That is where the question of authority which we discussed earlier comes in. This is being emphasized because there is a school of economics that maintains and propagates the notion that the functioning of an economy is automatic, subject only to its own inner laws, often referred to as the *invisible hand*. We will recognize as we move along to the next stage of our thought experiment that such an approach cannot be considered valid or sustainable and that *decision making authority is integral to the effective functioning of an economy even when its presence seems invisible or is not identified easily.*

Chapter 2

The Economics of Multiple Households

Most aspects of *economics* are concerned with *interactions* between basic units of society. However, some fundamental concepts of the ordering of a multi-household society depend on *factors of production* which are present in the efforts that even a single household must make to assure survival. Such was the reason to consider, in the form of a *thought experiment*, the economy of a single household even though it is becoming a much rarer form of human existence to-day, even in India. Therefore, as we move from a single household to consider the organization of multiple households into a larger social unit, we move closer in our *thought experiment* to more relevant findings that we can more easily observe in current real life.

Ownership

We will start with an issue which was identified in the *Introduction*, but was not referred to in the previous chapter: the nature and significance of *ownership,* a major concept in the evaluation of economic theories.

A brief historical account will be helpful.

Ownership and the manner in which it influenced production and the distribution of products constituted the central theme of political economy. This can be seen from the writings of the early authorities on the subject who have come to be known as *Classical* economists. The familiar names are Adam Smith, David Ricardo and Karl Marx. But as production increased and became diversified, *exchange of products* came to the fore and became the main concern of a new generation of writers on the subject. Prominent

among them were William Jevons, Knut Wicksel and Leon Walras who have come to be known as "*Neo-classical*" economists.

Walras, the mid 19th century engineer turned economist was very ambitious and set out to convert economics into a *physico-mathematical science.* He treated ownership as an extraneous and institutional aspect. This continues to be the approach taken even today in Neo-classical economics, which is being taught in schools, colleges and universities in our country and most parts of the English speaking parts of the world. On the other hand, it is to be conceded that no 'modern' economist will consider the ownership of resources an unimportant issue, particularly for public policy, even though the majority would treat it academically as belonging to the soft disciplines, such as law, sociology and politics. To phrase it differently, most 'modern' economists treat ownership as a *given* in their analysis – meaning that it does not need to be taken into account as an important factor that affects the whole field of the interactions that constitute the core of economic analysis. This is rather ironic because modern economics begins by asserting, if not examining or let alone establishing, that scarcity of resources is the *central theme* of economics. If they take Adam Smith seriously, they will be convinced that he established the existence of a close connection between *scarcity and ownership*.

You would have noticed, right from the beginning, that I attach great significance to the *ownership* of resources. This is not because Adam Smith or Karl Marx maintained that ownership was important in understanding the dynamics of an economy. It is real life that provides us this critical insight. We must consider the nature of ownership in depth to understand its relevance. To do that let us step out into the real world!

Ownership Rights

The reason why *ownership* did not figure in our thought experiment of the economy of a single household was that an isolated household, such as a tribal household with no

neighbours within sight, has only to consider whether it has *access* to land, not whether it *owns* the land. When there is a neighbour, the single household is no longer isolated, and therefore has to ensure that the neighbour does not make any claims to the *ownership* of the land he plans to cultivate. The most *crucial aspect* of ownership is that it gives power to the owner to exclude another's use. This presupposes the need for an external power or authority, external to the householder as well as the neighbour to guarantee ownership which includes *the rights of exclusion*. Frequently the third party that exercises this power is the *State* – the authority that guarantees the rights of exclusion. Many early writers on political economy asserted plainly and boldly the main function of the state was to protect property ownership and the rights associated with it. Not only economists, but many philosophers of those times considered this authority to be divinely sanctioned. It would not be entirely fair not to point out that some among the philosophers and political economists did spend a great deal of time and intellectual effort to analyse the fundamental nature of ownership. Karl Marx, the philosopher-economist of the 19th century provided a very incisive analysis of ownership and property rights.[1]

Let us go back to the consideration of the nature of ownership in greater detail. While the *right to exclude* is the decisive characteristic of ownership, it also confers two other rights: the *right to use* and *the right to alienate*. These three features of ownership play such a fundamental and significant role in real life economies that it is surprising that the mainstream of economics ignores them. More accurately, a time-honored understanding of the nature of ownership is taken for granted. The role of ownership therefore, does not enter as a critical component in the development of economic theories.

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1 Incidentally it is worth indicating that the Supreme Court of India has declared that property rights do not belong to the category of fundamental rights that our constitution specifies and guarantees.

Relationships based on Ownership

With these clarifications, we can move on and proceed with the understanding of the interactions between two neighbours. Let us postulate that Household **A** *owns* more land than it requires for meeting its demands for production and can effectively utilize considering the limited number of members it has. Household **B** belongs to another category with considerably less land than is required to provision the needs of its members (If household **B** had the same characteristics as **A**, our analysis will more or less be similar to our discussion in Chapter I).

In the technical language of economics, household **A** is subject to *labour constraint,* while household **B** is subject to *land constraint.* The question we are eager to consider is: what kind of economic relationship is likely to be established between these two neighbours?

Threatened by hunger, because of inadequate land, **B** may make the first move by asking **A** whether an unused portion of their land could be made available for cultivation by the surplus labour that **B** has in the household. **A,** of course has the option of saying, "*No".* On the other hand, members of household **A** may find in the situation an opportunity to get some paddy without any effort on their part. Hence they may allow the members of household **B to** cultivate some part of the land that is lying idle. In return, they may tell the members of B that a share of the output resulting from cultivating the extra land be given to household **A.** Household **B** may consider this a reasonable arrangement. But the interaction between the two households would not be complete until a deal is struck which stipulates how the increase in the production of paddy resulting from the utilization of **A**'s excess land and B excess labour should be shared between them. It is unlikely to be a 50:50 sharing. Without much analysis, we can infer that **A** will have the upper hand in the negotiation and some ratio like 60:40 or 70:30 in favour of **A** is likely

to be established, because **B** is in greater need of increased production of paddy to assure its survival.

This not an imaginary situation! In fact anyone familiar with the Indian rural situation will already know that there is a widespread cultivation arrangement known as *share cropping* whereby households who do not own enough land to produce the basic amount of paddy to ward off starvation will cultivate parts of the land of the local landlord (who in most instances owns 50 or 75 percent or even more of the cultivable land in the village) and pass on to him a major portion of what is produced by the sweat of their brows –literally!

If you would like to test whether our *thought experiment* about multiple households holds true to real life, all you will need to do is to familiarize yourself with the large number of *village studies* that have been undertaken by research institutes or universities. They will document who owns village land, how it is cultivated and how the outputs get divided between those who produce them and those who own the land.

Let us proceed with our thought experiment and introduce one more household **C** with the most extreme case of *land constraint*, namely, with no land at all. Members of this household have no choice but to negotiate with household **A.** We already know that in the negotiations between **A** and **C**, members of **C** are at the total mercy of members of household **A,** because unless **C** agrees to the most egregious conditions, **A** has the option of leaving the land fallow than give it to those who desperately need it for production of food, the basic need of life. If members of A are of charitable disposition they certainly can allow their poor neighbours to cultivate a part of their land that is not in use and thus make a living. On the other hand, they also have the option of taking advantage of the situation by allowing the members of C to cultivate the excess land and give them merely a part, perhaps a very small part of the additional output. This arrangement is not exactly like the previous one. The members of A are simply

‘compensating’ the workers of C for work done. The latter have very little say on how the terms are determined. As long as the arrangement gives them something for their survival they will accept it. We can say that members of C work for ‘wages’ or become ‘wage workers’. Thus a new type of relationship between the neighbours emerges.

You should remember that households such as **C** are not a figment of the imagination introduced into the experiment just to make a theoretical point. In India, about 20 percent of households belong to this category known as ‘landless agricultural households’. Does that come as a surprise?

By now, you may have been convinced about the major role ownership plays in real life and hence should be an indispensable aspect in economic analysis. In the elementary situations we have considered, ownership determines three crucial things: it determines the extent of production in any basic agrarian economy; it defines the manner in which the products are distributed; it also defines the nature of relationships among the participants.

Barter

Now we can turn to another prominent interaction, or in technical language an *economic activity* described as *exchange*, which was absent in the consideration of a single household. We are all familiar with this activity: in fact, *exchange of products* is what makes all of us participants in economics, directly or indirectly. Its connection to *ownership* and perhaps even to *production* may go unnoticed. In this chapter we shall only deal with the rudiments of exchange, to show it is connected to production, which in turn is linked up to ownership. It is related to the right to alienate that ownership confers.

Let us return to Households **A** and **B**, both of whom have land for cultivation. Imagine that members of **B** cultivate bananas, with output not enough for their survival, so they have *leased in* (leased out from **A**'s point of view) land from **A** on condition that only paddy is produced on that land.[2] Thus, there is not only a two household economy, but also a *two goods* economy**. B** has bananas and paddy, the latter as share of the production from leased in land. They like the more balanced banana-paddy diet, but would like to have more paddy. They can lease-in more land because of excess labour, can cultivate more and thus achieve their objective. If they cannot achieve this, they have another option of persuading members of **A** to give them some paddy in exchange for bananas. If we assume that through conversations with members of **B,** members of **A** also have become convinced about the advantages of a more diversified diet, how will the exchange of bananas owned by B take place in exchange for the paddy produced and owned by **A**? More precisely, in economic terms, how will a *rate of exchange* of banana for paddy get established?

This process is known as *barter* and it is based on bargaining because both members of **A** and members of **B** are eager to get as best a deal as possible, because each group has put in a lot effort to produce their respective good. We can imagine a dialogue taking place along the following lines:

B. *We have found paddy very nutritious and are willing to offer 10 bananas for a measure of paddy. What is your call?*

A. *We are quite comfortable with paddy for our food, but if you are keen to get some more paddy we are willing to give you a measure of it for 100 bananas.*

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2 Throughout we will be referring to A, B etc. both in the singular and plural forms as the context calls for.

B. *What? One hundred bananas for one measure of paddy? We have some interest in your paddy, but what you have quoted is atrocious! We are willing to go up to 20 bananas per measure of paddy; what do you say?*

A. *Now, look, Aren't you the ones who want our paddy? We have managed very well so far without your bananas; however, we are willing to give you a measure of paddy for 75 bananas*.

B. *We started this discussion, so how about a deal of 50 bananas for a measure of paddy, and at that rate, we are willing to take 4 measures of paddy.*

A. *Alright, it is a deal – 4 measures of paddy for 200 bananas.*

Now that **A** and **B** have struck a deal, let us examine what this barter transaction implies. First, there is no rigid distinction of a *buyer* as such or a *seller* for that matter. **A** is a seller of paddy and simultaneously a buyer of bananas; **B** is also at the same time a buyer and a seller. Second, some quantities of paddy and bananas have been *exchanged* after some bargaining in which each side tried to get as good terms as possible, and during which some bids were rejected. Third, those quantities of goods exchanged imply a *rate of exchange,* in *this* instance 50 bananas for one measure of paddy which is the same as one measure of paddy for 50 bananas. These rates, which may be referred to as a *price* is a 50:1 ratio or a 1:50 ratio depending on the point of view of **B** or **A** respectively. Fourth, this deal does not establish *a* price for either bananas or paddy separately and individually or for the next transaction of goods between **A** and **B or for** that matter anyone else. It is just a one-time price. *Barter as a form of transaction* gets extinguished the moment the goods have been exchanged. But we need to answer the question whether barter can be extended to include more goods and more households.

Let us allow one more household to enter our into our thought experiment and see its effect on barter as a form of exchange. Household **D** enters the picture with some land, but not very suitable for the production of either paddy or banana. With grass growing on its land, the members of **D** can graze cattle and produce milk which they can use to get paddy from **A** or banana from **B,** or both.[+] Following the bartering process we just mentioned, let us say that a paddy: milk rate of 1:2 between **A** and **D** and a banana:milk rate of 60:1 gets established between **B** and **D** in two independent transactions. No problems so far, if all the barter deals remain independent and unknown outside of each transaction.

But if the established bilateral rates prevail *and A, B and D are aware of them,* new possibilities arise in our 'community' of two farmers and a cowherd. A will see that he does not to deal with B for bananas, and that it is to his advantage to get them indirectly through D who does not produce them at all! B, however, is not going to be passive about it. He will offer better terms to A (after all, B is the producer of bananas) and will try to cut out D's attempt to play the role of a 'middle man'. D will also come up with new offers of milk for paddy and bananas. The terms of transaction initially established will get disturbed and new offers will be made. There is a good chance for a new paddy:banana:milk ratios will get established. If it does, it will depend on the ease with which these three goods can be produced by the respective producing households and the intensity of desire for these goods that the respective non-producing households have. Later in the discussion on exchange these will surface respectively as 'supply' (representing cost of production) and 'demand' (as indicating purchasing power). But this sort of extending of barter transactions can happen only in very small 'communities' where everybody comes to know of all the goings on.

Where there are large numbers of participants, barter runs into a serious difficulty which, in textbooks, is frequently referred to as the problem of 'double coincidence'. The basic issue is simple: each person who has some good to offer (paddy) and wishes to

have some other good (banana) must find somebody else who is willing to offer bananas and take paddy in exchange. That may call for a great deal of searching!

Trade

So, let us look for an alternative procedure going back to our community of A, B and D where the initial exchange rates have been established, but they remain strictly bilateral because the parties that have established the deals know only what they are directly involved in. Now introduce another character into the scene, rather different from the three. To show this person's 'distance' from the three households, let us refer to him as 'T'. This person produces nothing, but has information about all the deals in the community and the prevailing rates. T thus figures out that he can offer new rates to A, B and D which do not adversely affect them, *but yields some benefits to himself.* He persuades A to lend him 1 measure of paddy saying that he would return it as bananas, certainly more than 50. With the 1 measure of (borrowed) paddy he goes to D and gets 2 measures of milk. With the milk he goes to B, exchanges 1 measure for 60 bananas which he takes to A and gives him 55 or even 60 bananas in return for the 1 measure of paddy he had borrowed, and yet having 1 measure of milk for himself at the end of the day!

What T did was to detect the differences in the barter rates that had existed and make use of that information to his advantage. He is quite a smart person and his trade name is 'Trader'. A trader is one who enables to extend barter which is a bilateral transaction into a multilateral transaction. How he does this is the theme of the next chapter.

But now that we have brought the trader (or merchant) on to the scene, let us get to know him and the nature of his trade. The arrival of T, the trader, is a significant event in understanding the nature of the economy. So far, paddy, bananas and milk resulted in members of the households concerned working on land. But here is householder T who

was able to get milk for himself and members of the household (with a child, perhaps) without using land as an input. Note that T's action does not by itself add to the total paddy, bananas and milk in the 'community' that now has four member households, but a redistribution of the outputs. It can also be thought of as a new way of earning output by a participant. In the example given above, it is possible too that at least A, the producer of paddy may increase production having learned of the advantages of having some surplus paddy to trade with.

Let us get back to T. How does he come to have some goods without producing any? He uses the information he has (and which others do not have) to benefit himself. Two inferences can be drawn from this. The first is that the *asymmetry of information* can be made use of to gain economic advantage. The second is that it is achieved through the process of intermediation: T in fact has to establish contacts with A, B and D striking deals with them.

One or two traders in a community largely of producers may not make much of a difference. But the emergence of a class or group of traders certainly will. Greater intermediation will come to play a major role in the economy which will impact production also. This is another major step in the understanding of economies and of economics as an aid in that process. As a matter of fact, to understand any modern economy is to get to know the process of intermediation in it. To express it differently, *differences among modern economies depend greatly on the nature and extent of intermediation in them.* Look out for this principle as we move along.

How barter which is a direct transaction between two parties and two goods gets transformed into exchange involving many participants and many goods is the first step in moving on from our simple economies consisting of producers into more complex ones with different kinds of participants and processes. We shall consider it in the next chapter. But before proceeding to that aspect, let me clarify that barter is not altogether

a thing of the past nor prevails only in isolated situations. It is widely prevalent informally as when kids exchange a ball for a ball point, or when two neighbours exchange some sweets for occasional babysitting. Another example is when two professionals, let us say an ENT specialist and a dentist exchange their respective services directly (either as expression of friendship or to reduce their income tax payments!) More significantly and formally barter is an accepted form in international trade. Not long ago we used to get capital goods (like machinery and fighter aircraft) from the then Soviet Union in exchange for leather shoes and toiletries. Even today, such transactions between countries are prevalent.

A brief reflection about the thought experiments of Chapter 1 and the present one may be helpful before we turn to the next chapter which is a transitional one between thought experiment and real life situations. Chapter 1 may have appeared to be completely removed from reality, though let me repeat that we do have such isolated households in our country. What we were able to see from the discussion in that chapter is that the basic concern of a household like that is to ensure the survival of its members for which it has to engage in production, that is, interact with nature making use of their labour power, neither of which is derived from the economy and certainly not on the basis of any economic principle.. But we saw also that an isolated household need not be at the survival level, and if conditions favour, and if they so desire, they can go above it. This can mean either raising the level of living *now,* or producing capital goods which will increase productivity and living standards *later.*

Chapter 2 showed that an economy of multiple households is significantly different from a single unit economy. Ownership arose as a central issue having a bearing on production as also the basis of exchange. Ownership also greatly influences distribution. We saw this last aspect only indirectly by recognizing that ownership of resources has a bearing on bargaining power. Briefly, therefore, the thought experiments in the two chapters have shown that ownership and control over resources greatly determine the pattern of

production and the distribution of the product. In this chapter we have also seen the decisive role that intermediation plays as new economic activities emerge. Thus the thought experiments have helped us identify two basic clues to study economies. Economics as a tool of analysis has emerged!

Chapter 3

Exchange and Intermediation

In this chapter we shall attempt to go beyond barter. We left the last chapter after seeing that barter can only be repeated, it cannot be generalized into a large-scale multilateral activity. Let us see why. When a barter agreement is arrived at for the exchange of a certain quantity of paddy for a specific amount of bananas, we saw that the ratio between the two goods can be thought of as a *price* derived from these two quantities: one measure of paddy for 50 bananas in the first example in chapter II. We can say that the *price* of 50 bananas is 1 measure of paddy, which also implies that the price of 1/50 measure of paddy is 1 banana, if we wish to express the *price* in terms of banana. In other words, there has to be something in terms of which the *price* can be expressed. We saw that barter between banana and milk can also be achieved on the basis of quantities of these two goods exchanged between two households and a *price* can be expressed in terms of either of these goods. A problem arises when many goods and many households are involved. In terms of which particular good can the *prices* be expressed in the various barters? In technical terms the *good* in terms of which the varying ratios between goods in multiple exchanges can be expressed is known as the *numeraire.* In the 3 independent barters involving the three goods and the three households (paddy, bananas and milk and **A, B** and **D)** that we were dealing with in our thought experiment, paddy, the good that **A, B** and **D** use as staple of their diet would be the obvious choice for the role of *numeraire*.

Money

Multilateral exchange is always based on a *numeraire***.** We don't usually appreciate this fact, because the numeraire that we use while shopping is money. In India it is the *rupee* and all prices are expressed in terms of rupees. The only difference is that instead of expressing what quantity of other goods will exchange for one unit of the rupee, we take

the reciprocal and express the price as so many rupees for one unit of bread, pen, TV, mobile phone or whatever else we want to purchase. But, do not overlook the fact that if you know the prices in rupees of a TV and of a pen or one kilogram of tomatoes, the price of a TV in terms of the number of pens, or of kilograms of tomatoes can be calculated although that is not usually done. But when the price of a good appears to be unexpectedly high, we still resort to such comparisons: somebody offers to buy you an expensive pen and you respond: "Why spend money like that; I can get 50 ball point pens for the same price"!

The transition from barter to multilateral exchange was neither sudden nor smooth. It was a long historical process. But instead of tracing that history, we shall do an analysis based on history. Barter, let us recall, is the exchange of one good for another, or to use a more professional expression, one commodity for another commodity (a commodity being a good that enters into or goes through exchange). You may want to think of it as a C-C form of exchange.

The generalization of exchange begins when *money* ***M*** enters into the picture. Think of a rural situation where a household produces practically everything its members need, but requires a few critical things like salt and dried chillies. These items could be purchased from itinerant merchants who would bring them to the nearby weekly market once a week or so. A household would take a bunch of bananas, sell it to the village coffee shop and then use the *money* to buy salt and chillies from the merchant. The activity of the household now involves two distinct exchanges (unlike in barter which involves only one exchange), a sale first and then a purchase, thanks to the *mediation* of money as the *numeraire*. With money mediating, then this two fold exchange can be described as a C-M-C activity, very convenient as a shorthand description, but with major implications for the understanding of the emergence of *market*. Since the commodity represented by

the first C and the second C (first commodity being banana and the second commodity being chillies) are not the same good, we can rewrite the relationship as C-M-C'.[3]

Money and Merchants

To proceed further, we must understand the role of the *merchant*. He certainly performs a useful service, first to the person from whom he bought the chillies and then to the person who buys chillies from him. Think of a situation where the producer of the chillies and the buyer of chillies did not have the merchant as an intermediary. The producer of chillies would have to find a producer of banana, who wanted to exchange bananas for chillies and vice versa. Thus using the information he has on who has bananas to sell and is looking for chillies to buy and vice versa, the merchant brings them together facilitating exchange. To put it differently it is the *mediation* of money and the *intermediation* of the merchant that lead to the multilateralisation and generalization of exchange as an economic activity. Bringing together the seller and buyer through his *intermediation* is an important service that the merchant renders. Otherwise, there will be only very limited exchange which will also mean very limited production. Second, the merchant as a seller keeps available a stock of things that buyers come to purchase. You can see the importance of this service if you think of an item such as furniture. In the absence of a merchant who keeps a stock of furniture, when you need a table or a chair, you will not only have to go around searching for a carpenter, but will also have to wait till the item gets manufactured. So, by holding a stock of goods the merchant makes available to you what you want, when you want it. There is a third, socially useful service that the merchant provides. He also stores information about the goods he deals

3 The following account is based on Karl Marx's treatment. Even those who claim familiarity with Marx's writings think of them as being concerned only with production. While production and relationship of production were his main theme, his writings on exchange, finance etc. are also exceptionally insightful.

in, possibly about who sells them to him and even about those who buy them from him.[4]

But why does the merchant do what he does? Is unremunerated service to the society his objective? If we were to consider the issue for a moment, we will realize that the merchant performs his *mediating function,* because he is making a *profit* for himself (the 1 measure of milk that T made at the end of the day in the example of the previous chapter). Let us recognize and accept that making a profit or money through trade is quite a legitimate and honorable thing to do, because it provides a service. It is a widely prevalent occupation and for millions in our country and throughout the world it is means of livelihood.[5]

Let us try to understand precisely what the *intermediation of the merchant* contributes for the facilitation of exchange. The merchant enters the exchange scene with money **M,** buys a good or commodity **C** from one household and then sells that commodity for money to another household. So exchange comes to have two distinct forms when it gets generalized, the **C**-**M**-**C** format that we have already seen. Now from the point of view of the merchant, it takes an **M**-**C**-**M** form. If the merchant makes a profit in the form of money through these transactions, the first and second M cannot be the same – the same quantity in this case. The second **M** will be larger: it can be denoted either as M' or since the difference between **M** and **M'** is a quantity, or as **M +Δ M** as delta usually stands for an increment.

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4 Even today big commercial concerns ask you for your name, date of birth, address, e-mail id, mobile number etc. in return for which you get an SMS from them wishing you on your birthday!

5 Through the intermediation process, the merchant plays a socially useful service and the profit thus made can be thought of as remuneration for that service. The problem arises as we shall soon see when a trader enters into a transaction **primarily** to make profit, and continues to make more and more profit. Its social consequences are different.

Thus we come to the conclusion that *generalized exchange* will have to consist of two distinct forms which can be expressed as **C–M-C'** and **M-C-M' (M+ΔM).**

You may claim that there is a third form of exchange, that you and I generally practise: we go to the shop with money **M** and come back with what we wanted to buy, **C**. Isn't that an **M-C** form of exchange and isn't that the most general form at least in today's real world? That is quite a legitimate question, but not quite appropriate. Let us see why.

Where did the money in your wallet come from? Let us say that it is your monthly salary. Obviously, you do not get a salary for nothing! You or your parents must have worked to earn it. That is a form of exchange too! You exchanged *your labour* for an amount of money, not very different from a transaction point of view, since it is like a farmer selling banana for money. While that may seem a rather crude form of expressing work at an office or the remuneration you receive at the end of each month, you will see the importance of looking at it in this manner because many millions in our country have nothing other than their labour power (either physical or mental) to sell for those who can use it and give them money in exchange for it. The money that an ordinary labourer gets at the end of a day is called *wages*, whereas what an office worker receives as remuneration for his labour during a whole month is called a *salary*. Even if the payment is made to those who labour on a monthly basis, as in the case of domestic help, such is often designated as wages! The point is that apart from the different words that we use salaries and wages mean the same thing! They are both payments received for the exchange of a good. In these instances, labour power is made a commodity: that is the only difference, which is merely a semantic distinction that expresses snobbishness of our class hierarchy! If you go to a supermarket with money and buy something, what we have transacted is the second part of the **C-M-C'** exchange the first part having already taken place in an office or a factory as the case may be.

Price and Cost: Supply and Demand

There is another aspect related to exchange that we should consider. We have already referred to price in its relationship to exchange. If somebody asks you "What is the price of that beautiful necklace you are wearing", you may reply: "Oh, it cost me an awful lot, Rs 25,000!" The term you used, *cost* is quite a legitimate substitute for *price* in that context because the two statements, the *price* of the necklace is Rs 25,000 and that it *cost* Rs 25,000 have the same meaning. If you look back into the nature of barter, you see this more clearly. The expression "the price of 50 bananas is a measure of paddy" conveys the same meaning as "50 bananas cost a measure of paddy". Here we are using the *numeraire* of rupee to convey the identical meaning.

But there are two errors that can enter into our understanding of the nature of exchange that we should be aware of. The first is the glib statement that exchange (or *market* as we shall soon see) determines prices. The more familiar expression is that "*supply* and *demand* determine prices". It is one of those statements that most people associate with economics. Not surprisingly, that proposition is also the most widely taught lesson in economics. Those who have learnt economics in a class room may be familiar with the diagram that is often used to illustrate the principle. See Fig 3-1.

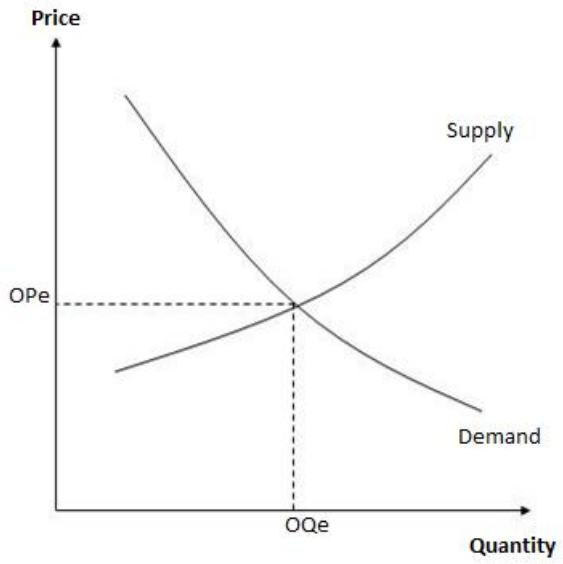

Figure 3.1 The Law of Supply and Demand

Denoting price on the vertical axis and quantity on the horizontal axis, the downward sloping *demand* curve and the upward sloping *supply* curve are shown to cross at the point of intersection. This intersection point is considered to determine the *equilibrium price* **OPe** and the *equilibrium quantity* **OQe**. This exposition is used to establish (if that is too strong an assertion, at least it is used to strongly imply) that the market *determines* price. Underlying that claim is the notion that the supply curve represents the producer's cost curve subject to the "**law of diminishing returns"** and the demand curve represents the preference of the consumer said to be governed by a similar law, "**the law of diminishing utility**". The law of diminishing utility says that the more of a good you have the less additional utility you derive from extra units of it and so you will be prepared to pay only less for having more of it. The Law of Supply and demand is based on the Law of Diminishing Returns and the Law of Diminishing Utility. That appears very s*cientific* indeed!

But is it really so? There are some issues here which have gone unexamined from generation to generation. For instance, if the diagram is supposed to show generalized exchange via the market, the supply curve should be that of the seller's actions, and everybody knows that sellers are willing to supply more at lower price per unit, as long as there is profit: so the supply curve must also have a downward slope! If so, the two curves which have similar slopes may not intersect at all! This issue is seldom considered because Neoclassical economic theory (which is supposed to be illustrated by the diagram), while it has a place for buyers has no place for *merchant sellers* in it. If on the other hand, it is an attempt to generalize barter, which certainly determines a price, we have seen that such generalization is impossible without merchants and their profit! There you are, as far as the 'scientific' nature of theory is concerned.

That is not to say that supply and demand do not influence prices. Everybody knows that a sudden fall in the supply of vegetables because of an unseasonable rain, for instance, increases their prices or that an increase in demand for houses because of a movement of population into the city raises rents. What we can concede is that changes in the supply and demand for goods will get *reflected in prices*, but we will have to maintain that they do not by themselves *determine* prices.

The second error insists that prices are *determined* by cost of production, though this is less of an error because if prices and costs are synonymous, then what determines costs will also determine prices and the cost of a good is what costs to produce it. Such a formulation does not help very much because the cost of producing a good is the price of goods used to produce it! After all, goods are produced using other goods.

There is no easy way out. Economists of the last few centuries have wrestled with the problem and have not been able to arrive at a satisfactory answer. But there is something of an obvious answer. Production ultimately is the interaction between nature and the physical and/or mental labour of human beings. If nature is treated as a

given, then cost, in the final analysis, is the labour expended in production. Adam Smith and Karl Marx, founding authorities of different, if not opposing schools of thought, were agreed on this approach. Modern economists take significantly divergent views on this theme. However, as we shall see in chapter 8, there is unanimous agreement that in measuring and analyzing the *value of* output of a country during a given period such as one year, the *value added* is treated as the contribution of labour.

While exchange cannot and does not determine what is referred to as the real cost of labour, it gives some measure of the *opportunity cost* and that information is useful in many ways. Take the case of housewives many of whom do a lot of work at home, but do not get paid for it. If they can find work outside the home, the wages/salaries can be taken as an *opportunity cost/price* (which they forgo when they work at home without compensation). But opportunity cost cannot be considered to be a proxy for real cost. This can be appreciated to be true when due to large scale unemployment, many people cannot find employment where they can earn wages or salaries implying that the opportunity cost is zero. Does that indicate that the real cost is also zero? In later chapters of this book we will clarify the distinction between real cost and opportunity cost and how that distinction becomes useful in understanding many real life situations.

To conclude our discussion of exchange, let us recall some of its characteristics and indicate a few more. Exchange is a form of inter-unit interaction: the units may be two households or even two individuals, two production units such as corporations, two countries and so on. We have seen that there are other forms of inter-unit interactions also, such as between a landlord and tenant. Yet another form of inter-unit interaction is that between a State and its citizens who pay taxes. In the last two inter-unit interactions that we have mentioned the two parties are at two different *levels.* Exchange as a form of inter-unit interaction is between two parties who are at the *same level*, because both are owners (go back to the households in Chapter 2 who enter into exchange) and each feels that entering into exchange is beneficial to it. However, this does not mean that the

parties are of the same *strength*. Their bargaining power will depend on a variety of factors, greatly on their purchasing powers, as we shall see in the next chapter.

Part II

THE INTERMEDIARIES

In Chapter 3 we saw exchange being generalized through intermediation of merchants. It was a transition from the economy being a sphere of activity and set of relationships where participants interact directly, including when they engage in barter, to the economy becoming essentially a mediated process. The intermediation first turns exchange of goods into an indirect process with merchants (traders) acting as intermediaries between sellers and buyers, the market becoming the institutional arrangement for it. Markets then link up production and exchange leading to increase in production, but increasingly dependent on exchange. Soon intermediation becomes present between lenders and borrowers giving rise to new institutions known as banks. With that intermediation enters the sphere of surplus generation and utilization, increasingly impacting production and transforming wealth from physical to value categories. In turn, it gives rise to different forms of proxy wealth. That provides the opportunity for finance to emerge as the third form of intermediation dealing in these proxies, first as trading in them creating the impression that it is an upgrading of trade and markets. Soon by becoming producers of proxy wealth and its easy multiplication, financiers open up avenues for manufacturing instant wealth for those who already have a concentration of wealth under their control and generating an aura of glitter through risky operations. Finance then becomes a new 'planet' rapidly expanding and dwarfing planet earth still engaged in the pedestrian activity of production of goods in which the vast majority of workers are engaged. In the meanwhile, what was initially risk for individual participants in the business, instant manufacturing of wealth soon becomes systemic risk leading to meltdown and collapse of the entire system with global ramifications.

This chain of transitions is set in motion by the entry of money along with merchants in the realm of exchange as seen in Chapter 3. Chapter 4 traces the dynamics of the money-merchant-market link up. Chapter 5 is on banking and finance where money again plays the crucial role of being the abstract measure of everything that appears in the economy.

There is another simultaneous transformation, in social relationships that accompany these economic activities. Profit that appears initially as a fee for services rendered by merchants gradually turns out to be the motivation for economic activity and maximizing profits by means fair and foul becomes the effective objective. That, indeed, is a greater transformation, though perversion may be a more appropriate term to describe it.

Chapter 4

Money and Markets

In our discussion on exchange, we made frequent references to money and indicated that the *market* is the locus of exchange, especially *generalized* exchange. We shall now move on to a more detailed analysis of money and markets and their interrelationships.

Market

The two are related to each other through their association with exchange as an activity of human beings. Hence, as exchange was a primordial characteristic of human interactions, money and markets were among the oldest of human institutions that facilitated exchange and to make it a generalized activity. Each has a fascinating history of evolution and transformation which is too elaborate for us to trace here. But, it is necessary right at the beginning to set aside some misconceptions about them, especially about the nature of the *market* and its emergence. There are some scholars, who have no hesitation in saying ,"In the beginning there was *Market*", as if it gave rise to everything that we discuss under the name economics! That is just ignorance, because we know that there are human households and communities who do not interact with others. Because they do not have and do not need to have anything more than barter exchange, they do not have and do not need to have *money* or *markets either.* There are many scholars, ancient and modern, more of the latter, who almost give the *market* the title of divinity, though seldom do they identify it with the capital *M, but none the less claim that it works according to its own immutable Laws.* This approach is false and is propagandist. By the end of this chapter, you will be able to make your own assessment of the role that the *market* plays in economies of different types.

Money and market are intrinsically related. We shall deal with them sequentially first before we try to understand their interrelationships

More on Money

What is money? Perhaps, it is so much a part of our daily lives we seldom pause to think about what it really is, except when we happen to have very little of it left at the end of the month! The reality is that *money* can mean many things, or more accurately it has many attributes. Among the many roles it plays, what comes first to our minds is that it facilitates exchange, that is, it is *the medium of exchange*. Closely related to that is its role as the unit of account, because as we saw in the last chapter, it is used to express *the ratios or prices* involved in the process of exchange – in India it is the unit known as Rupee. Look into any statement of accounts in India, personal, corporate or governmental, it is all expressed in terms of *rupees.* That is a good practice too, instead of in terms of a variety of goods owned, because comparisons and evaluations of relative value become possible.

If money is the unit of account, the *universal equivalent,* to use the technical term for this attribute, a third role of money becomes fairly obvious to all – it is a *store of exchange value*. Described in another way, it is condensed purchasing power. That is why all of us carry some of it with us whenever we leave our homes. It enables us to buy what we wish to have. In this sense it is also used as an *indicator of wealth*. Wealth, that is accumulation of purchasing power owned as exchange value, is a powerful link between the past, the present and the future and is a measure of economic activity and its outcome among individuals, groups and nations.

If the segments of economies and their activities have been changing and evolving over time, money as the link between them and the facilitator of activities must have been changing too. The articles used as money primarily as a medium of exchange have

changed enormously over time. In the example used in Chapter 2, we saw that paddy could have acted as the medium of exchange. The explanation for its use in primitive times is obvious. It was acceptable to everyone and was likely to last for a while without spoilage unlike milk or even banana. Other entities like cattle have been used as money, though its divisibility is limited, a disadvantage that paddy does not have. But apart from useful goods of this kind, stones and shells, which though not particularly useful, but were more permanent than either paddy or cattle were also used as medium of exchange, that is money.

When trading, or large scale exchange became common and long distance travel for trade was necessary, other forms of money had to emerge. A small trader travelling long distances could deposit a commonly accepted good with a large trader and carry a letter from the latter to another trader in a far away place known to him. The small trader could then exchange that letter for goods when he reached his destination. When this practice became common, letters from large traders, even though they had no intrinsic value, began to take on the role of money, because they were commonly acceptable in lieu of other forms of universal equivalents.

Consider another example. At one stage in the evolution of economies certain precious metals such as silver and gold were used as money. But there was a disadvantage in their use because these metals could have varying levels of *purity*, which affected the constancy of their value in facilitating exchange. Those who deal in gold know that 18 carat gold is not as valuable as 22 carat gold, the latter being more valuable than the former. Rulers whose authority was acknowledged extensively found a way out of this difficulty by issuing precious metal coins of specified quantity and quality with their figure, usually their head profile embossed on them to guarantee their *purity and weight.* The property of these coins that guaranteed their use as money was the *authority* of the person whose profile was on it rather than its intrinsic value.

Later in history, even a thing that did not have much intrinsic value, such as a piece of paper, could serve the role of money, provided it carried the guarantee of a recognized authority. That is how paper currencies became widely accepted as money. In our country, Indian currency notes carry the statement: "I promise to pay the bearer the sum of rupees…" signed by the Governor of the Reserve Bank of India, whose power to issue these promissory notes has been recognized by the Government of India, the highest authority in the land. But, neither you nor I as a bearer of a currency note of a particular value walks into a branch of the Reserve Bank and asks for the number of rupees *in precious metal coins* corresponding to the number of rupees on the note. We just pass the note on to another bearer in exchange for goods or services and he in turn to another and so on.

This reasoning can be extended even to international trade. The US dollar is generally accepted in global transactions as a means of payment because it is widely accepted, which means that it can be converted into any other currency in the world. On the other hand, the Indian rupee is not generally accepted because it cannot be converted to many other currencies and hence is not a *universal equivalent* in international trade.

We are forced into the conclusion that no matter what currencies are made of, what makes them *money* is their acceptance as mediators of exchange value. Acceptability in turn depends on the trust people have in that form of money and usually on the authority that is behind it. This is called the *fiduciary* characteristic of money. We will see in the next chapter that it is this nature of money that makes cheques, credit cards and other substitutes play the role of money.

Subject to this major consideration, other features will also be helpful for something to be accepted as money. For instance, its carrying cost must be low. It should be easily divisible. That is why usually a monetary system has higher value dollar, pound and

rupee, and low value cents, shillings and paise. Increasingly, these lower value monetary units are one hundredth of the larger unit to make calculations easier.

One might ask whether money should have any intrinsic value at all. We have seen that in the early stage of many economies, it was the intrinsic value of whatever was used as money that gave it that role. We seem to have moved to the other extreme in modern times. Ideally, what serves as money should not have any intrinsic value at all, because it is merely a representation of relative value among many goods. If money does not have any value at all, it becomes an entirely independent or abstract quantity in terms of which everything else can be valued. Money will then also determine what is of value and how much each item is valuable. This has some advantages, perhaps, for theoretical economic analysis. But it can turn out to be a dangerous ideology too.[6]

Mediated Transactions

Let us now pay some attention to understanding *markets*. The first step in a realistic understanding of the market is that it is a *mediated transaction* between a buyer and a seller, not between a consumer and a producer. This is for two reasons. The first reason is that in practically all real economies, as distinct from idealized theoretical analyses, the bulk of buying is transacted by producers who buy goods from traders to be used as *inputs* in the production of their *outputs*. These goods are, therefore, *intermediate goods*. Secondly, the producer's interest in the market is indirect. If he is producing for himself and his family, the market (the platform of exchange and its rules) do not enter into his calculations at all. If he is a carpenter and is producing a piece of furniture for someone else, on the basis of a specific order, he does not have to worry about the market. But, if and when he is producing to sell, the market will be of prime concern to

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6 Our discussion of money will continue in the next chapter because in practically all national economies of the present time, banks have a major role in money matters.

him. Then his appearance in the market is as a seller, trader or merchant. Strictly speaking this distinction between producer and seller holds even in the case of a producer who is producing for self-consumption, but goes to the side of the road to sell the little surplus she has.

More on Markets

With this preliminary observation about a primitive economy before the arrival of the *market* on the scene, let us probe into the phenomenon of the market. The term *market* is used to denote different concepts. In my younger days in a village, it was associated with a geographical location. If you were asked, "Where are you going?" the answer could be "To the market", as spatially specific as the school or the temple. The spatial dimension of the market has not quite disappeared for it is still common to refer to the vegetable market, fruit market etc., though the accent in these cases is probably on the commodity rather than the location. Note that the term *market* is increasingly associated with the *commodity* even when it is linked to a place. For instance, to say that the market for tomatoes is *poor* does not indicate anything about the quality of the tomatoes. The statement "the gold market has crashed" does not refer to the quality of gold available for sale or purchase.

It is obvious that the term *market* connotes transactions, the volume some times, but more often the *rate or price*. The claim that is usually made in association with the market is that the impersonal forces of the market establish the rate or the price. The element of truth in this statement was already noted in our treatment of barter where we saw how an alternative source of the good can and usually will change the rate of the transaction. We will consider some specific cases here. If there is only one seller, but many buyers, it is reasonable to claim that the seller will have the upper hand in deciding the rate of the transaction. This is the case in *monopoly.* The opposite case is *monospony,* where the single buyer has more power over rate determination. In the case

of *bilateral monopoly* where a single buyer confronts a single seller, it is not easy to specify what may happen. This situation has to be distinguished from barter because barter not only has two parties but two goods for exchange. Oligopoly is where there are few sellers and many buyers, as in the case of suppliers of telephone services and other utility services.

Based on these considerations, there is a tendency to theorize that moving from the limit case of barter to the most general case of large numbers of sellers and buyers competition among them will lead to the *optimal* or *equilibrium* price over which neither any individual seller nor buyer will have any influence. This is considered to be the *ideal* state of the market, because then it can be claimed that the *market sets* the price. Apart from the large numbers necessary to make this theoretical conclusion, there are additional conditions also that must be met. We shall point out and discuss one such crucial condition later. There are sophisticated methods for establishing this *theorem* and scientific papers and treatises have been written expounding it. Incidentally, this is what is taught in most of our class rooms of economics as the *perfectly competitive model of the market.*

Generalization and Segmentation of Markets

But what is the real life market like? We have established through substantive reasoning that exchange does not and cannot get generalized without the *mediation* of money and the *intermediation* of merchants. However, promoting exchange is not the primary objective of merchants. They are primarily interested in making profits through trade. We must explore what their own reaction will be in the real world when they face competition from other merchants.

If you are familiar with the situation from the experience of daily life, you will know that what each merchant tries to do under this circumstance is to make efforts to convince

the buyers that he is different from his competitors. This can be done in a number of ways. He may offer some special deal – the more common ones being the offer of discount for large purchases, to have goods delivered to where the purchaser wants it delivered, to provide some credit accommodation etc. Another merchant may advertise that the goods that he sells are different from what the competitors sell. Thus is easily achieved by merchants who manufacture goods that they themselves sell, such as bakeries do in India. When we turn to the *organization of production* in a subsequent chapter, we will see that most producers now gear their production *for the market* and hence must have more *creative ways* of selling their products. A standard way of achieving this goal is referred to as *product differentiation* obtained by branding of products. That is why there are so many brands of soaps, tooth pastes, TVs, cars….. etc. The close connection between product differentiation and engaging the services of *celebrity brand ambassadors*, can now be understood as part of the activities essential to being in the market as a seller. They are all attempts, individually and collectively, to carve out a protected segment in the wider market.

Where do all these activities lead to? Let us state it in somewhat formal language. *As exchange and markets get generalized through the entry of competing merchants, markets also tend to get segmented: that is, the generalization and segmentation of markets go hand in hand*.

This is the closest we can get to a *Law of Markets***,** as an empirically observed and logically derived statement.

Asymmetry of Information

Let us proceed further with the activities and strategies of merchants. We know that merchants not only store goods, but *information* as well. When they are competing with other merchants for a share of the market, a logical conclusion is that *asymmetry of*

information must be accepted as closely *intertwined with intermediation*. This may mean partial information or distorted information. Another inference we can make from this is that in a situation of generalized trading where merchants are intermediaries, it is not legitimate to assume that all participants will have equal information. *In other words, both product differentiation and informational asymmetry are inevitably associated with competition that enlarges markets and that they cause segmentation of markets.*

It may be of some interest in this context to recall that asymmetry of information became a topic of professional interest among economists only recently. Initially *asymmetry of information* was thought to be related to certain special category of goods such as a used car where the seller would have more information than the prospective buyer. So new was this approach to asymmetry of information at that time that it attracted a lot of attention and the author was awarded the Nobel Prize for his work in this new field of economics!

We made this detour, because it was necessary to understand the complex role of the market in *price determination.* One inference we can make is that markets do not *establish prices* over which any individual buyer or seller has any control. The main reason is that individual sellers are always striving to establish some element of monopoly for themselves, and this is especially true when competition increases because if a seller does not succeed in having a *market of his own*, he will certainly be eliminated from the market. The element of monopoly may be spatial, as is seen when street vendors have some agreement about *territorial rights* with their neighbours who are their competitor; related to product differentiation which is again an attempt to ensure that some degree of monopoly exists within the framework of competition: loyalty of clients created on the basis of a wide variety of reasons; strategic use of asymmetry of information, and so on. In effect then, the market does not arrive at anything that can even be remotely considered to be a *uniform price,* let alone *an*

equilibrium price. If and when you come across uniform prices, it is safe to infer that it is not decided by the market, but some external agency, usually *the State*.

The most reasonable explanation for the prices that one comes across in the market is that they are determined by the cost of production plus a mark-up. Ask anybody who deals with prices and this is the answer you are most likely to get. However it sort of begs the question of what determines the cost of production, providing plenty of scope for *theoretical* discussions and debates. Let theoreticians do their job!

We shall continue to understand the market *as it is, where it is*. Much more can be stated about the market from the seller's side, as for instance, the distinction between whole sale and retail markets. But the buyer is waiting to be attended to!

Purchasing Power as Entry Fee

One way of indicating the role of the buyer is to suggest that he has some preferences in his mind and some money in his pocket as he goes shopping. A great deal of *theory* has been built up about *tastes and preferences* and how they have a decisive role in determining the characteristics of the transaction. Who can deny that the buyer, particularly if he or she is a consumer has tastes and preferences, but who can say anything specific about them unless he is a mind reader? Yet, frequently introduction to economic course is through what is claimed to be the *theory of consumer preferences* where economic theorists cannot claim to have any special competence.

Fortunately, there is another way of exploring the role of the buyers in the market. Recall that the buyer need not be, and frequently is not a consumer and consequently, the theory of consumer behavior may not be the most appropriate route to understand the role of the buyer in the market transaction. We shall concentrate on the more objective

fact that the buyer has to have resources, represented by money, not necessarily in his pocket, but available to him through his bank, for instance.

But what exactly does it mean? Obviously one cannot buy any good without paying for it.[7] There is a common saying that the first lesson in economics is, "There is no such thing as a free lunch". Let us see what it tries to convey. First it means that if the buyer's assessment of the situation of transaction permits it, he or she will make an attempt to bargain for the good that he or she wishes to purchase. Bargaining does not need to be crude. It may take the form of an enquiry to the seller, "What discount will you offer", or "Will there be a reduction in price if I buy a large quantity?" Of course, there are situations where *open bargaining* is the *modus operandi* of the transaction – known as auction. The typical situation is where there are many bidders for an item, a rare good typically, where the extent of purchasing power is the decisive factor in the transaction. The good goes, after rounds of bidding, to the buyer who is willing to part with the largest amount of purchasing power, for something as unique as Mahatma Gandhi's spectacles or Sachin Tendulkar's cricket bat (or Sachin himself if the bidding is in connection with the IPL!). Another example of auction is where merchants bid on the beach for a catch of fish freshly brought from the sea.

A very important aspect of bidding based on or backed by purchasing power in the auction is that the final bidder walks off with the good excluding *everybody* else who had the desire to own it and had some purchasing power to support that desire. Actually, a bit of bidding takes place in most transactions, except that there is no visible sign of it. If most goods are in the market already priced (as is the standard situation now, and arranged in rows of shelves in the supermarket) the choices that a buyer has are limited -

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7 Note that we are not maintaining that one cannot get anything in life without paying for it: many things in life come without paying for, possibly the most important ones. Think about it.

to buy if he wants an item and can afford it, or walk away silently if he cannot afford it, a kind of binary operation resulting in *self-exclusion* from the market.

When we reflect for a moment, we see that this process of exclusion is the operating principle of the market. It is often asserted, that the market is open to all. That is not true. There is an *entry fee* to the market (understood as the process of transaction) which is not checked by any security officer. But you can be active in the market only if you are backed by adequate purchasing power. Otherwise, you stay outside, doing window shopping at best. If there is another law of the market, *this is it!*

However, don't jump to the conclusion that the market excludes anybody actively. The market indeed wants everybody in! There are arrangements by which such an outcome is almost possible. We have already seen that arrangement – segmentation of the market. An example will illustrate this. Suppose you want a cup of tea. Think of the numerous alternative sources for a cup of hot tea, all the way from the many five star hotels in the city, to the corner tea shop at a road junction, to the street vendor who carries around tea in a flask shouting, "*Chai, Chai*". Faced with all these alternatives, what do you do? Isn't it true (except when you have a friend with you, especially of the opposite sex, when the desire to impress may be the decisive factor!) that it is usually your pocketbook that makes the decision for you? Often you do not even think of the many options because there is not much point thinking of the many hypothetical options as the selected choice appears so natural. This is because there is a market to suit everybody, or almost everybody. Economists refer to this phenomenon as *segmentation of the market* based on purchasing power. Total exclusion is the rare limit case. But exclusion remains the operating principle of the market.

It is worth noting that market segmentation is not solely dependent on purchasing power as implied above. The tea served in the five star hotels is not tea, pure and simple. It is associated with an ambience of affluence – well laid tables, piped in music,

uniformed waiters at your beck and call…. There is, therefore, a type of segmentation based on product differentiation as well. To put it differently, most market transactions are *packaged deals.*

Think of other examples: the housing market which includes isolated mansions, exclusive villas, wide range of apartment complexes…. slums. Isn't the same true about clothes, furniture and almost everything in life? *To each according to his or needs and the ability to pay!*

On the basis of our exploration so far about the *characteristics* of *money and market,* let us draw some conclusions about the role of market**s** in a functioning economy like ours. First, as the operational aspect of exchange, it plays a useful role. It makes it possible for everyone to benefit from the division of labour because in its absence everyone or every small group like a household will have to produce all its requirements, which will mean life at a very primitive level. The possibility of selling in the market provides the incentive to increase production. The market is also a functioning distributive mechanism. It provides an opportunity for many people to make a livelihood.

However, the driving force behind the market is purchasing power derived ultimately by opportunities to earn it and the manner in which resources are owned and controlled. Those who do not have adequate purchasing power are systematically excluded from many segments of the market, which means under present conditions in India, a vast majority of people. The matter is more involved as we shall see later on in our continuing discussion. Many are incorporated into the market because they have no choice except to sell the only thing they have that the market is looking for, that is the limited power of their labour. But if they do not get paid adequately for it they will not be able to enter other segments of the markets which demand higher purchasing power. Go back to C households in Chapter 2 to identify those who have nothing except their labour power to enter into exchange. There are many such households who are eager to sell their

labour power. Some of it will be bought, but at terms decided largely by the buyers because they face a *buyers' market.* What they thus earn will be hardly sufficient for them to enter into other segments of the market. Many of them will also be totally excluded from the market in its entirety. Hence the slogan *"Leave it to the market",* frequently heard and claimed to be based on sound economic theory, effectively means "*Leave it to those who are well placed in life".*

Before concluding this analysis of the market in its multiple attributes, let me direct your attention to the commonly used expressions, *Buyers' market* and *Sellers' market.* As seen above buyers' market means that buyers are in a position to set the terms of the transaction and the opposite is true of the sellers' market. If you are planning to buy a house or an apartment, a friend of yours or your real estate agent may advise you to wait for a while because "there is a sellers' market now". This again shows that the market is not impersonal, a purely mechanical institution as it is often claimed to be.

In the next chapter, we will be coming across some of the real *players in the* market.

Chapter 5

Banking and Finance

Banks are extensions of the mediation that exchange makes necessary and one of their widely recognized and noted functions is to facilitate “cashless” transactions. You have a payment to make (obviously for something you have bought or received) and you write out a cheque authorizing your bank to make that payment from your account, that is, the money you hold there (deposited). If the payee of the cheque has an account in the same bank, a book transfer is made from your account to that person’s. Very convenient indeed, especially when you are separated by distance from the payee.

Credit cards are increasingly used to make payments. When you receive a credit card, an authorization is made by the bank about the amount you can draw on (extent of credit) depending on the banks assessment of your credit worthiness. When you hand over the credit card in a shop to settle a payment, the information is electronically communicated to your bank and it verifies whether the amount is within permitted limits. If so you sign a receipt acknowledging that you have used up the amount. The bank charges you for this facility and periodically asks you to settle your credit card bills. If you use debit card, the amount you can draw is limited to the amount available in your savings bank account and so it is rather like the use of a cheque to settle the payment, though a lot more convenient because the other party is electronically assured that you have enough amount in the bank to draw on.

Bank as Dealers in Money

But facilitating cashless transaction is not the main business of the bank. To understand this you have to consider why you deposit your money in the bank and the bank is keen

to get you to do this, even paying you to provide you safe keeping of your money. When you examine this you will see, may be to your surprise in the first instance, that the bank is an arrangement or institution which exchanges money for money! In other words, the bank as an intermediary trades in money.

This is related to the apparent contradiction about money itself. In one sense it is worth nothing; in another it is the worth of everything else. If that is too strong, think of money as command over other things, i.e. the power to purchase other things- purchasing power. That is why it is so much sought after; that's why it is stored. And storing money (for those who become its clients or customers) is one of the primary functions that banks perform.

Let us look at it. You come to have a lump sum of money (either as a salary, or through a sale, or by winning a lottery, or …, anyone of the many legally acceptable ways!) You don't need it all at once; that is, your spending of what you have received is going to be over a period of time. So, what do you do? You can keep it at home. But you don't think it wise, either because you don't think it is safe, or because you feel that once you have money with you, you may spend it all at once. Comes the banker who says, "We will not only keep it safe for you, but will also pay you for doing so. Come, deposit it with us."

How is the bank able to do so? Well, not everybody is like you; lot of people are in need of money for a variety of reasons and don't have enough of it. The bank looks out for people like that and offer them money – mind you, *your* money, not for free, but for a rate higher than what it pays you, the difference being the bank's earning for services rendered. So, you *lend* money to the bank, and the other person *borrows* money from the bank; and the bank is intermediary between the two of you. In this the bank behaves like a merchant who buys goods from those who wish to sell, stores them and sells them to those who wish to buy. So banks are intermediaries like merchants.

Banks as Intermediaries

But the intermediary role that the banks play has some differences. The crucial one is the intervention of time. You don't usually deposit money in the bank today to take it out tomorrow. You want it to be in the bank so that it will grow over time. The role of time is more pronounced in the case of borrowing. It is very, very unlikely that a person borrows from a bank expecting to return it immediately; while borrowing can be for consumption, usually it is for some long term project – collegiate education, for instance, or building a house.

There is another sense in which time enters into the operation of banks. When you deposit money in the bank, it is either what you had saved in the *past*, or because you expect to save for the *future*. This emphasis on savings also indicates that the basis of intermediation that banks provide is at a level different from what merchants do in exchange. The basis of the bank's intermediation is *surplus;* the bank converts monetized surplus into *credit* which forms the link between the past and the future via the present thereby certainly links the present and the future thus contributing significantly to the smooth functioning of the economy.

Lending is the more active of the functions of the bank; borrowing (accepting deposits) is to facilitate lending. The bank's role here is of a special nature. While accepting your deposit the bank assures you that your money is safe but it lends it to somebody else who uses it. It is a kind of having the cake and eating it too! The bank is *creating* credit.

Creation of Credit

What is the rationale? If the bank has only one depositor and one borrower, the bank is taking a huge risk relying solely on your intention to leave your money for a fairly long duration during which (at least a portion of) it can be made available to somebody else.

Otherwise your deposit will be just idle cash. But of course, any functioning bank will have many depositors who leave their money in the bank for several months or years (the 'term deposits'). Where such is the case, the bank will be relatively safe if it lends a good portion of the deposits as loans. Even where deposits are into 'savings accounts' from which the depositors can withdraw cash anytime, the bank will know from experience how much of cash withdrawals are likely to be in a day, week, or any given period. A loan given by the bank also becomes a new deposit on the basis of which further loans can be made available.

It must be noted too that where a bank gives a loan, to build a house, for instance, it does not give the full amount all at once. It will open a 'current account' and allow the borrower to draw cash as and when required. This is a safety provision in creating credit.

When we move from a single bank to a group of banks, the group (the banking system as a whole) is in a better position to create credit, while at the same time individual banks in the system may be taking more of a risk. Let us look at both these aspects. The group as a whole can create more credit because over all it will have a much larger quantum of deposits to back it. At the same time if the borrowers of an individual bank are from several other ones, or don't have any deposits at all, the bank is obviously taking a bigger risk.

But the banking system has measures to 'cover' the risk. You cannot walk into a bank and claim credit saying that banks exist to provide credit. You will have to establish your 'credit worthiness' and banks have several ways to ensure that extending credit to you is sound business. First, you will have to provide 'collateral', i.e., some assets, usually land or buildings or shares, which you pledge to the bank (mortgage). You can be sure that the value of the mortgage will have to be much higher than the credit the bank gives you! If you can provide such backing for your loan, why do you go for a loan in the first place? The answer is that the asset you pledge is not liquid, whereas the loan you get

from the bank is, which means that you can use the loan to purchase other things whereas your asset (let us say your house) cannot be used like that. Also you can continue to *use* the house even if it is mortgaged to a bank but the bank will ensure that you cannot sell it (the right to alienate which ownership of the house confers on you). And how does the bank ensure it? By asking you to part with the title deed as long as you have the loan obligation. Similarly if you buy a car which is being financed by a bank, the car is 'hypothecated' to the bank till you pay up the full amount. The bank is thus separating two features of ownership, the right to use and the right to alienate. By doing this the bank enables you to use an asset that you have and *leverage* it to get a loan which can be used to generate more assets.

In assessing your credit worthiness the bank resorts to other measures as well. For instance, the bank will make enquiries about your past performance as a borrower, whether your track record is good. And while it may sound odd, you will have greater chance to get a new loan if you've been a habitual borrower in the past and has a clean record of repaying also. First time borrowers have a tough time. Even when you try to get a credit card, one of the standard queries is whether you have any other credit cards and if so from which other sources. To put it differently, if you are already in debt it is easier for you to get credit!

A second way an individual bank protects itself from the risks of lending is to have arrangements with other banks to borrow from them if suddenly there is a demand from its borrowers and depositors for cash. Those banks, in turn, may find themselves in the same position some other time. So this is a kind of mutual security arrangement.

Banks do this because if there is any doubt that a particular bank is not able to pay cash for whatever reason, its depositors will immediately queue up to withdraw their deposits and thus create a "run" on the bank. This is not a hypothetical situation either. Many banks including some of the largest and most powerful banks in the world, such as

Lehman Brothers of the United States (in 2007) have faced such situations. And while banks usually compete with other banks every one of them knows that a run on any bank, even its biggest rival, will adversely affect it also. This means that the successful banking operations of banks depend crucially on the confidence that the banking public has in the soundness of the system.

Central Bank

Recognizing this fact, public authorities (the state) make arrangements to protect the banking system as a whole within their jurisdiction. The commonest of those is to set up a Central Bank to supervise and advise the banks and to regulate their operations. In our country this responsibility is with the Reserve Bank of India (RBI). It is an independent body with a variety of functions and responsibilities (usually referred to as 'monetary policy') but in a broad sense working in tandem with, and ultimately responsible to the Government of India.

One of the powers of the Reserve Bank of India as the country's Central Bank is to require all banks to deposit with it a proportion of their capital to be held as reserve (known as Capital Reserve Ratio, appearing as CRR in the news media). It is an effective tool to regulate the extent of credit that the banking system can create. Thus, when credit has to be restricted or limited, the RBI puts up the CRR and banks will be forced to take note of the signal. The RBI will receive deposits from the banks paying a rate of interest (known as repo rate) and banks can borrow from the RBI at a rate higher than the repo rate (known as the reverse repo rate). These are also used by the RBI to control credit. It can be easily seen that an increase in the reverse repo rate will be a signal to put a break on credit expansion. The banks then put up their lending rates, on housing loans, car loans etc.

Lending Other People's Money

We can now turn to a more detailed discussion of the main function of banks*, creation of credit,* and making it available to those who want to borrow from them. Let us note that the deposits that you and I leave in the bank reflect savings (savings accounts and term deposits, the latter taking different forms). Borrowers borrow for a variety of purposes (to conduct a wedding, to make a tour, to finance the purchase of a car, to build a house, to construct a factory and so on). When the bank gives a loan – creates credit – for these purposes note that it is not giving out its funds, but your money and my money. In general, then it is dispensing out other people's money. Credit, therefore, can be said to be OPM! And borrowers can be said to be playing with OPM.

This is the first statement we need to make about credit. It is a statement of fact, not used in a pejorative sense because it can be shown to be good to promote economic activities. Let us say that an industrialist borrows money from a bank to build a factory and fabricate some machines to bring out a new product. All this takes time, of course, but when the process is completed a new product becomes available, many people find employment, their productivity goes up. The act of the business man is investment, creation of goods (including the well we saw in Chapter 1) that raises productivity in the future. Such goods are called capital goods. Investment is therefore, the activity that results in capital formation (Unfortunately in everyday language 'investment' has come to mean a financial transaction such as when you say "I invested Rs 10,000 in mutual funds"). We will soon come across this. Recall that if your savings and mine were to remain in our own safes, that factory might not have come up at all. By mobilizing our savings and making them available to the business man as credit banks thus perform a very useful service. This is because many who save do not wish to take the risk of going into production to generate capital goods, and those who invest do not save enough to do the kind of investment they are capable of. Hence when savings decisions are made by one set of people, usually households and investment decisions by another set of

people, industrialist as individuals or through 'firms' or companies, banks perform a very desirable role of acting as intermediaries between savers and investors. This is the primary mediatory role of banks, not the mediation that occurs in the daily purchase of goods with cheques and credit cards.

In the next chapter on the organization of production we shall see more about this aspect and shall note also that the savings and investment decisions are not always done by different sets of people (the household in Chapter 1, after all makes these decisions almost simultaneously) and in later chapters we shall look into some problems that arise when the savings and investment decisions are made independently by two different sets of people.

Concentration of Resources

But let us continue with the role of banks. Banks mop up money that remains idle from large numbers of economic units, primarily households. In relation to any one of its depositors the bank as another economic unit is likely to be much larger and stronger because it manages to mobilize the smaller amounts of its customers. That is the first step in a process resulting in the concentration of purchasing power and therefore of economic power.

Once a significant amount of money is mobilized, banks begin to disburse credit. On this side of its business also they will have many and different kinds of customers ranging from those who have great difficulty convincing banks of their credit worthiness and providing collaterals acceptable to the banks to those whom the banks are eager to have and may go out of their way to persuade to be customers, borrowing from them. In fact, in respect of such customers a bank may not even want to use the expression 'borrowers' preferring instead to say that "so and so is one of our valued clients" or "we are privileged to have so-and- so doing business with us". And who are these high profile

customers? They are the big traders, the big producers, the big businessmen – anybody who is big in terms of their money power. More often than not, they are not even individuals, but corporations that have legal sanction to use OPM!

Why does the bank do this? Obviously because it is from big money that the bank makes its profits, and as an intermediary the bank's concern is its profits.

The implication of this attitude and arrangement should be not difficult to see. A major collateral of big concerns is that they are already indebted to some other bank. Banks compete with their professional rivals (other banks) to capture the business, offer them competitive rates. The 'borrowers' too bargain with different banks and finally a deal is struck which provides what appears to be a win-win deal for both parties. Thus, those who already have come to have some more – a second procedure leading to concentration of economic power.

The difference between a small borrower and big borrower should be noted. In the case of a small borrower, there is hardly any bargaining about the conditions of the loan. The bank lays down its terms and it is "take it or leave it". In the case of the big borrower there is invariably a process of "negotiation" of terms and conditions. Practically all big borrowing is a "package deal" which provides for negotiations on different aspects of the package, the bank yielding on some and the client asking for better deals. Those who have economic power, whether inherent or borrowed will be able to 'leverage' it to get more and at favourable terms. *Money not only talks; it gets things done.*

In short, the banks – one of those economic institutions modern economies can hardly do without and are unavoidable facilitators in many ways – have the built in propensity to reinforce, quite solidly too, the system's inequalities and to lead to pronounced concentrations of economic power.

Let us note too that the banks and their favoured clients are big players in the market. They are the ones who finance and undertake production; they are the ones who deal with trade. Whether you deal directly with them or not, they are influencing your lives.

But there is more to come.

Finance

Many people say that they do not understand finance: some are ashamed of it; some are proved of it. If you belong to either of these categories pay special attention because finance is indeed more difficult than markets and banks but they play an increasingly prominent role in the contemporary world.

Finance as Extension of Banking

Finance, actually is an extension of banking. Let us go a little deeper into this connection. We have already noted the link between banking and surplus. When you deposit your money in the bank, especially on long-term deposit, you are entrusting your surplus in its monetized form to the bank for safe keeping *and* growth. In return the bank gives you a sheet of paper*, the deposit receipt* which you will consider as part of your *asset. Note that your asset is liability for the bank,* just as when you take a loan from the bank it becomes a liability for you but an asset for the bank. There is a more important issue here. Your surplus which is the basis of a component of your wealth changes form into a sheet of paper -- increasingly, even just a record in a computer system. You may also have physical forms of wealth such as land, buildings, cars etc. But a major stage in economic evolution is when wealth comes to be represented by proxies or tokens – money, bank deposits and yet other forms that finance generates. This is the link between money, banking and finance. All of them deal with wealth generating a variety of proxy forms of wealth in that process. Production which alone actually generates

surplus and wealth is supposed to be serviced by money, banking and finance, but these intermediaries also have a way of delinking from production (of goods) and becoming short-cuts to the generation of proxy wealth. Watch the show in this chapter!

Proxy Wealth

Let us start with some of the options if you have some surplus. If you are interested in seeing that it grows over time, you know that there are options other than depositing it in a bank. How about 'Mutual Funds'? You don't say mutual funds 'borrow' money from you. The representative of some mutual fund may approach you and give you a sales talk on the many advantages you will derive by 'parking' your money with the company concerned. You are assured of a good 'return'. It is like the interest you earn on your bank deposit, except that it is not a fixed rate. You will be told that the return you get (called 'dividend') will depend on the overall performance of the fund. Secondly, you will be told that parking your money with the fund is a highly 'liquid' option, meaning that you can sell your certificates anytime you want to and convert them into cash because there is a 'market' for them.[8] Above all, you will be told that you have a good chance of capital appreciation, that is, increase in the value of the amount invested, especially if you are willing to park for a longer period. This means that over and above the dividend you got annually, let us say 10 per cent in the first year, 9 per cent in the second year and 14 per cent in the third year, you may be able to sell your mutual fund certificate of Rs 100 for Rs 150. Great deal, isn't it?

But things are not as simple as they seem! If you have seen a mutual fund advertisement in a newspaper or on TV, you would've noticed at the end a 'statutory warning' (meaning that the warning *must be* carried as part of the ad) to the effect: "Mutual Funds are

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8 You can encash --'close' is the expression used – a fixed deposit in a bank also, but there is a penalty attached; usually you will get only 1 per cent less than the agreed rate of interest.

subject to risk. See the details in the Prospectus". Why is this so? Because the dividends you get can turn out to be as low as (let us ay) 3 per cent per annum and, what is even worse, instead of a capital gain you may end up with a capital loss, because the value of your Rs 100 certificate could have plunged to Rs 50, Rs 30 or even less!

In that scenario we have captured the difference between banks and finance. Banks deal with time and money; finance with time, money *and* risk!

Let us seek some clarification on this new component which differentiates between banks and finance. Mutual funds mop up surplus funds from those who have it as banks do, but in turn 'park' them not with themselves (mutual funds do not keep your money) but invest them in another form – 'shares' -- for which there is more of a market than mutual funds themselves. The presumption is that its operators know how to select appropriate shares of companies and when to trade in them better than you do. They are taking a risk and so are you. This is one of the simplest of financial transactions and yet you see risk surfacing as a major factor.

Let us now look at another pattern of tapping OPM, other people's money, used by the financial system, without borrowing. That's what 'shares' are all about. You probably own some of them; if so you are among the very top section of the population of the country, though many claims are being put forward that we have already entered the era of 'people's capitalism'! Note that if you have shares you say you *own* them, whereas you only *hold* mutual fund certificates, though in both cases it is from your resources that you came to be in possession of them. The distinction is important because in the case of shares you've become an *owner*, a business partner of one of the top business concerns in our country -- let us say Infosys or The State Bank of India. You probably did not know that because you've had no direct dealings with either of these giants. You just picked up, through an agent most probably, these shares form the market. This is one way finance makes even ownership a commodity.

Let us see how this is done. First, not everybody, every business concern to be accurate, can issue shares – the technical expression is 'public offer' of its ownership. The organization (for which let us use the familiar expression 'company') has to be fairly large, must have been in business for a while and must have had credible operations in the past. Its proposal to make the public offer has to be scrutinized and approved, including the amount it wishes to raise, say Rs 1000 crore, by the appropriate authority. Then the company must make public announcements about the offer and invite applications. The shares are usually priced Rs 100 these days though the company has the option of fixing a higher initial price, say Rs 300. The response from the public, as is well known comes largely from other big companies. The applications for a certain number of shares, along with payment of the amount due are submitted. The chances are that the offer is *oversubscribed* indicating that the total applications far exceeded the number of shares. If so the company will *allot* shares and you would be lucky if you were to get a few shares. But if you do, you've become a 'share-holder', that is, owner of the company which means, theoretically at least, that you can get a chance to shape its policies.

But don't get excited too soon! The policies of the company are decided at the meeting of the shareholders, the annual general body meeting, AGM, where the principle is *one share, one vote*. You know then who will shape the policies. There is a descriptive title "sleeping partner" to describe petty shareholders, possibly the vast majority in terms of numbers.

What happens during an initial public offer is a tortuous story, and the chances are that you didn't go through such a tedious route to get your Infosys shares. It is more likely that these shares were available in the *secondary* market and you just bought them through an agent. That is another interesting thing about shares – they have a primary market and a secondary market and the latter is the more active and, indeed, hectic.

Literally every moment of the working days large volume of transactions in shares take place and the forces of supply and demand reign supreme. When the demand for the share of a particular company goes up, price goes up too and when supply increases price slumps.

Finance as Market for Proxy Wealth

But why is this so? Buyers usually secure shares not to hold on to them, but to make profit through trade. Expectations differ. Those who expect the prices to go up will hold on for a while, those who are afraid of the price coming down will sell. Those who think that they have made enough of a profit will *book for profits* and sell, bringing down the price of such shares. There may be a few underlying factors determining the mood and momentum -- 'sentiment'-- of the market, but the actual situation is anybody's guess. No wonder we talk about *bear* and *bull markets.* Speculation is the standard method. It has been rightly stated that your success in the market will depend on knowing better than the market what the market will be like! Because of this you can see how crucial asymmetry of information will be in financial markets. The larger number of intermediaries that the financial system gives rise to, the greater will be their advantage to create and maintain *asymmetry of information,* compared to the many buyers and sellers who have limited access to information. Under such conditions if the former take advantage of the situation, is that a matter of surprise? *Insider trading* is the expression used when an intermediary takes advantage of his knowledge to mislead some unsuspecting buyer or seller.

Such being the case, owning and dealing in shares is a rather risky proposition. When you buy you stand the risk of the price coming down, and when you sell you take the risk of the price soon going up. Only those who have the resources to take such risks usually enter the share market.

Not that all financial products involve risks. Companies – and more so the government – directly borrow from the public by issuing 'bonds' which promise a fixed rate of interest. Government bonds in particular, are long term ones; in addition there are 'bearer bonds' which means that irrespective of who the lender is the interest is paid to whoever happens to be holding the bond on a particular day. Those who want an assured income and cannot afford to lose any of the funds they possess--Trusts being the typical example – go in for bonds: they are safe, give a steady income and are highly liquid.

Proliferation of New Financial Products

There are other financial products also some of which we shall describe later. But a very significant aspect of financial products is that they have a built-in propensity to generate additional markets – there is a *round* of selling and buying, which triggers further transactions, a second round, a third round and so on. With each one of these rounds new intermediaries emerge, and instead of spreading information about these transactions widely and quickly, it gets filtered, delayed and distorted, adding to the risk generated by ever widening asymmetry of information. There is another factor that reinforces this inherent tendency: introduction of new *financial products* that may provide greater gains with higher risk is easy because cost of production of these virtual products is extremely low, and success of financial intermediaries often depends merely on their ability to convince those who can spare monetary resources that the new product can be profitable. But that assurance can be valid only if what is bought can be sold at a gain which often is problematic.

Thus proliferation of new products, new intermediaries and new purchasers is a feature of finance – but all these are possible only with ever increasing risk. In fact, it may be even worse, because a qualitative difference becomes part of the nature of risk. Individual buyers and sellers can to a large extent protect themselves against risk through appropriate insurance coverage. But as more and more individuals enter the

fray and products with different risk-and-gains possibilities appear in the market, what had been individual risks can turn out to be *systemic* risks which often is not perceived and cannot be insured against because the insurers themselves are players and get caught up in the whirlpool. A meltdown becomes inevitable and *a financial crash* results.

The Global Financial System

This is what happened at a global level in 2008 and the best way to examine it is to describe briefly what happened and how. It will also give us an inkling of what we mean by *the global financial system.*

It all started in the United States of America, the world's largest economy, the world's biggest military power and because of the combined effect of the two, the world's acknowledged political power. When we deal with a real historical event it is difficult to decide where to begin, but let us start with the banking system in that country in the 1970s. Banks in the US received large sums of deposits during that decade from American citizens and residents but also from foreigners. You may recall that during that decade the petroleum producing countries of the world raised the prices of petroleum products twice, in 1973 and 1979. These countries had to decide where to deposit the sudden increase in funds they came to have. They deliberated, considered the possibility of lending some to poorer countries for their development and finally decided that the best place to park their windfall was the US, with the US government and the US banks known for their strength and stability. The main reason was that although the US dollar was not as strong as it was a few decades earlier, it was still the only globally accepted currency.

As a result of the enormous flow of funds into the US banks, they were very eager to lend. They gave loans to many countries (which got into 'debt crises' later because of poor management) but were eagerly looking for ways to persuade Americans to borrow

as well. That was not very difficult. There were numerous “buy now, pay later” schemes to encourage unsuspecting people into borrowing without recognizing that they were running into debt and mortgaging their future. Easy availability of credit cards was one such trap.

The banking system’s credit expansion scheme led to new credit instruments and institutions which developed into what American bankers and financiers came to celebrate in the 1990s as the ‘new financial architecture’ **(NFA**).

Let us explore how the financial disaster began to take shape gradually gathering momentum as it proceeded to end up as a crash. We have noted already that when banks lend money they come to have collaterals of various sorts. When credit expands and collaterals increase, several secondary markets emerge subsequently. The main reason for this is that many of the collaterals are ill-liquid and ‘non-negotiable’ meaning that they cannot, strictly speaking, be used for anything other than what they are meant for. However, there is nothing against repackaging them into different sets of new financial instruments and making them available to others if there are individuals or institutions willing to accept them as sound investment for their stored up wealth to generate more income and more wealth.

Let us see how this is done. Loans that a bank makes, backed by collaterals, are its *assets*. But they tie up its funds for a long period. When it wants additional funds, one possibility open to it is to repackage the loan into other forms of securities and sell them to agents who are willing to take them on and sell them again hoping to make a net profit. Remember that loans granted over a period of time may have different rates of interest and, if the interest prevailing at the time of purchase of the new securities is generally *lower* than the average in the package they can make a profit. However, there is risk involved as some of those who have borrowed from the bank may default in their payments. The default from one end of the chain travels to the other worsened by the

fact that there are several intermediaries on the way and each had added a profit margin for its involvement in the creation of the chain. Any perception of the possibility of the chain breaking initially causes panic and ends in a crash.

Securitization and Derivatives

Or, take another example. You have several credit cards and each one has its own terms and conditions. A new financial agency which has the necessary permission to do so approaches you and offers to consolidate *all* your credit card payments into one payment on its own terms and you agree. This is a new intermediary on the scene with a new product and with a new assessment of risk -- that is *securitization.*

A generic name used for these new products is *derivatives* because their value is derived from another (debt-related) instrument. The most striking fact about them has been the rate at which they have been proliferating: first, second, third… generation ones, those that bear different names (to show that each is different!) such as *Collateralized Debt Obligation* (CDO) *Collateralized Mortgage Backed Securities* (CMBS) and so on. Indeed there were CDO^2, CDO^3, indicating successively new and more powerful generations! This product differentiation process was facilitated by breakthroughs in desktop computing and the entry of highly qualified academics into the world of finance (PhDs in economics, statistics, mathematics and so on from prestigious universities) who could rearrange asset classes depending on even slight differences in the value of assets, rate of interest, risk and so on.

It was not only business concerns that were involved with these forms of freshly manufactured assets. As recently as the mid1980s, 75 per cent of household savings in the US was in the form of savings accounts or fixed–interest securities; by the end of the 1990s the position changed substantially with about the same per cent chasing the high

profit, though risky new assets. Nobody wanted to miss the chance to make additional incomes.

Investment Banking and the 2008 Meltdown

With these changes came a new set of banks who styled themselves as *investment banks*, which included powerful private bodies, well known corporations such as Lehman Brothers, Goldman Sachs, Merrill Lynch, who in no time became the biggest players in *the market,* who were the highest profit making bodies whose shares, therefore, were sought after by everybody and whose chief executives were among the highest paid professionals in the world.

Along with these developments there was a lending spree also, particularly in the housing sector in a country which boasted to be a "property owning democracy". Banks were competing to lend to those who wanted to have a house of their own which resulted in a real estate boom. To encourage this situation to continue, banks were willing to lend even below their standard mortgage rate creating what came to be known as *sub–prime lending.* They relaxed other conditions associated with lending to offer *ninja* -- no income, no job, no assets – loans. Everything was fine for a while.

But inevitably there were more and more defaulters as could be expected as the loan terms and conditions for mortgages were relaxed. By 2007 doubts were beginning to be expressed about the sustainability of the real estate and housing boom. By the middle of that year, it was public knowledge that two major financial institutions called 'hedge funds' were in trouble. By the fourth quarter financial giants like Citibank, Merrill Lynch, Lehman Brothers, and Bank of America had to announce major write downs on their balance sheets.. Even big insurance companies that were merrily underwriting the operation of these giants were in trouble. The Federal Reserve System (The Central Bank of the USA) whose former chairman who was an outspoken advocate of America's 'free

enterprise system' and under whom the NFA had evolved and who found in it "a new paradigm of active credit management" had to admit that things were not moving in the right direction.

And then in September 2008 Lehman Brothers which was a broker and guarantor to many of the collateralized debt services went bankrupt even though it had shown a huge net revenue and pre-tax profit in 2007.. The next to fall was the global insurance company AIG.

The US government (under President George Bush) adopted a standoffish position till then partly because of the ideological consideration that the market would correct itself, but also because there was strong opposition to spending 'public' money to save or support 'private' firms like Lehman Brothers. But the crisis and panic was so intense that a wait and watch position was no longer tenable. The 'Fed' brought down its rate almost to zero to enable banks to borrow funds from it to tide over what was acknowledged to be a severe, but still considered to be short–term crisis. The Treasury also decided to pump in $700 billion to enable banks to lend more on the assumption that the crisis was one of liquidity, shortage of money in the system. The real issue, however, was the insolvency of many big financial institutions as a result of profit–chasing recklessness. And so in 2008 it had to be formally acknowledged that NFA, America's pride and success symbol of its powers of invention in the field of financial services had crashed sinking the world's biggest economic power into deep crisis.

The nature of that crisis is also worth noting. The most visible was that millions of shareholders of the big companies that became insolvent lost their hard earned life time savings. Ordinary employees in those companies lost their jobs. The failure of banks caused big trouble to production and manufacturing units – General Motors and Chrysler among them. Hence unemployment became wide spread.

And, of course, the crisis in no time became global as well and created a world-wide recession.

But – watch this paradox – the top executives of none of the fallen companies in Wall Street lost anything. They got their salaries and perks; their arrival in Washington D C in their private jet aircrafts to negotiate with government officials to bail out their companies became the cruelest joke of the season in the Main Street. The recklessness of some of these top executives in taking risks was due to the conviction, backed by previous experience, that if there was to be a collapse caused by private agencies and institutions the government would come up with bail out packages in the larger public interest. According to a well-documented case, a private equity firm claimed to have 'created value' of some $100 million by laying off workers, but the partners who managed the firm gave themselves a bonus of $1 billion for their commendable performance!

That too is an inherent part of 'the system'.

I hope you are not too weary by the tedious description of this initially American but soon to become the global economic epidemic of the immediate past the treatment for which has not been successful so far. But it is a true account of what an unbridled financial crisis of one country does to the world at large when it spreads like wild fire.

Trade, Banking and Finance as Manifestation of Mediated 'Market'

So let us close this chapter with a brief summary. Banking and Finance are extensions of the Market. Their main trade is money and stored up money (or wealth) which takes many different forms. Hence they are also real and powerful instances of the intermediation which is the main characteristic of the market. Trade, banking and finance – these are the tangible ways in which the intermediation manifests itself. There

are the intermediaries also: merchants, bankers and financiers. Merchants trade in goods; banks in loans (credit); financiers in risk management -- that is the sequence of the chain. All of them perform socially necessary and useful marketing functions. But their primary motive is profit for themselves, and when that motive becomes unbridled and turns into greed for quick profits -- a steed with wings -- there is hardly anything that can tame it. It takes some of them, a few at the top of the system to the skies while everything and everybody else crashes to fall back to earth! That is the nature of 'the system'.

One more comment is necessary here. Those big market players and the institutional arrangements they create and lead are often represented as the Private sector of the economy as against the other big P, the Public Sector, the State. This is a false representation. If you and I are the *real* public, then the banks and financial organizations are public too because they are not playing with their private funds, but with our money. They mobilize the 'public's' money and play with it. Hence they are public too, and the public – that's you and me and all the ordinary folks like us – must have a say on matters that they handle. It is not easy to specify how this is to be achieved, but we shall return to this question soon in Chapter 7 where we discuss the role of the big P in the economic system.

But before we do that, in the next chapter we shall examine production as a social activity. This is not to say that we be saying good-bye to the market. We don't and we can't. For, in practically all modern societies the market is the central economic institution and it has a way of popping up here and there, also every now and then. Look for it as we continue our tour.

However having established the relationships and the constant interactions among the three territories of the market – goods, money, and risk – we may pause a while to reflect on what their interactions mean for a proper understanding of what the market is

and what it does. The first comment is that there is a tendency to compartmentalize the three which may be necessary for academic study and investigation, but they do not exist as separate entities in the real world. Historically, of course, they denote three stages of the evolution of the market, the market for goods being the earliest, the credit market being the next to emerge and the sphere of dealing with risk as the third market emerging last. But there was no big gap between the emergence of the goods markets and the credit market, though the financial or risk market came much later. Second, even if the market for goods is *the market* for most of us, we are already in a stage where the word 'market' has almost come to be identified with the financial market. Think of the widely used expression, 'market sentiment' which conveys that only financial market (or more specifically financiers!) has sentiments. One plausible explanation for this expression is that the financial market is prone to frequent volatility and hence sentiments become very prominent.

Third, through the interaction of the markets is constantly evolving, In recent years the most rapidly expanding one has been the financial market. Look at these figures for 2006. The value of the world's total output (goods market) was around $47 trillion; of derivatives outstanding some $473 trillion! But the credit market and even the goods markets are expanding too. We know of the latter judging by the wide range of new goods that become available on day today basis.

Ongoing Marketization

Even the goods market is constantly engaged in bringing more and more goods under its domain. An important aspect of it is bringing into the market (that is commoditizing) what was kept out of it. Let me give you two examples, one from history and the other from our recent experience. The historical example is from Britain where for ages land and labour were kept out of the market, land because it was considered to be nature's gift and labour out of a feeling (conviction if you like) that human beings and even their

labour power, were not to be bought and sold. In fact, to prevent this from happening, each 'parish'-- the local community – was obliged to take care of those who did not have their own means of livelihood. These provisions were known as 'poor laws'. From the early part of the 19th century when those who had enough money (the 'capitalists') wanted to set up factories for which they were desperate to purchase labour power for 'wages', they mounted a campaign saying that the poor laws were making people lazy and that production would increase only when people learned that if they did not work for wages they would have to starve. Many parishes were pressurized to withdraw their poor laws, and in 1848 (as recent as that) the poor laws in the country as a whole were legally abolished. Thus labour power was formally recognized as a commodity.

The contemporary example is the sale of water. In my younger days it was considered to be one's moral obligation to give water free to anyone who asked for it. It would have been shocking if there was any instance of selling water. The same feeling probably prevails in the rural areas even today. In the urban areas too there was no public sale of drinking water till recently. Even in the early 1980s if you were travelling by train, every major station had arrangements for providing cold drinking water to the passengers free of cost. But by the end of that decade bottled drinking water started appearing in shops and stations for sale. And in no time the provision of free drinking water became extinct and bottled water became a widely sold and a highly profitable commodity. A secondary market for that commodity has also emerged!

Another contemporary instance of the spread of markets is in the realm of sports and games. Have you noticed that practically all of them have been not only commercialized, but that they have become avenues of big business? And even the auctioning of sportsmen*, human beings,* has become so common that it does not shock us any more.

Invisible Hand?

Does this mean that the market has a life and logic of its own, some sort of 'Invisible Hand' steering it? That is another myth about the market: that it has 'laws' of its own; it works best when it is left alone without human interventions. But we have seen that the market is very much an evolving social institution initiated by human beings and always under human control, though difficult to control situations do arise similar to stampedes in a crowd when an unexpected panic strikes. Then why has it acquired a kind of supernatural aura in certain circles? The answer must be pretty obvious. If the market is allowed to function without external intervention it will be to the advantage of those who control and manipulate it: it is that simple! The tragedy is that there are academics ready to use their economics and mathematics to derive 'theorems' and their proofs to peddle their *ideology* of what *the* market is and how it functions? These are some of the best minds of the past and the present that the world has seen; but many are naïve followers who, without applying their minds, are willing to propagate the ideas of the 'great minds'. That being the climate it is easy to make use of any unverified and unverifiable assumptions as basic principles and then churn out theorems and models to propagate what they have already decided is the valid position. Socrates said: "The unexamined life is not worth living". It is worth pondering whether theories and models based on unexamined premises can be relied on to formulate policies in real life situations.

Part III

PRODUCTION AND AGGREGATION

We started with an understanding of production as a basic economic activity and how it leads to the relations of production. Production takes place in and through specific production units such as farms and factories. In Chapter Six that follows, we shall look into production units in greater detail. The Chapter bears the title 'The Organization of Production' to remind ourselves that the 'units' are not merely physical ones showing differences in size, location etc., but are social entities reflecting different kinds of relationships.

The economy is a multi-layered entity. At one level it is a production unit. But a collection of these units in a geographic area such as a country can be thought of as an economy at a higher level, usually as 'the national economy'. Treatment of the economy at such different levels cannot be the same for at least two reasons. The first is that at the lower level one concentrates on a single economic activity, usually production which is internal to the unit concerned. The unit has external links as well, such as trade with other units. When we move to the higher level, production and transactions together become internal to it. Secondly, money and the valuation of variety of goods produced that it makes possible, facilitates an aggregation of the economy so that one can speak of a measure the (total) output of the economy at the higher level, the national economy. Among the many branches of knowledge about society (such as sociology and politics) this method of aggregation is unique to economics. Special features of the economy at a higher aggregated level are treated in Chapter Eight.

The in-between Chapter Seven deals with one of the units of the socio-economic order which the territory that the polity and the economy share, the State which is the locus of authority and therefore has special features of its own.

In Chapter Nine we move to yet another level of the economy whose units are national economies. It is now widely known as 'the Global Economy'. One of its features is that it also has trans-national units. Yet with these different types of units it does not have a 'state', the locus of authority. This absence of authority is made use of by the strongest element in the system now, namely finance to extend its sway to all parts of the globe.

Part Three therefore promises to be an exciting segment of our tour. You will have to be really alert not to miss its subtleties!

Chapter 6

Organization of Production

Production is the first economic activity of human beings and in its primary sense is human interaction with Nature, human beings working with land, Nature's endowment, as we discussed in Chapter 1.

There was an earlier stage when human beings were gatherers of fruits, roots and leaves, but that too was interaction with Nature. In our *modern* era, it is so easy to forget how dependent mankind is on Nature. Indeed, is it not true that we, particularly those of us who claim to be civilized because we live in cities, think of Mother Nature only when she appears cruel and perverse to us during occasions of storms, floods, earthquakes, and tsunami – forgetting that often we plunder and rape her. Yet, despite human folly, Nature is still forgiving and giving, indeed remains, to use the words of a poet, the "wellspring of the joy of living." We need to constantly remind ourselves that like our early ancestors, we are still gatherers of nature's bounty and need to be grateful and be responsible stewards.

Agriculture

Settled agricultural production is a relatively recent development in the long history of the evolution of human beings, only about 15,000 years old. But it is significant because it is through *settled agriculture* that humans became active and sustained participants in production, demonstrating that they can not only gather what Nature provides, but also cooperate with Nature in the generation of goods that were essential for their survival. While it is possible that even in gathering the bounty of Nature, some rudimentary tools were used, it is in the context of agriculture that human beings started inventing and producing tools.

Our interest is primarily in the characteristics of production and the organization of production. In Chapter 1 we explored certain limiting characteristics of primitive production including the law of diminishing returns, which as we recognized is an affirmation that factors of production are not perfect substitutes for one another. In the context of agriculture, it means that households need land for agricultural production. Even when such an observation may seem trivial, we can conclude that in the organization of agricultural production, the availability of land and labour plays a decisive role.

Peasant Farming

Let us briefly review the household interactions that we came across in our thought experiments in the early chapters of this book. First, we had *isolated* single households, described as type A. It does not face a land or labour constraint and therefore, the level of output is determined merely by the needs of the members P and the willingness of the W members to provide labour. To specify the organizational structure of production, we take note of one significant fact; they are producing *solely* for their own use. In the situation of the *isolated* household, this is eminently true. We can combine all these facts and describe an organization for agricultural production as consisting of those who use their own land and family labour and produce exclusively for their use. Such units have been referred to as *peasants or peasant farmers.*

We can infer many of the characteristics of peasant farmers in real life. First, they do not have to be isolated units. More often than not, several peasant farmers may live side by side as good neighbours without entering into any *inter-unit* interactions. Second, they are all likely to be producing a basic food item, paddy that is used as their staple diet. Third, since they are dependent on climatic conditions for the production of paddy, all of them will be following similar production-oriented calendars preparing the soil, sowing

the seeds, weeding, transplanting when necessary, harvesting, threshing, storing and ending in some sort of harvest festival.[9]

Obviously, as this form of agrarian organization is meant to provide for survival, peasant farming has a long history of wide prevalence and is so even contemporaneously. But we should realize that what we have envisaged above is a *pure type,* to gain an understanding of what constitutes the bare essentials. In actuality, the peasant farmers are unlikely to conform and be limited to these *pure* characteristics. For instance, even while they are all producing the same crop, as their land holdings and family sizes may vary, some will be barely above survival level, while others may have some surplus of product. This situation can lead to some time constrained or temporary borrowing and lending. Another form of inter-unit interaction may consist of collective decisions about the extent and sequencing of watering patterns, if several of the farmers are dependent on a common irrigation source such as a nearby stream. Where tools are in use, instead of every unit possessing all the required tools for agriculture, some sharing may be possible. Further, while all the units will be producing the common output, paddy, any household that has enough land and labour can produce other things as well: bananas or milk by having cattle as well. They can also produce *commercial crops* such as pepper, or betel leaves and can take them to the market place for the sale of these products. Another widely prevalent pattern is for peasants who have limited land to sell part of their output immediately after harvesting to meet obligations related to production and buy the same good later from the market at a later stage.

Tenancy

Let us now turn to another kind of organization for agrarian production, already referred to in chapter 2, namely *tenancy.* For tenancy to prevail there will have to be two types of

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9 As part of dependence on Nature it may be noted that paddy production, particularly is crucially conditioned by the availability of water so much so that the pattern of production differs considerably between 'wet' and 'dry' land.

households or farming units, those with labour constraint and those with land constraint. When this happens, the latter may *lease in* unused land from the former and may produce some output, passing on part of the produce to the owner of the land as remuneration for the use of it. This *share* to be given to the owner is decided either through direct negotiations or by the acceptance of traditional arrangements for such purpose. Payments may be made in kind or cash.

An implication of tenancy is that it brings distinction between *ownership units* and *operational units* of land. It should also be noted that it is not necessary that the *leasing out* household unit is better off than the *leasing in* household unit, but the terms of the transaction are usually decided by the former. This is the basic historical as well as the contemporary arrangement. The opposite is also a reality when small owners *lease out* their land to a unit that is eager to *lease in* such as a big company to produce sugar cane. Here, the big company may have the upper hand in the transaction. *Share cropping or tenancy* thus becomes a second form of agrarian organization used for production.

Landlords

There is a third form of organization in agriculture. A household which owns plenty of land may decide to use land, but not its labour for production and instead become a *landlord producer* and may *hire in* labour from those who do not have enough land or are totally without any land. You must note that unless deliberate decisions are made about ownership of land, the traditional patterns of the past, determined by social arrangements, and often even approved by religious traditions will continue. In practically all parts of our country, land was owned for long by members of the upper caste who claimed that religious principles prevented them from undertaking any manual labour, while the Dalits were prevented from owning any land on the basis of religious sanction. Hence, in the country as a whole, there were and there still are many who have vast tracts of land while many others are totally landless, thereby permitting

the emergence of the landlord form of agricultural production. In early days of history, payment for work done was made in kind, a practice which continues even to this day, but cash payment for agricultural workers is becoming more common. What is important to note is that the bulk of produce will remain with the landlord as a consequence of his ownership of the land. It is not necessary that all agricultural labourers employed by a landlord are landless: even small landowners whose land is not sufficient to produce their minimum requirements may and do work as agricultural labourers for parts of the year. Some members of such households may seek work as agricultural labourers all the year round.

The *pure* type of landlord organization may be extended to mixed forms. Members of the landlord family may directly engage in agricultural production, though more often they hire in workers. This is particularly true when modern implements such as tractors are used in cultivation, where a member of the landlord family may work as its tractor driver.

To get a better understanding of agricultural production we must take two aspects of it into account: the need for credit and the influence of the market.

Credit and Markets

Production, more specifically agricultural production, is a process through time. The field is prepared, the seed is sown. The harvest will come. But until then, what? That is where credit becomes relevant and so the history of agricultural production is also the history of money lending, for a long time informally conducted, but more recently through formal institutions such as banks. Timely credit is a must for uninterrupted agricultural production. In its most elementary situation, it is a *consumption credit* that is required. In view of this those who can provide credit have the upper hand and can dictate terms of credit. What does a poor farmer provide for collateral for credit except the small piece

of land he may have? If credit is obtained in time and the harvest does not fail, all is well and his land is secure. But if one of the many *ifs* fails, what happens, then? The land goes into the hands of the benevolent lender. Often the lender is none other than the big farmer close by. He may not ask for land as collateral. All he wants is for the borrower to pledge his future services as a labourer. A small farmer who cannot pay back his loan on time and falls into debt will become *bonded* to the lending neighbour. If the farmer does not succeed in clearing the loan, his children after him become *bonded* too. In a country like ours, where there are many agricultural families with small plots of land that they own or operate, and where natural calamities are not infrequent, a great deal of transfer of land from small owners to large landowners who also act as money lenders takes place. In the process many *free workers* become bonded because of their inability to pay back their debts on time.

Properly structured and generous credit facilities provided through institutional channels are an essential requirement for agricultural operations. Apart from consumption loans, credit is necessary for purchase of inputs such as fertilizers and implements like plow, tractors etc, for a variety of production organizations.

Markets also play a major role in agricultural production. When that production of agricultural goods is solely for the consumption of the farmer, the dependence of agricultural producers on the market may not be as crucial as that of producers in other spheres of production.

The market impinges on agricultural production in a number of ways. The first is the standard case of the need to buy inputs and sell outputs. Even granting that there is a stable market for many of the inputs, the market for the products of agriculture is notoriously volatile. In the case of grains, there is a fall in price during the harvest season and a sharp rise as stores of grain get reduced later on. Even when these seasonal fluctuations are anticipated, their ill effects on the producers, especially small producers

cannot be totally averted. This is because the many market obligations that they face, with the need to make immediate payments for the inputs already purchased on credit being one of the biggest. Therefore farmers are frequently forced to sell grain when it has the lowest price and subsequently buy back when the price is high. There are also instances where producers of perishable goods such as tomatoes and onions have to destroy part of their output immediately for fear that unloading large quantities into the market may adversely affect their prices.

Another market related problem that producers face is the change in the relative prices of goods that they buy and the goods that they sell. If the former remains stable and the latter declines, the farmers are said to face *"adverse terms of trade":* they will have to sell more grain to buy a given quantity of fertilizers. Even if grain prices are going up, the farmers will face the same problem, if fertilizer prices are going up faster than that of grain. The *"terms of trade"* phenomenon, therefore, is a critical factor in the long term development of the whole agricultural sector of an economy in relation to other sectors such as industrial production.

'Interrelated Markets'

There is also the phenomenon referred to as 'interrelated markets'. In general it may be assumed that each good has a market of its own which reflects its price; though it is clear that the price of an input that goes into production of an output will have a bearing on the price of the output. But think of a deal like the following. Let us say that sugar prices are fairly high and consequently the price of sugar cane will also be high. A farmer wants to cultivate sugar cane. But for that he has to purchase some inputs, once again fertilizers because it is the most widely used purchased input in farming. Initially the farmer does not have money to purchase the input. Now, a merchant comes along and says he will advance the fertilizers to the farmer on condition that the sugar cane crop is sold to him and to nobody else. The deal may not specify any price either of fertilizers or

of sugar cane, but will clearly state the quantity of sugar cane to be given for a specified quantity of fertilizers. In this sense, the merchant and the farmer together create a separate fertilizer–sugar cane 'linked market' independent of the fertilizer market as such and the sugar cane market as such. It is not difficult to see that the terms of the interlinked fertilizer-sugar cane market will be set by the merchant. Implicitly a credit market is also tied into the deal. The same merchant may have another fertilizer–sugar cane – credit deal with a second and third…farmer as well. And other merchants too may have other deals with some other farmers. Competition does not eliminate this phenomenon, may indeed intensify it. It is a manifestation of the segmentation or fragmentation of markets we have already noticed.

It is not necessary to have intermediaries such as merchants for this phenomenon to surface. The mill owner who finally buys up all the sugar cane to move on to another stage in production such as cane crushing may do it too, although it is unlikely that he will go out and strike deals with *very small growers of sugar cane.* It will be to his advantage to leave the field to the intermediaries.

A similar situation arose when during the phase of mass propagation of tube wells to make water available for cultivation the large farmers in rural areas took advantage of the subsidized credit that the government was providing, had tube wells put into *their own* lands and then *'sold'* water to the small farmers around. The 'deal' was that they would sell their produce *exclusively* to him at the immediate post- harvest price, when prices are likely to be low.

This sort of exchange where one party has power over the prices of both the goods being transacted is referred to as *unequal exchange* and you can see immediately that although 'freely' entered into by the two sides, it is highly exploitative. Market apologists theorize on the basis of barter that because it is advantageous to both parties, there will be All Round Advantage when the operation of markets reaches out. But the

intermeshing of production, trade and credit is what frequently happens in the real world and it puts the actual producer at the mercy of the more powerful merchant, money-lender or even a bigger producer.

Industry

If in agriculture the presumption is that a large number of producers consume all or a part of their production, in industry the position is the opposite: most producers produce for others. There are of course, exceptions. Those who weave, for instance, may be using some of their output. But in general industrial producers have other customers in mind. It is interesting to note also that while agriculturists have that common appellation irrespective of what specific good they produce, in industry one speaks of weavers, carpenters, shoe makers, tailors etc. depending on the particular goods they produce and note this, according to their particular 'trade', which is an indication of the link between their production and transaction.

There is another difference between agriculture and industry. While in agriculture land plays a major role and tools secondary role as aids to labour in production, in industry tools are far more important than land. Tools were earlier produced by labour and referred to as physical capital. For long periods in history, the tools used by the producer belonged to him. Much later in history capital came to be owned by one set people who bought the labour power of others and 'employed' them in production. That resulted in a major transformation of the organization of production with economic, social and political consequences. It is this change that is usually referred to as the 'Industrial Revolution'.

The earliest form of the organization of production in *manufacture*, is self- employment' – a producer, with the help of the members of his family, possibly working with his own tools, *but for somebody else.* Except for this new feature, it is fairly close to peasant

farming. The product was largely *made to order*: a customer approaches the producer and places an order, specifying details of the article – table, knife, shoes, shirts or whatever.[10] The price is also settled, with some bargaining, and an advance is taken from the customer to cover the cost of materials that the producer has to buy and also to meet his personal livelihood, if the period of production is long.

This arrangement has its advantages mainly that the producer does not have to worry about sales. But it has its disadvantage too, that production is not steady with the producer frequently facing periods of slack in relation to demand for production. So the producer accepts the reality that it will be to his advantage to separate out production and sale, and that it will be helpful to hand over the latter to a merchant, an intermediary between himself and a buyer. The merchant thinks so too and the twain meet and a producer-merchant tie up is established. If the merchant does only his specified job of buying and selling, the producer will have to turn to some other source for the credit he requires. A banker may enter into the production process too. Hypothetically production, marketing and credit can play their independent roles. But as in agriculture, so in industry too, they get interlinked.

Production and Trade

Not surprisingly, it is the merchant who performs an active role in bringing these three aspects of production together. Since the producer needs to buy inputs and sell the output, the merchant's mediatory role appears quite natural and so it is. The issue is whether he takes 'undue' advantage of his position. The point is that if his objective is making profits nothing would appear 'undue'. So what happens?

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10 This was the standard practice all over India, except in cities during my childhood and continued for several decades and is practised even now in some instances. Even today ships and jumbo jets are made to order but not by self–employed artisans!

The situation can be similar to what we saw in agriculture, with stronger incentive also because while in agriculture some production can take place without purchased inputs, in manufacture that is not possible at all. So the merchant's offer to provide inputs is accepted. But the merchant's major interest is not in 'selling' inputs to the producer, but in buying his finished product which can be sold to some customer. Hence, inherently the buying of the output from the farmer is linked to the buying of inputs from the merchants. Thus, there is a built-in tendency for independent self-employed industrial producers to become dependent on the merchant. This is also an 'accepted' pattern and has come to be known as the 'putting out' system. In fact, the bulk of petty producers operate under this arrangement.

There is an interesting anecdote from Russia of the late 19th century narrated by Lenin that illustrates how this happens. It is about a group of women lace makers whose product was initially given to the landlords of their own locality in exchange for agricultural products or even money. But the women soon found going house to house inconvenient and decided to entrust the sale to one of the lace-makers who was compensated for time she lost.[11] She would collect lace from all producers, take the goods to the nearby city of Moscow, sell them there and return with thread for further production. Soon she would become a specialist in trade. She would bring other wares from the city and sell them to her colleagues as well as others in the rural areas. She would sell the lace above the price set by the producers and pocket the difference. She would take advantage of the monopoly she had over trade to subjugate the lace–makers completely. She would bring back fresh orders from the city, give loans required during the period of production and buy up all goods produced. So, in one sense the trader woman was the trusted colleague and helper; on the other, she gradually becomes the boss with near total control over the production and even the lives of her 'friends'. This

11 An early instance of self-help group?

historical anecdote is an excellent example of the interconnectedness of production, trade and credit and how such a connection develops quite naturally.

'Putting Out'

The *putting out* system may have disappeared in Europe where it was originally prevalent, but has become wide spread now in countries like ours. The *bidi* industry is usually shown as the typical example of the system with the merchants distributing tobacco and the leaves to the producers, mainly women and children who work in their own homes, but have to fulfill daily the target set by the merchant who collects the *bidis* at prices that he sets. The same must be happening in the case of many other goods produced by 'independent, self–employed, small scale producers who supply things like hand woven cloth, pickles, *pappads, agarbathis …* and many more. These production units are known as 'household industry', 'cottage industry', 'traditional industry' and so on.

Similar to the Russian anecdote mentioned above, there is a common practice among the weaver community where a 'master weaver' exercises supervision and control over many individual weaver families, giving them designs, inputs, and credit and also arranges for the sale of their goods.

What is really interesting about the *putting out* arrangement as a form of industrial organization is that it is *not* a primitive system on its way out. Indeed, it is very much a contemporary institution globally prevalent with a fashionable name. Have you guessed already? If your guess is *subcontracting*, you are right! We shall examine it a little later.

Some Aspects of Petty Production

Before we move on to other organizational patterns in industry we must note a couple of aspects of petty production we have been dealing with so far. The first is that while for

the disposal of their output petty producers are dependent on the market, in terms of factors of production they are largely out of its purview. In the pure case of where a producer uses his own tools and relies on the labour of the members of the family, his contact with the factor market is nil. The reason for this is partly historical and also cultural to some extent. As in agriculture, so also in non-agricultural manufacture, the household is the 'natural' unit of production. Because of this there may be reluctance to work for others. That is the cultural factor. When those who have monetary resources of their own insist on lending these for profit while also working for others as happens in most 'advanced' economies even such alternate approaches should be recognized as evidence of a cultural tradition! However, there is a strong economic factor responsible for self-employment, namely, the inability to find work elsewhere. If that is the case, as is likely to be in labour abundant economies, the rationale for self–employment as also in other forms of petty production similar in pattern to it is that the joint utilization of labour *and* other resources will yield higher income than the earnings that can be expected from using them separately. This fact undermines the neat logic of factor market allocations proposed in theoretical discussions, but such is real life.[12]

The second is closely related. Since the household production units are using their own resources, they have no way of making comparative assessment of their production processes. External observers like theory-bound economists who make comparative studies of production processes of large and small units, have frequently claimed that petty production is 'inefficient' in the sense that they use more of *all* inputs, especially aggregated ones like capital and labour, per unit of output than the bigger, scaled up, units of production. This may well be the case. However, if the household production units have decided that generating an income for themselves is more important than

12 It is important to make a distinction between petty producers who are motivated by a "survival strategy" and the better-known production units that we shall soon see that follow a "business strategy".

following canons of efficiency, what is wrong with that? And who is more relevant in this instance, the household or the learned economist?[13]

The most important aspect of household production units is that though their income levels may be low, they may still be able to generate some savings through surplus production especially when they need to make more investment. We saw in Chapter 1 how this is done. Households usually have 'excess capacity' or reserve of labour power that can be used to increase output. It would mean working harder and/or longer or some of the NW members helping the W members. And this increase in output can be more of what they usually produce or the means (tools, for instance) to increase that production. This form of direct capital formation is not negligible and cannot be ignored, as we shall see subsequently.

What emerges from these observations is that there is much that is 'informal' about petty production. There are several variations to be noted. An enterprising modern entrepreneur may set up a unit for food processing employing a few workers. A partnership of two or more persons to fabricate metal products is another example. More recently, a single individual with a computer and mobile phone can create a market and set up a production unit for a variety of much needed documents. We shall not go into the details.

Co-operative Production and 'Large-Scale Production'

A uniquely different form of industrial production is the cooperative production unit where a number of producers operating more or less the same size of production units

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13 Do these facts of life discussed in the paragraphs above make sense to you? Let me tell you that these facts formed the basis of my Ph.D. thesis done at the prestigious Stanford University in the early 1960s. I had a hard time convincing some learned members of my Doctoral Committee that what I was dealing with was a sensible issue, though perhaps a little unfamiliar or unconventional. The fact is that the logic and language of professional economists often make it difficult for them to understand real life problems because they begin by ignoring the relevance of context for "convenience of analysis".

come together to share tools of production and for marketing arrangements. Cooperatives can get credit more easily from commercial banks or cooperative banks as well as other public sources. To a large extent they can also eliminate the role of the middlemen in trade.

We turn now to a totally different form of production in large factories with modern implements as well as power supply, using the modern corporation, as the organizational structure. Consider first the organizational structure. It is an incorporated legal entity which has the status of an individual person: it can sue and be sued. But from the point of view of production its distinguishing feature is the separation of ownership and management. The owners are the shareholders whose liability is limited in the sense that an owner is financially responsible only to the extent of shares he/she owns of the particular company or corporation. The rest of the shareholder's wealth is kept out of all reckoning as far as the company is concerned. Most shareholders are, as we have already seen in Chapter 5 'sleeping partners' quite willing and in fact eager to let the company be managed by professionals as long as they get as dividends a fair share of the profit that the company makes. Shareholders also will be eager to see the value of their shares go up which they see as a sign of the company's good performance resulting from good management. But when the share price goes up, they may sell their shares and thus cease to be owners. They may do the same when the share price is low and the prospects for profits do not look promising!

From the perspective of those who manage the company this is a good arrangement because it gives them considerable freedom to do what they want. But in real life situation there is not such a clear separation between ownership and management. This is because those who own large number of shares will definitely have a say on who manages the company and how it is managed. Due to the principle of one share one vote, those who hold many shares will have many votes and hence greater influence on the manner in which the corporation is managed. Seen from the other side, those who

manage will possess enough shares to see to it that owners allocate appropriate managerial remunerations – salaries, perquisites, bonus etc. In effect a sub-set of owner-managers run the show. Altogether a rather cozy arrangement using other people's money!

We have already noted that companies can raise money through different arrangements, which means also that a few people come to have large quantities of monetary capital at their disposal and exercise control over how it is used.

With the money at their disposal the managers of company employ workers who are paid wages. Work is done in factories, using power and modern equipments. In these respects the arrangement of production is in sharp contrast with that in the older form of '*manu*factories' where production is on a small scale, at home or in small sheds, the power used is primarily the muscle or finger power of the workers and equipments are only extensions of hands and fingers. Modern factory production tends to be on a large scale because of 'increasing returns to scale' or in simpler terminology, cost savings resulting from large scale of production.

Since wages tend to be the major cost item, there will be an incentive to those who run large factories through the company form of organization to increase productivity, namely to augment output per worker. Hence constant change in technology is built into this organizational pattern which implies that over time the capital intensity of production is likely to go up. "More (output, sales and profits) with less (labour)" is the guiding principle.

Production will also be steadily increasing, with greater volume of the same products and a constant supply of new products. Hence much more than any other form of production, the modern production arrangement is much more dependent on the market. The connection is easy to see. Technology will change and become more

sophisticated; output will increase; new products will keep appearing; but unless more and more is sold profits will not be realized!

Production and Trade

This means that the connection between production and trade becomes more intimate. The large scale producer must have a large sales section of its own, or must have a tie up with a high volume sales merchant to sell the product. In view of this connection trading will also tend to be of corporate form. Indeed, marketing will become the testing point of success in production – whether it is motor cars, television, processed food, perfumes, furniture… everything that you see around you.

This has other expected implications as well. Ongoing product differentiation is one; increasing magnitude and variety of advertising is another; getting celebrities to 'endorse' products is yet another. Marketing itself will get transformed with a hierarchical form developing; the firm that has the initial contact with the producing firm; several intermediaries from the big wholesaler to the small corner shop; market research; sales teams and ever increasing pressure to sell. It reminds one of the weather phenomena of hurricanes!

One of these new phenomena deserves special mention: attempt to increase sales by encouraging the customers to "buy now and pay later" which is an attempt to remove the limit that current incomes and purchasing power set on sales and in that process extend the role of credit from the sphere of production to the sphere of consumption as well.

So we have come full circle: production, trade, credit and finance increasingly involved with each other while retaining an autonomous expansion path of its own. These ever

enlarging interconnections are the defining aspects of most contemporary economies. Let us make a quick review. Modern organizations of production depend greatly on finance for their very formation in the form of increasing numbers of shares sold to consumers with the financial market becoming increasingly the indicator of their performance. Production is crucially dependent on trade and credit institutions. This interdependence reinforces finance which of late has become the most innovative and rapidly expanding sphere, critically based on the assessment and marketing of risk.

I must again remind you that 'production' 'trade' 'credit' 'finance' etc. are not impersonal entities operating through some mechanical laws of their own. Behind each one of them are human beings and the institutions that they build up. Once they are set in motion no one individual may be able to direct them. Their interactions make the economy what it is. The economy, then, is driven, controlled and manipulated by human beings, unfortunately by a handful of them interested in their own profits and their incomes, making the rest of us rather passive participants.

The evolution of the organization of production is a continuing process as we shall see when, fairly soon, we shall be turning to the global economy. In that arena we shall come across a new form of production unit, the multinational corporation, MNC.

Chapter 7

The State

Production units and their facilitators – merchants, banks and financiers – constitute the bulk of the economy. But what about the rest of us, households, you may ask, and rightly so. Sure enough, households count too, and we have already taken account of a segment of them as producer-households. But the role usually assigned to households is as *final consumers*. There are glorified accounts of the consumers, assertions that the entire economic system functions to satisfy their needs, that 'the consumer is king'; but how often have you received royal treatment? Standard courses in economics based on college text books, begin with an analysis of consumer behavior. But, all this must be taken with a pinch of salt. Of course, if producers represent the *supply* side and consumers represent the *demand* side the pricing process can be greatly simplified. But it is not needs or desires that constitute demand, but *purchasing power* and everybody's purchasing power comes largely from some form of production.

Households derive their income, which is the source of purchasing power through involvement in production, including work in offices etc. What draws a distinction between households and production units is that in the case of the former income acts as a rather rigid constraint on their economic activities. We have seen that such is not the case with production units. For their economic activities, apart from their own resources they have fairly easy access to other sources, credit in particular, in the form of other people's money, OPM! Households also can borrow, but even that borrowing is limited by its own resources. On this basis a useful distinction has been drawn between *economic units* or production units and *economically active units* or households. The presumption is that the latter, though participating in economic activities, such involvement is not their primary concern. Who can avoid some involvement in economic activity that is essential to life, unless one has withdrawn from society and gone into vanaprastha? In contrast, in the case of the former, their economic involvement is their

raison d'etre. This distinction, certainly, is helpful to understand the economic behavior of the many participants in the economy and why it is not appropriate to depict all decision-maker participants in the system by a homogeneous feature variously referred to as 'self-interest', 'rationality', or 'maximizing behaviour'. It is as good as saying that all participants in the economic system are human beings – very true, but not very helpful in the context of an analytic approach.

This introduction is necessary to this chapter because it deals with another participant in the economy which has features different from households, production units and intermediaries – the State.

The State as a Player in the Economy

The treatment of the State as a participant or player in the economy won't be easy because there is no clear understanding of what the State is: it appears different in its manifestation to diverse individuals such as economists, political scientists, and philosophers versus its concrete reality to the ordinary citizen. Therefore, the analytical treatment of the State as an entity often tends to become rather abstract.

We shall try to be as matter of fact as possible. Hence the best way is to begin by considering what can be generally accepted as what the State does. It imposes taxes; it enacts legislations; it settles disputes; it protects territory. These are different kinds of powers it exercises and more of such roles that the State plays can be enumerated. But what each of these activities of the State demonstrates is that it exercises authority. In its essence, that is what the State is, the locus of authority recognized by a group of people. In discussions of economics and politics 'the group of people' usually taken into account is the nation so that the State can be thought of as the locus of power recognized by members of a nation and accepted as such by other nations. There may be history, constitution etc. that form the basis of the recognition that a State comes to have, but

quite simply we may say that members of a nation accept the authority of the State because they know that other members accept it too.

We saw in Chapter 1 that even in the most elementary of social formations, the household as we considered it to be or even as a tribe two characteristics of society to be noted were the division of labour and the need for a locus of authority. The division of labour, in due course, gives rise to exchange and to transformation via the mediation of traders which generates markets. We also recognized that money facilitates the growth of markets and that money to be generally accepted called for the backing of an authority. In this sense the interaction between the market (representing the economy) and authority (which emerges as the *State)* has been an evolutionary process. Initially it took the form of personal relationship, of an individual trader with a person he thought exercised power over a territory into which he wished to move. Traders were the first to store money and thus to have a form of wealth other than land and cattle. As time went on, traders realized they needed protection and rulers recognized they needed money. Thus the interaction between the economy and the State has been a long standing one. It must have passed through various stages and different forms.

For our purpose what needs to be considered is the role of the State as an integral part of the economy and yet in a very meaningful sense being apart from it and above it, exercising authority over it. It is this *dual characteristic* that calls for a separate treatment of the State.

A distinction between the state and the government may be useful. “Governments may come and go, but the state goes on forever” is a frequently heard statement and it communicates a major distinction between the two. There is a well-defined temporal dimension to the government as can be seen from common references to “the government of the day”. It implies that the government is the visible manifestation, the contemporary representative, so to say of the State, the state being the lasting locus of

authority. It must be noted too that the government of the day does not fully represent the State: along with the government there are other 'organs of the State', the Judiciary is one such and where there is an independent election commission, it is another. If this distinction is understood and kept in mind, it is permissible to use the terms State and government interchangeably. For instance, it is the government that imposes taxes; but it is a functionary of the State in this regard.

Nobody in his/her right senses will deny the existence of the State even when it may appear to be a rather vague entity. Even those who take the position that it should take a 'hands off' policy towards the economy, leaving it to that mysterious *'Invisible Hand'* acknowledge its existence. The best way to remove this vagueness about the State and its role in the economy is to specify as clearly as possible the nature of its involvement with the economy.

Let us start with ownership which we have been featuring as the defining characteristic of any economy. In practically all contemporary economies the State is not only an owner, but a big owner as well. You may say that this probably is true in communist or socialist countries, but not in others. If so, you are in for a surprise. Did you know that in the much celebrated capitalist and free enterprise country of Singapore land is fully owned by the State? You can, of course, have use and control of some land on long lease, but not ownership as such. This is an exceptional case made possible by the fact that it is a *small* country. Its Prime Minister can drive round the entire country in less than a day and so they keep all roads spotlessly clean! But in most other countries, part of land, forest, rivers etc. are owned by the State. In some countries minerals, natural gas, nuclear energy etc. come under State ownership. We know also that in many countries, including ours, railways are owned by the State. It is not unusual for many states to have airlines owned by them even when many privately owned airlines also may be in operation. States own industries, banks, postal services and many other economic enterprises as well.

The State usually is a big employer too. This is not surprising because those in public administration at all levels and the military are employees of the State. It is not unusual for the State to have a share in the employment of doctors, teachers, lawyers and other professionals as well.

The State is a prominent participant in the market too, both as buyer and seller. Its participation in dealings in financial instruments is also accepted as normal.

A unique role that the State plays in the economy is to provide its backing for the monetary and credit system. We have seen that it is the assurance that the State provides that makes money what it is. To some extent its role is direct. Even when there is an independent agency like a Central Bank with special responsibility for money supply, the State can have a powerful impact on the monetary system. Even in the credit market the State's role is not negligible.

Taxation, of course, is one of the major responsibilities of the State. Apart from raising revenue for itself the State uses taxation, particularly indirect taxes such as sales tax, excise and custom duties, value added tax, to influence the market. The State's budget (the manner in which it raises revenue and the pattern of its expenditure) also has profound impact on the economy. Whether the budget is balanced or not also will have a bearing on the economy. That is why the budget of the State is much more than a mere statement of its book keeping, and becomes a policy instrument. The State also has much larger borrowing facilities and uses them not to keep itself going, but to influence the economy. It is not particularly eager to clear its debt either: in most countries a long lasting 'public debt' that goes on from generation to generation is an accepted reality.

The State as a Special Player in the Economy

The State also has an economic power which no other participant in the economy has; it can confer purchasing power to itself! In common parlance it is known as "the government printing notes for itself". There are, of course, limitations. The point is that no undertaking that the State considers important, unfortunately though it is often fighting wars, is given up or put off simply on the grounds that it doesn't have the money for it.

It must now be clear that the State is very much a part of the economy, and not a mere 'add on' either. It is different from *all* other participants as well.

Let us now consider the specific responsibilities or duties of the State in the economy. The first to spell it out was Adam Smith himself. He assigned three responsibilities to the Sovereign, the sovereign or the monarch personifying the State for him as the government represents the state for us. The first was "that of protecting the society form the violence and invasion of other independent societies". The second was that of protecting, as far as possible, every member of society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice.

These two are clear and not likely to be controversial. Smith went on to clarify that the administration of justice was essentially one of protecting property.

The third duty is specifically related to the functioning of the economy, and if you want a sample of late 18th century English prose, here it is:

"The third and last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works, which, though they may be

in the highest degree advantageous to a great society, are, however, of such nature that the profit could never repay the expenses to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect or maintain. The performance of this duty requires, too, very different degrees of expense in the different periods of society."

What do we make of this? The thrust is on those goods and services that are beneficial to society at large which, however, will not be considered worthwhile in terms of the calculations of private providers whether individuals or corporate bodies. Note that the issue is not whether it is feasible to provide them; they are, but private persons or agencies will not find them *profitable*. Smith went on to say that these are "chiefly those for facilitating the commerce of society, and those for promoting the instruction of people". Smith who was a champion of education could see that it was not a particularly profitable proposition for private entrepreneurs.[14] But Smith's list included 'public works' such as "good roads, bridges, navigable canals, harbours etc.". Even of these 'public works' some would get done, he conceded, and ways would be found such as toll collection to defray their cost in the long run. But in general these public works would remain the responsibility of the public', the State.

The economic rationale for this was provided only a couple of centuries later with the formal recognition of a category of goods called 'public goods'. Street lighting was taken as one of the first examples. Recall what we had seen as the logic of the market: exclusion, which meant you buy a good by excluding somebody else. In the case of street lighting, however, that does not apply: just because one person benefits by it, it is not the case that only less will be available for others. It also means that no one will be willing to reveal the intensity of desire for such goods. Consequently the price signal will

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14 Two and a half centuries later 'promoting the instruction of people, whether nurseries for children or colleges of engineering or medicine appear to have become highly profitable for private agencies of various sorts!

be an unreliable indicator to decide on their production. These are, therefore, referred to as instances of 'market failure'. 'Public goods' therefore must be provided at public expenditure. That is the rationale for the State to be especially responsible for public goods, 'infrastructure' as they are referred to these days.[15]

If during the days of Adam Smith the economic role of the State was rather limited, many changes have come about since then and in most countries the State has a much more prominent role. In democratic countries based on universal adult franchise political compulsions draw the State into many forms of 'welfare measures'. These are considered to be steps that the people take via the State to help themselves. In advanced countries the most widely accepted welfare measure is some form of unemployment compensation on the assumption that under 'normal' conditions the economy through its standard operation ensures 'full employment': that is employment to all who want it through appropriate adjustments in the wage rate. However, temporary unemployment is likely to arise, between jobs, for instance. Even where large scale unemployment surfaces it is presumed that it is a temporary phenomenon and hence unemployment compensations for limited periods and at low levels, usually referred to as 'doles' have become quite common. Other social security measures are also quite common such as maternity leave when a baby arrives, and increasingly even paternity leave for the same reason. Education up to middle or even high school level is also accepted as a standard welfare measure. Beyond these there is considerable variation depending on the accepted political philosophy of the people concerned. Scandinavian countries are noted for their comprehensive welfare measures, "from cradle to grave" as they are frequently

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 Here is another instance where the use of the word 'public' is rather problematic, in particular in view of the 'public/private' dichotomy that has entered into common parlance. There are instances, as in the above discussion where 'public' excludes the State as when one refers to the state's responsibility to 'the public'. What is even perplexing is that in some instances 'public' means 'private' (all those 'public schools', for instance) and what are claimed to be 'private' are very much 'public' as in the case of 'private' companies that raise the bulk of their resources from the 'public'.

referred to. In the United States any attempt to increase welfare measures is viewed with suspicion, especially into spheres such as health care, insurance etc.

Less developed states are much more reluctant to accept responsibility for welfare measures on the grounds of financial burden. However, as in our country, poverty eradication measures from the early 1970s have been among the most prominent of the welfare measures. The coverage has been increasing over time with the notion of right to life becoming an accepted democratic principle. Food subsidies for the poorer sections have increased; free and compulsory schooling up to the age of 14 has been brought into the statute; various forms of employment guarantee schemes have been launched.

Two general observations are necessary in this context. The first is to note that there certainly is an element of political compulsion in these matters. The very fact that many new schemes are announced on the eve of elections and make their appearance in the manifestos of competing political parties bears this out. In a democratic country this is quite natural although questions can be raised as to whether the supply of colour televisions and laptops comes under the category of welfare measures.

Second, there is the mistaken notion that welfare schemes, especially financial subsidies are meant only for the poorer sections and are, therefore, transfers from the rich to the poor. The principle of transfer of resources from one section of the population to another (pensions for those who have retired from work, for instance), and more specifically from the rich to the poor is a widely recognized one as can be seen by the general acceptance of progressive taxation, that is the rate of income tax going up as incomes increase. But if the complaint is that subsidies are given only to the poorer sections, it is not true. One of the most widely subsidized goods in our country is cooking gas, used by the 'middle class' and 'upper class' alike. Note that in this instance there is no discussion on *who* is subsidized; only *what* is subsidized! That apart, subsidies are

given to *those who* export goods (again, it is usually claimed the *exports* are subsidized), to those who locate industries in backward regions and so on. Land is given at heavily subsidized rates to set up 'priority' industries, even when the 'industry' finally turns out to be luxury apartments for the richer sections of the population.

Our concern here is not subsidies as such, but the nature of the State at once as a political and economic entity with very strong presence in the economy of both rich and poor countries.

The State as 'above' the Economy

The State has a role to be *above* the economy as well. Three such responsibilities of the state for the proper functioning of the economy are becoming increasingly prominent, mediation, certification and regulation. All three are required in market dominated economies, but to serve their purpose they must be beyond market operations.

Contracts are central to the functioning of an economy and they are agreed upon by the parties on the assumption – trust, indeed – that all parties will abide by the terms. A distinguished economist who won the Nobel Prize for his rigorous exposition of the logic of the market economy has stated that it is based on trust which is not a marketable commodity, for if it is, it is no longer trust! But suppose that one of the parties violates the terms. What do the others do? They turn to a person who has the authority to settle disputes, a judge, for instance *trusting* that he will mediate fairly. But what if the mediator makes it known that his verdict will go in favour of the highest bidder? The arrangement breaks down. A judge is appointed by a higher authority on the specific stipulation that he will function according to the law without fear or favour. But note that the mediator need not be a government servant. He can be anybody whose sense of fairness and authority that the parties trust. In a broad sense that is what the State is, the commonly accepted repository of trust and authority in society. It is easier now to

appreciate the distinction between the state and the government; a government that loses trust gets thrown out, but the State remains.

Certification is similar. Consider two different cases. To practise the profession of a doctor or airlines pilot one has to undergo a long and rigorous course of training and at the end of the course a competent authority must certify that the candidate has successfully completed the course and is competent to practise. That authority need not be and ideally speaking should not be appointed by the government of the day; it should be somebody who has the competence to do so. In these cases authority based on competence is the issue. That authority, a Medical Council for instance, must have the confidence of the practitioners and of the public; the backing of the government may be useful for that purpose. But here again, if that agency starts issuing certificates not to those who are competent, but those who are willing to pay and buy such a certificate, it will lose confidence and consequently authority as well.

It is not only services based on prolonged professional courses that need certification. Goods that flood the market also need it because an ordinary customer may not have the competence to judge the quality of the goods he/she buys. As the market expands and more goods and more brands of the same good appear, the customer gets bewildered by the variety and complexity. Doubts naturally arise about the claims that are put forward. This is because the customer is aware that in the quest for profits producers may sacrifice quality and intermediaries may indulge in false propaganda. How much of the tall claims in advertisements do you trust? Some competent authority such as Indian Standards Institution must certify that a particular good is authentic and reliable. If this does not happen the market itself will not work.

In our discussion of finance we saw that the profit maximizing principle of the market frequently leads to the collapse of the market. It is now widely accepted that there have to be ‘regulators’ who will be constantly vigilant, apply brakes when necessary and even

direct the activities of the market. In the Indian financial market there is such an agency SEBI (Securities and Exchange Board of India) consisting of experts in the field who are entrusted with the task of being watch dogs. Because of the global meltdown of 2008-09 there is now fairly universal recognition, including in the United States with its naïve but widespread belief in the gospel of 'the free market', that some form of designated independent authority is unavoidable for the management of credit and finance, and the proliferating and variety of institutions that manage them.

The need for and scope of independent regulator is indeed growing. The context is the rapid growth of public utilities such as electricity and telephones. These require huge investments and the pattern has been for them to be monopolies, generally public but occasionally private as well. In such instances there are accepted principles of the pricing of the concerned utilities. But with the markets exploding and new providers entering, pricing raises many complexities partly because the providers are few, the fixed costs are huge and the services stretch into the future. Nobody really knows how "to leave these to the market". And yet both providers and customers need to have some clear notion about price which cannot be left to the calculations of the providers either. Hence price regulations for each of these utilities are becoming unavoidable. What these regulations require are expertise and authority. Expertise comes from familiarity with the field. Authority can come only by common recognition to facilitate which the State can play a role. In all instances of mediation, certification and regulation the common component is the ability to exercise authority vested in them without being influenced by any one or a group of the participants in the concerned field.

A comparison may be useful in this context. Think of a widely popular game such as cricket. The game consists of the actual players, divided into two teams who compete one against the other. But the game will not proceed smoothly unless there is an umpire who is *above* the players, but is a part of the game. If the umpire does not discharge his duties impartially, the game will not be what it is supposed to be. But note that while the

umpire is above the players, he is very much a part of the game. The role of the State in the economy is fairly close to that of an umpire in a game.

The State as Locus of Authority

We can now sum up our discussion of the State as an entity in and in relation to the economy. The first thing to note is that is not "an unproblematic empirical given" as a scholar has aptly put it. But it is very much of an active and large participant in the economy and in the market as well. It is the locus of authority and the champion of 'the common good' doing for the public at large what private agencies will not and cannot do. It also provides the backing that the market requires for its own logic to be effective.

But the most important thing is that the State as both internal and external to the economy is the reminder and warning that the market, a useful social institution in itself, will result in the law of the jungle of *might being right* if it is driven solely on the basis of profit motive or self-interest. The operational counterpart is the insistence on the need for authority to mediate in and regulate market activities. That need is not fulfilled by a single institution or agency. The State is the ensemble of such 'public' institutions including the government of the day.

Chapter 8

The National Economy

With the discussion of the State as a participant in the economy we have completed the enumeration of those who drive it, referred to variously as agents, players, decision-makers etc. The list has been quite impressive. We started with households and saw that they are a heterogeneous group, the differences being based primarily on the basis of ownership of resources, with land as the earliest resource. In the early stages of the evolution of an economy households are the production units and many continue to be so. They do interact with one another, initially to lease in or lease out land, again a practice that continues into the present. Another form of interaction is exchange which begins as barter but soon becomes mediated exchange with the intervention of merchants and the introduction of money. Thus a new set of participants, merchants or traders enter into the economy and along with a new and tremendously important facilitator, money. Merchants and money give rise to the economy's pivotal institution – market, actually *markets* in the plural form, for as the market expands it becomes fragmented as well.

Merchants, money and markets lead on to new facilitators – credit and finance activated by banks and financial agencies as new institutions, which come to dominate economic activities. In turn, they come increasingly to work for the interests of and under the domination of those who own and control resources.

We then continued the discussion on production concentrating on the organization of production noting the variety of production units. In particular we examined the formation of production units specifically established to use other people's resources and produce goods for sale, thus establishing the link between production and markets further, enlarging the sphere of operation of merchants. Consequently the connections between production, credit and finance also became reinforced.

Without going into details we saw the role of households as 'final consumers' who provide a major portion of the demand for goods produced in anticipation of purchase by customers.

Finally, we got acquainted with that enigmatic participant in the economy, the State. Apart from the fact that it participates in the economy, another reason for introducing the State is to emphasize what may be designated as the 'social embeddedness' of the economy. That expression is a little high sounding: so let us say that the economy is set in or forms part of a larger entity, the society. We saw this aspect right at the beginning when we described the economy as *'society's* arrangement …' We saw too that the State, while participating in the economy is beyond the economy too, meaning that there is a larger whole from which we 'carve out' (via 'thought experiment') the economy to study its distinguishing characteristics. Now, the state can also be viewed as representing society, the larger whole. Do we set some boundaries for that larger whole? Yes, we do, but a physical boundary – a geographical entity usually designated as the 'country'. But to ensure that we are not here switching over to geography, we indicate that there is a group of people who claim to have much in common by way of history, culture, social goals etc. who occupy that geographical territory called 'country' and proclaim themselves to be a 'nation'. When these two, the country and the nation are put together, the resulting entity takes on a proper name such as 'India'. Doesn't that name bring to mind a geographical territory seen in an atlas as well as a group of people with self-identity, Indians?

National Economies

What is referred to as the economy also gets identified with that entity and hence one deals with 'the Indian Economy', 'the Chinese Economy' and so on. From Chapter 10 onwards we will be dealing specifically with the Indian Economy, but in this chapter we shall examine characteristics of national economies in general. The first question to

consider is whether there is anything specific about a national economy apart from what we have already seen about its participants. What do you think?

The answer is 'yes' and I shall give you a clue which we shall elaborate as we go along. Consider any one of the participants, let us say, the kind of household that you and I belong to. And let us take a time period such as one year. During that period there will be a flow of income that accrues to the household -- salary, dividends, interest or agricultural income if it is farming household. Similarly, there will be a flow of expenditure also, food, clothing, education, entertainment, medicine … Let us say careful accounts were maintained of both the amounts received and expended and these are added up at the end of the year. The chances are that one of them is larger than the other, income exceeding the expenditure, the difference being considered as the household's savings.

Now turn to the national economy. The Income of the national economy is the summation of the incomes of its participants and similarly the Expenditure of the national economy is the summation of the expenditure of the participants. But the Income of the national economy at the end of the year cannot be different from the Expenditure. In other words the total Income of a group of participants will be *identically equal* to the total Expenditure of the group! The reason is simple: one person's expenditure becomes the income of another person or unit.[16]

Briefly, the whole is not like the part in all respects, but will have characteristics of its own. That is the rationale for the study of a national economy in addition to the study of

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 Note, however, that even the accounts of an individual unit (household or firm) can be shown as 'balanced' (as accountants invariably do) by introducing a residual item "Excess of income over expenditure" (where conventionally a '(+)' sign indicates the excess of income and a '(-)' sign indicates excess of expenditure) at the end of the Income and Expenditure Statement which necessarily balances the two sides. However, this is, of course, not based on one unit's expenditure becoming the income of another unit.

its parts or participants. These too are referred to respectively as 'macro-economics' and 'micro economics' – micro means small and macro is the opposite.

Increasingly, discussions on economics are turning out to be concentrating on macro-economics. The reason for it is fairly obvious too: it is the result of popular interest in economics, especially in democracies, where representatives of the people, most of whom with no special interest in economics have to enter into discussions on the national economy. Academics also find it more comfortable and prestigious to deal with macroeconomics because it is relatively new – only since the end of the Second World War or so – and mathematical modeling and treatment are relatively easy there.

Hence before we turn to macro-economics as such, it is important to recapture the nature of the participants who constitute the national economy. The first thing to emphasize is that they are a heterogeneous group: they differ in their endowments, their environments, their motives, their agenda and the extent of their involvement in the economy. What usually happens is that they are all categorized as 'decision-makers' with the same nature and objectives and then divided into 'households' and 'firms' for convenience of analysis. Of course, if it is *a priori* determined that the *analysis* is identical with the functioning of the market, then the procedure is very convenient indeed, because the 'household' can then be treated as suppliers of 'factors of production' labour and 'land' or 'capital' and demanders of finished products while 'firms' can be considered to be suppliers of finished products. The 'economy' can be and is then represented as an incessant circular flow, making it easy to represent it through diagrams or higher mathematics, the former to innocent beginners and the latter to already brainwashed 'advanced' students!

The second aspect we have noted about the components of the system is that they are in a process of change and so represent different historical stages. A fascinating aspect of the Indian Economy is its characteristics as a living museum of the distant past and the

modern times. Think of the organizational structure and the technological characteristics of the active production units in the cotton textile industry, or the wide range of credit providers in the rural areas. Whatever may be the way they are represented in text books and treatises in economics, nobody interested in real life economics can afford to ignore their temporal diversity.

We can combine these two features of the participants of the economy that we have noted and say that a national economy such as ours must be treated as a complex evolving entity rather like the universe. And economics is the study of its many and diverse participants and the variety of their inter-connectedness, the increasingly mediated interactions via the markets for goods, credit, finance and labour. A great deal of this 'inner' complexity can be overlooked in macro-economics and that is how it is usually done. But to pretend that the inner complexities do not exist is not permissible.

National Income

To understand 'national income' a distinction between *stock* and *flow* will be helpful. The easiest way to understand this distinction is to think of a water tank. The volume of water in it *at any given time* is the stock; the volume of water flowing into it or out of it *over a period of time* such as one hour is the flow. When we look at a national economy its wealth is the stock. Addition to national wealth during a period, typically one year, is *national income*. Following convention we shall represent it a 'Y'. Income as a flow consists of the value of the output during the reference period, once again following convention, the financial year from 1st April to 31st March of the following year. The output of an year consists of goods used (consumed) during that year, consumption ('C') and goods produced during the year meant to increase output in the following year, i.e., 'investment' ('I') as we have already seen. Hence, income is consumption plus investment, that is,

$$Y = C + I \qquad (1)$$

We saw in Chapter 1 that what a group produces to increase production in subsequent periods is the savings (S) of the group. That relationship holds good even when the group concerned is a nation. Hence we can re-write the relation shown above also as

$$Y = C + S \qquad (2)$$

which means that (aggregate) income is equal to consumption plus savings.

If that is the case, we can from the above two equations restate the relationship of savings and investment at the macro level as *identically equal,* and written as:

$$S \equiv I \qquad (3)$$

The above three, (1), (2), and (3) are the basic relationships of 'National Income Accounting'.

However, because of the prominent and different role of the State in the economy, sometimes it is considered helpful to treat it as a separate entity within the national economy and expand (1) above and spell out national income as follows:

National Income = Private Consumption + Private Investment + Government Consumption + Government Investment (4)

So far, everything looks neat and 'scientific'. But if national income is the *value* of all that is produced during a given period, how are all types of production traced and how are the wide varieties of them valued? If all production is for sale and if the market values everything fairly we can assume that there is a reasonable approximation of the national

income via that route. But we know that the two "ifs" in the sentence above are both indeterminable in any economy and more so in economies like ours which have production units who consume directly their entire produce or at least a substantial part of it.

Consider first the general problem. What is referred to as 'output' for national income accounting in most economies consists a large share of 'services' also.[17] This would be a valid procedure, up to a point, to the extent that services are also rendered for monetary considerations, and a good number of them are. However, throughout the world services which women do at home – and note that these women include your mother, sister, and wife as well! – are not included as 'services'. This is based on a widely prevalent 'theoretical' definition of 'work' as anything done for 'others' and for which one gets paid! So by an appropriate 'theoretical definition' a social issue of major consequences is 'neatly' taken care of! The absurdity of this concept of work can be seen if you consider that a man who sits on a chair with a desk in front of him in an office from 10 am to 5 pm and does nothing will be considered working, 'rendering a produce called service' while the slogging that his wife does at home without any specification of time is not 'working' merely because she doesn't get paid for it! This matter comes up for discussion from time to time, women in particular insisting how wrong this is, and how right they are!: but no satisfactory answer has been found yet.

In the case of goods where only part of what is produced is marketed, the best example being food grains where many producers consume a fair share of what they produce, what is usually done is to have actual output measured or estimated and then use market process to value total output. This procedure has problems, though. The main problem is the underlying assumption that the price that the markets shows for the proportion that has come to the market is the proper price and would not change if the

17 Former socialist economies had a measurement of 'material output' which excluded all services also.

entire output were to be brought to the market. This also shows that whatever may be the problems of petty production, where it accounts for a significant proportion of total production and a good share of it *does not* go to the market, the system has something of built-in price stability. You may wish to compare price fluctuations in the food grains market where the marketed amount is a low proportion of total production and in the vegetable market where it is usually very high.

There is another problem in relation to valuation arising from the nature of markets we have already noticed. The justification for using market prices for valuation of output is the notion that for each unit of a particular good or service sold in the market, there is a uniform price. Usually this is taken for granted on the theoretical assumption that as market transactions increase and markets become more and more competitive, price will become uniform. But we have seen why it does not happen.

Apart from these two considerations which have significant bearing on the theoretical and practical aspects of valuation there is a deeper social factor that influences the valuation of total output. The valuation problem does not suddenly pop up after production has been completed and the goods appear in the market for sale. *Production decisions themselves – what will be produced, how much will be produced, what processes will be used in production – are heavily influenced by value considerations.* This can be seen readily with respect to the 'what will be produced' or the product mix issue. The standard discussion of this matter was in terms of "guns versus butter" and a 'theoretical' answer was that the decision would be made by the 'consumers' and the technical possibilities arising from substituting factors of production. We shall not go into details. But assume for a moment that guns are required by the well-to-do (not a wild assumption!) and butter (or bread or *roti*) by the *aam admi.* It is clear what signals the market will give to profit maximizing producers and which of the goods will be produced. The fact is that production decisions are made not on consumer preferences in the abstract, but by demand backed by purchasing (resource) power. To put it more plainly,

what is produced in an economy is decided to a large extent by how resources are distributed in the system which determines the distribution of purchasing power. Apart from what bearing this has on the valuation of goods produced for national income calculations, it will also bring out the fallacy of the standard argument that for everyone to have more, the 'cake' will have to grow larger as a precondition.

That leads to the role of demand in the determination of national income and its growth. Remember that in Chapter 1 we referred to the role of the 'demand constraint' along with resource constraint and labour constraint as the determinant of total output. What we saw there was that if the household does not have a resource constraint or a labour constraint the actual output will be what the household considers to be its need or requirement and we had flagged it there to be taken up further in this chapter.[18]

The best way to take up the role of demand in the determination of national income is to place it in the historical context. You may recall from your knowledge of the great events of the past that one of the worst economic crises, frequently referred to is the Great Depression which spread over a few years from the late 1920s to the mid 1930s. In fact you will remember that when the recent global meltdown happened a few years ago, it was very common to hear that it was almost as bad as the Great Depression. The comparison was partly also because both these calamities started in the USA and then spread to other parts of the world. As in the recent instance, so in the early 1930s also unemployment of workers was one of the most visible and tragic manifestations of the crisis – almost a fourth of the American workforce becoming unemployed.

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Before we move on to that, are you a little surprised by the similarity of treatment in some important aspects between a single household and a nation? Don't get it wrong: what is implied is NOT that the nation is a 'blow up' of a household. The similarity in treatment arises from both an isolated household and an isolated nation being 'closed' analytical units. In the immediate context it means that the $Y = C + I$ statement and the $S \equiv I$ identity are both applicable when closed units are treated in terms of their aggregates. In the case of a nation, we shall see in the last section of this chapter what happens when the nation ceases to be 'closed' and 'opens' up to other nations.

As it happened during the recent meltdown, the malady soon spread to Europe and other parts of the world as well and there was a lively discussion among British economists about the causes of and remedies for it. Professional views were sharply divided.[19] One position was that workers become unemployed because the wage rate is not flexible downward, that is, they refuse to accept wage cuts. Incidentally this view was championed by a very humane economist of the period who had received attention and praise for his work on *Economics of Welfare*. He pointed out that economies go through periods of adjustment in the short run, but that in the long run the system would come out of the crisis if prices, including wages, were flexible, that is, if the solution is left to the 'market'. A younger colleague of his who was well acquainted with real life economics rebutted the reasoning by declaring: "In the long run we are all dead" and insisting that there was an effective short run way out. His name was J.M. Keynes. As an observer of the real world, he pointed out that most workers were unemployed against their will or were part of 'involuntary unemployment' and that while they remained unemployed factories also remained closed, or were running below capacity. He, therefore, insisted that the problem was not something that affected only the labour market, but all markets and the system as a whole.

It was Keynes, who in recent times, drew the attention of the profession and the public about the complexities of the economic system as a whole as a 'macro' unit, pointing out that while producers, meaning capitalists, had their aggressive 'animal spirit' and were always eager to keep moving, consumers, that is households, also had other sentiments and would often tend to be overcautious. We owe to Keynes the Y = C + I statement and the S=I identity. He pointed out that demand in the system as a whole consisted of the demand for consumer goods by households and for investment goods by producers and since consumption was the larger component, consumers as a whole with their

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 You know, don't you, that you can trust economists *not* to agree on just about anything!

‘propensity to consume’ were the real drivers of the economy and accounted for a major share of the total demand. He used this to argue that *reducing wages* was the wrong remedy to remove unemployment because it would reduce total demand further and thus lead to further reduction in output.

Keynes demonstrated also that even if the level of investment was kept up and of consumption was reduced, national income would fall because Y = C + I and that the adjustment mechanism of the system was *income* and not *prices*. Also, making use of the fact that “one man’s expenditure is another man’s income” and, therefore, total income was equal to total expenditure, he argued, to the surprise of many, including professional economists, that the way to increase income was to boost expenditure! But if nobody was willing to spend, producers because they were facing a depressed market and consumers because vast sections of them were not having much of an income as they remained unemployed, the government should step in. “If there is nothing else to be done, get workers to dig holes and then to fill them up” he is supposed to have declared. But in more sophisticated ways he was implying that the government’s spending by ‘deficit budgets’, increasing expenditures more than it collects as income, had a major role in the system and that ‘public works’ were the best way out of the depression.

All this was so novel in the late 1930s that the new doctrine came to be referred to as ‘the Keynesian Revolution’! It must be pointed out, though, that while Keynes’s position may have appeared ‘revolutionary’ in academia, Franklyn Roosevelt who won the US Presidential Election of 1932 by promising massive public works programme had started implementing such deficit budgets in America.

Not that all economists accepted the Keynesian doctrine. Those who tenaciously held on to the assumption with some lame justifications, that the economy left to itself would automatically reach ‘full employment’ of resources and workers, opposed it. Some of Keynes’s devoted followers in his own university, Cambridge, staunchly defended him, he

was quite a fighter too, and many American economists also joined the battle. The academics continued the fight for decades and even now there are economists who write expounding or criticizing Keynes. But on the impact of government's expenditure on the rest of the economy there is now a generally accepted understanding, with the result that a few decades back an American economist who was for long hostile to Keynesian approach in general conceded that on this specific issue "we are all Keynesians now".

However, it must be noted that the argument that the government can kick start the economy by stimulating demand – 'pump priming' as it is referred to – is conditions specific. It can work only when there is a 'slack' in the economy, that is, that there is *both* excess capacity and unemployment with the workers seeking work. Under such circumstances the government spending will have a 'multiplier' effect. Though it is a technical expression, the idea is quite simple. Let us say that the government gives a subsidy to a big shoe manufacturing company to start production again after it had shut down for a while as there wasn't enough demand for shoes. The company recalls its workers and pays them. The workers use their earnings to buy things that they had postponed for a while as they were unemployed. Demand goes up for several goods including shoes, raw material such as leather which is needed to make shoes etc., down the supply chain. Many industrial units get revived. There is more production. More income, more spending –the economy recovers. So from the government's initial expenditure, a good deal of more of incomes have been generated -- 'multiple times'. Since the multiplier is based on the propensity to consume, once that is known, the multiplier effect can be calculated also.

A second and closely related matter is about the government's budget. There are many, including economists, who hold the view that as in the case of individuals and organizations, so with the government also prudence requires that it should live 'within means'. That the government must 'balance its budget' then becomes the dogma. The

fallacy must be obvious, but every now and then one hears profound discourses on the subject – a kind of *fiscal fundamentalism* derived from the original source, market fundamentalism.

There is the opposite fallacy also which maintains that the government, if it has the 'political will' can easily solve the problem of unemployment through deficit spending. In the early days of planning in our country some who claimed to be Keynesians put this forward as a policy recommendation. The basic fallacy here was that what is popularly referred to as 'unemployment' in our country is not 'open unemployment' that Western advanced countries experience from time to time. But even in the context of the Keynesian approach, as has already been noted, deficit financing as policy measure is recommended where there are *no supply constraints*. The supply constraints can be in the form of inadequacy of capital equipments, such as shovels or machinery, lack of skill of those who desire employment, short supply of goods on which workers will spend their earnings, especially food grains etc. These constraints must be fairly obvious and it should not be difficult to see that where an economy is characterized by them, deficit spending will not lead to increase in employment or output, but only cause a rise in prices or *inflation*.

At this stage we must say good bye to Keynesian economics which has not been our primary concern. But it is via Keynesian economics that analysis at the aggregate, macro level was made acceptable, valid, and unavoidable for a proper understanding of the complex set of human interactions called the economy.

Aggregate analysis is the basis for an understanding of the growth of the economy over time. We shall soon move to an exploration of 'growth'. Before entering into a somewhat technical discussion of it, however, it is important to grasp that no matter how national income is defined and growth is measured, growth implies increase in *productivity*, that is, output per worker which depends on the increase in capital per worker, technological

improvements, education and many other factors. We shall, therefore, attempt a further division of national income and a further grouping of workers to learn more about productivity.

Sectoral Analysis

While national income gives us a single figure account of the national economy, very helpful for some purposes, it is also too much of a lumping together. It does not allow us to *'enter in'* so to say. You may point out that we entered in via the production units. True. But what we did was to enter into the production units themselves to understand their internal structure. Then we *stepped out* to see how they relate themselves to one another, still remaining at the 'micro' level. The relationship between the primary units of the economy and the functioning of the national economy is rather like anatomy and physiology in the study of the human body that the medical students do.

We shall now attempt a partitioning of the national economy into its 'sectors'. This partition is done not to understand the *working* of the economy as was the case when we were dealing with the production units and the intermediaries. The *sectoral* analysis is meant to get a better idea of national income and its growth over time through a partitioning of the economy.

National income is the value of the entire output of the economy during a specified period, usually one year, as we have seen. But the output consists of a variety of goods and services. Is it possible to group these goods in such a way that the variety is reduced within each group? Economists use a rough and ready classification for this purpose. It follows more or less the sequence of production and more important, the valuation of the goods and services.

Since food gathering and production must have been the primordial activity of human beings, Agriculture (A) is the first sector to be considered. Note that it consists not only of paddy, wheat etc., with the variety within each, but also commercial crops like cotton, jute and rubber. It also includes products from the forests, yield of animals, fishing and products from related activities. Into that sector is brought in mining and quarrying as well. Because of this diversity within the sector, it is also referred to as the Primary sector (P).

The second category to be considered is broadly the output of Manufacturing or industry (M). It also includes electricity, gas etc. as well and hence an alternate name given to it is Secondary sector (S). Agriculture (A) or Primary (P) and Manufacturing (M) or Secondary (S) sectors put together will thus include all that is considered as goods.

The third sector then, consists of Services (S). This also, consists of a miscellaneous set—services rendered in trade and other intermediary activities, familiar services of carpenters, construction and transportation workers, those involved in communication, entertainment, finance, real estate, in the 'professions' such as teaching, law medicine, etc. those serving in the many activities of government including the armed forces, and many more. This sector is also referred as the Tertiary Sector (T). Agriculture (A), Manufacturing (M) and Services (S), alternatively also designated Primary (P), Secondary (S) and Tertiary (T) are the conventionally recognized sectors of the national economy. There is no special sanctity about this classification or the designation of the sectors. We shall follow the A-M-S division.

We have already noted problems associated with gathering information about output in these sectors because of the large number of units in each of them from the very tiny ones to the giant ones. The valuation process is even more difficult, especially in situations where only part of the total volume of product is brought into the sphere of the market.

In this regard the Service sector presents some special problems. How is the 'production' of this sector to be measured because the product is so intimately associated with the producer? Compare the production of this sector with that of the other two, taking the M-Sector for comparison. Let us take *cloth* from this sector as an example. We know of the large number of units in cloth production and the bewildering variety of technology within that 'industry'. We know also that not all that is produced in many of these units is brought into the market. And yet there are reasonably accurate, but approximate ways of estimating the total produced and can make the heroic assumption that the quality differences get reflected in market prices. However approximate and arbitrary these procedures may seem to be, some figure can be arrived at to convey the 'value of output' of this segment of the M-Sector.

Now turn to the S-Sector and pick one of the most widespread segments of that sector – trade. It covers a large number of self-employed persons, women in rural areas, men along the streets of the towns and cities, the millions of single person corner shops, employees, all the way from those working at the counters to the managerial category, of department stores. How can their 'output' be gauged at all? And how to move from there to valuing that output? A similar problem exists in calculating the value of output of teachers, lawyers, writers, politicians and many more.

A clever way in which this problem is partly solved is to stop worrying about the 'output' of this sector and to pretend that the earning of the members of this sector can be taken as proxy for the value of output. Smart move, isn't it? It not only means that the earnings of this sector decides the 'output' of this sector without any other independent procedure to validate it, but also that the sector's contribution to 'national income' becomes highly questionable. We shall put this matter on hold for the time being and get back to it later.

One of the reasons for viewing the national economy in terms of its sectors is the finding that when economies grow over time or as they 'develop', to use the more familiar terminology, the sectoral composition changes. Studies of national economies over long periods have shown fairly conclusively that the share of the A-Sector declines both in terms of output and employment, both first increasing in the M-Sector and then in the S-Sector. Another way of stating this is that in 'low income' national economies the A-Sector will dominate whereas in 'high income' national economies the S-Sector will dominate.

If you think about it for a moment you will see why. In a low level economy, especially in 'closed' ones, food production will have high priority and a substantial proportion of the workforce will be engaged in that activity. As income rises, proportionately less will be spent on food; manufactured items and the associated services will increase in demand. At the same time productivity per worker will increase, including in the A-Sector. Hence in the A-Sector output will get reduced proportionately to total output and workers will move out to the other two sectors.

While this is the general tendency as has been empirically demonstrated in the present day 'advanced' or high income countries USA, most countries of Europe and Japan that experienced this transformation in the 19th and early part of the 20th centuries) the pattern is somewhat different in countries that began experiencing growth in national income from the second half of the 20th century such as countries in Asia, including India and China, African and Latin American countries generally. We shall examine the Indian case in Chapter 11, but a sketch of the difference in pattern and the explanation for that follow.

Typically, in the second group of countries there was a big increase in population in the latter half of the past century. "Feeding the millions" thus became a matter of high priority. In such situations the initial response would be to increase total output by

bringing more land under cultivation and engaging more workers. There may thus be no increase in productivity either per unit of land or per worker. Gradually other measures such as increase in irrigation and use of fertilizers will be introduced and productivity will begin to increase over time. But where land is limited and irrigation facilities and technical changes are slow to come about, the natural alternative is to have more people working on land. This will be particularly so if the M-Sector is slow to pick up.

The expansion of the M-Sector calls for substantial increase in capital. That may not happen automatically and in most cases the State will have to step in. With some time lag, output of the M-Sector may increase as indeed the sector's *share* in total output. But the M-Sector is slow in absorbing workers. This is especially true in its 'modern' segment and more so when it is dominated by private enterprise because for those whose main concern is profit, wages constitute the major cost item and they will do everything in their powers to keep that down. But output and share of output of the M-Sector may go up. We must also recall that there is a vast petty, small business, production segment in the M-Sector which consists of those who have been traditionally in manufacturing and those who set up small manufacturing concerns to make a living. This 'unorganized' or 'informal' segment of the M-Sector is labour intensive and to the extent that this segment expands over time, the M-Sector's share of workers may show some marginal increase.

That being the case of the A-Sector and M-Sector, it is the S-Sector that is likely to expand both in terms of employment and output over time. The increase in employment is easily explained. A major component will be bureaucracy and military. 'Professions' will also expand. There will be increases in trade, banking, finance, transport and communications, hotels and recreation, real estate services and many more. But here, again, there will be an expanding 'unorganized' segment which is likely to be the residual segment for the entire economy. Entry into agriculture will be limited by the availability

of land. Capital is required to enter into manufacture. No such complementary factor is necessary to enter into the S-Sector.

But along with this low income segment of the S-Sector, there will also be a very high income segment. As people's incomes increase they not only create some low income earning employment for domestic servants, drivers etc., but also a section of high income earners as well. High income professionals would want holidays and that gives rise to travel agencies, upscale hotels etc. Many private hospitals, educational institutions and entertainment centers will emerge providing high priced services. In short, high incomes generate additional high incomes.

This has two major consequences. The first is that when high incomes in the S-Sector increase especially via market operations, there will be a semblance of increase in national income. If the growth of an economy is accompanied by an expansion of the S-sector that growth then must be viewed with suspicion in terms of its contribution to the national economy, as a great deal of it is likely to be illusory.

Secondly, 'growth' via the expansion of the S-Sector will imply increase in inequalities precisely because that sector is characterized by millionaires to low income earners, a good many of the latter self-employed struggling at the level of precarious survival.

Growth

We can now turn to a direct examination of the growth of the national economy. What is growing, of course, is national income, Y, over a period conventionally the fiscal year as we have already seen. Growth is the increment to national income, Yt_2—Yt_1 where Yt_2 is the national income of period 2 and Yt_1 of period 1. This increment is conventionally denoted as ΔY. Note that ΔY is an amount which can be converted into a rate $\Delta Y/Y$ and it is the *growth rate* expressed usually as a percentage. When you hear someone referring to the growth rate of the Indian economy being 8 per cent per annum or of the

Chinese economy being 10 per cent or of the US economy 2 per cent, this is what is meant. Hence 8.0 per cent and 8.3 per cent make a big difference – ask the Finance Minister or the Deputy Chairman of the Planning Commission!

Let us explore the growth phenomenon a little more. The first thing to note is that while there may be many factors responsible for the growth in output over a period of time, agricultural output may increase because of more land being brought under cultivation, growth in the final analysis is an indication of increase in *productivity*, of *labour* productivity, because, as we have already seen, labour is responsible for 'value added'. Augmenting growth effectively, therefore, will depend upon ways to increase labour productivity, directly by improving health and efficiency of the workers, by increasing their skills, and indirectly by making available more co-operating factors to them (better tools and capital generally), better technology and bringing about changes in the organization of production.

This has to be emphasized because there is a much celebrated tradition which maintains that growth depends on capital formation and its enabling measures, increase in savings and investment. Indeed in the early days of growth or development of poor countries of the world there was a widely held formula G=s/v, where G, of course is growth, s is the savings ratio (i.e., savings/national income) v, capital/output ratio indicating the productivity of capital. It was alleged that poor countries were poor because their savings ratio was low, from which the policy prescription was derived that poor countries must save more to achieve growth. A distinguished 'development' economist, who later was awarded the Nobel Prize, categorically stated that the crucial issue in development was to step up the savings ratio from 5 per cent to 12 per cent. If G is equal to s/v, if v remains the same, the larger the 's', the higher will be growth – by definition!

This is not to imply that savings and investment are not important for growth. *But the cart should not be put before the horse*. Let us see what role savings and investment play.

At one stage it was thought that generating savings was the crucial and most difficult issue. That was the position that our First Five Year Plan document took in the early 1950s. But, look at it this way. If you are finding it difficult to make ends meet, you will think of savings as a difficult and almost an impossible task. If you are slightly above poverty level and you think that some important matter for the future beyond current consumption has to be attended to, you will find a way of achieving it. Most parents in our country now decide that providing higher education, preferably professional education for their children is important. How do they achieve it? Very often by 'tightening the belt' – that is, by taking a careful look at all their current expenditure, cutting out what they consider to be 'unnecessary' and thus saving a part of their present income for future use.[20] But for those, whose present income is above a 'comfort level', no conscious decision is necessary to save; they will have a residual amount over their consumption level every month or every year. To such people saving is a passive residual. Most of the savings of the national economy comes from such people. In such situations the real question is not how to *generate* savings, but how to *mobilize* savings: we shall come back to it soon.

Investment is very much part of production, therefore, is the crucial issue as far as growth is concerned. And the best way to appreciate it is to go back to Chapter 1 and note that the work on a well for irrigation is very much a human activity associated with production, but not meant for immediate consumption. Not all investment, though, will be productive. In Chapter 1 we saw that even in the kind of economy we considered there, a locus of authority is required. Think of the single household as a fairly large tribe in which the authority is the Big Chief. The Chief can direct W, the working members, that apart from producing paddy, they should also work to produce a special living quarters for him. Since that work is not meant for current consumption it can be treated

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20 They can, of course, borrow for the children's education and ask children to repay the loan later – we have seen how this is done.

as investment, but since it is unlikely to increase output in the future, it will have to be characterized as '*unproductive investment'*. Note that it does not mean that all 'unproductive investment' is useless. That is for the community to decide. Let us recall also that all over the world in the past communities have spent labour and resources to produce monuments which certainly were not productive, but useful from *their* perspective. The point simply is that if any investment is unproductive, an increase of production in the future or 'growth' cannot be expected from it and therefore the nature of investment must be scrutinized along with the quantum of investment.

Given that the investment that is currently made will increase production and will lead to growth in the future, the next question to consider is what sort of growth in output will materialize. If there is only one good, paddy being produced, this question doesn't arise. When guns and butter are being produced, it becomes important to decide which should grow. Converting growth into an all- encompassing number has certain advantages, but it hides the really important issue of the *composition* of growth which depends on the *allocation* of investment.

Discussions of the sectoral composition of the economy are meant precisely to feature this aspect of growth. Since we have dealt with one aspect of this matter it is not necessary to go into details. However, a word about the allocation of investment may be added to what has been noted. If the flow of investment is left to the proclivities *already inherent* in the system, the chances are that much of it will go into the M-Sector because, as in production, so in investment also profit making is the main driving force. Perhaps it is justified up to a point because industrial growth has high priority. But by the same token investment in the A-Sector is likely to suffer, as much of the output there is *not* based on profit considerations. Hence if agricultural growth is required, investment will have to be directed into it by the 'authority', the State.

There is a deeper problem if we disaggregate the sectors further. In analyzing the national economy, aggregation and disaggregation are not a one-time process. If it is granted that the national economy is a complex entity, it will have to be viewed from different perspectives depending on the nature of the problem. Take housing as an example. There may be agreement 'in principle' that next to food and clothing shelter is the most important requirement of human beings and public affirmations such as in the Five Year Plan documents may endorse that *everyone's* housing needs should be met. And we know, even from casual observation that as the economy grows construction activity picks up quickly. It also means that investment is flowing into that segment of the economy. But what is the principle that presently *allocates* investment into that segment? The answer can be found if we look around and observe the kinds of houses that are coming up. Plenty of luxury apartments and houses and villas with a wide range of amenities are surely being put up. Construction of housing for the not so affluent is also taking place. On the other hand, if we go on the basis of needs, what we should have been observing is the construction of housing for the ordinary people, *aam admi,* indeed. But how many of these do you come across?

If you don't see many of them, reflect again and exercise your sense of reasoning or logic. Isn't it true that just as production is guided by purchasing power, investment too is directed and allocated by the same principle? We are back at the ownership of resources as the principal determinant of the market system. Resource power determines purchasing power which determines the pattern of output and the allocation of investment to augment output. *Briefly, then the nature of growth is determined by the existing distribution of resources which also allocates investment.* These underlying causative factors are conveniently (and deliberately too?) hidden by concentrating on growth as an all- encompassing number rather than in terms of sectoral allocation. Let us once again look at clichés such as 'the cake has to grow bigger for everyone to have more' which has a certain intuitive appeal. The way to meet such false propaganda is to respond that in this country (and those similarly situated) the production of cake and the

investment required for it to grow should be taken up only after producing *roti* to meet the needs of the millions – the starving millions – and ensuring that investment is steadily directed for the growth of that segment. If this is an 'ideological' position, the opposite is ideological too, but cleverly wrapped up in theories and innocuous numbers!

We shall now try to bring together what we have considered about the output, savings, investment and growth of the national economy. We started from the basic premise: the single clue to understand the performance of the national economy is *ownership and control of resources* because resources are the aid to labour in the production of goods. The control over resources determines to a large extent the pattern of production in the system along with the distribution of resources that send out the 'command signals' for production, as well as the distribution of earnings, essentially as wages for remuneration of labour and in the form of profits as returns to ownership.

Where a section of the population has comfortable earnings, part of it will be spent on current consumption, the rest, the passive residual accruing as savings. To the extent that the savings decision and the investment decision are made by independent agents, the savings will have to be mobilized (a role that is usually performed by intermediaries such as banks) and channeled into productive investment. If conscious decisions are not made to allocate investment into segments of the economy where increase in production is not considered to be socially necessary, the allocation of investment decisions will be governed by profit calculations and investment will flow into segments that can be expected to yield and augment profits. If there has to be a flow of investment into segments that do not account much for purchasing power, investment must be directed to them by the public authority. Leaving investment decisions largely to profit driven private investment and the market will result in socially undesirable production patterns, deepening inequalities, distorted and, indeed, *impoverishing* growth paths, however paradoxical it may sound. One may go a step further and say that

when profit oriented market investment campaigns become globally aggressive, they become destructive of human beings and nature. More on this in the next chapter.

Two more aspects relating to growth need to be considered. The first is what the strategy for the allocation of investment should be where the savings and investment decisions are jointly made by the same decision making unit. We shall take up this question specifically in the Indian context.

The second is to return to the question of valuation that was noted earlier. The point discussed then was how to assign monetary value to the variety of goods produced during a predetermined period to move from total output to national income. There is a related issue. If you want to compare national income over two different periods and make an assessment of growth you must take into account the changes in prices over that period. Prices of individual goods (paddy, biscuits, cars, perfumes …) are all likely to change from one period to the other. What is frequently referred to as 'the general price level' will also change. Let us start with the latter. The general price level is a weighted index of prices of individual items and there is a variety of such indices, the Wholesale Price Index, the Consumer Price Index and so on. The goods to be included and the weights to be assigned to each are decided after careful study of details. For calculations of national income what is relied on is the Wholesale Price Index (WPI). A typical year's national income is stated in Current Prices and in Constant Prices. Where it is expressed in Constant Prices, it reflects Current Prices adjusted for variations in prices using the WPI of an earlier year; the year chosen is given. For long term evaluation of growth national income in Constant Prices, of course, is more reliable.

'Closed' and 'Open' Economy

So far we have dealt with a national economy on the assumption that the (national) unit we are dealing with does not have any transactions with 'outsiders', namely other

national economies. Such an economy is referred to as a 'closed economy'. This is rarely the case. Most national economies are 'open' ones, meaning that they export their goods to other countries and import goods from other countries as well. So, measurement of the value of goods in a country must include not only what is retained in the country, but the value of exported goods also; similarly the value of goods available in the country should exclude the value of imports. Exports are conventionally designated as 'X' and imports 'M' and hence for an open economy

$$\text{National Income} = Y + X - M \qquad (5)$$

The figure thus obtained is referred to in common parlance as 'Gross Domestic Product' (GDP). Sometimes allowance for depreciation of existing capital stock is made thereby arriving at 'Net Domestic Product' (NDP), but that can be ignored because GDP is the more commonly used expression.

Having summed up national income as GDP it may be useful to recall that it consists of different components. Let us indicate it as follows:

$$\text{GDP} = \text{Private Consumption} + \text{Private Investment} + \text{Government Consumption} + \text{Government Investment} + \text{Net Exports} \qquad (6)$$

This formulation is simply a way of expanding (5) or even (1).

National income (GDP) divided by the total population gives *per capita* GDP which is another expression you normally come across.

An 'open economy' has movements of people, goods and capital into and out of its boundaries. These movements are not totally free; each country imposes its special conditions, but on the whole in today's world there is an attempt to see that such

conditions are reduced to the minimum and that there is no discrimination aimed at particular countries.

Movement of goods across national boundaries that we shall concentrate in this chapter (the movement of people and capital is considered in the next chapter) is referred to as 'international trade'. Nations trade with other nations essentially for the same reasons for which units such as individuals, households and firms enter into transactions with others; because it is to their advantage to do so. The basic reason, in both instances, is specialization arising from division of labour though between countries the explanation is not that simple.

The underlying reason for international trade being different from trade within nations is that in the latter case, there is an accepted common currency in terms of which transactions can be settled. It is the absence of a 'world currency', a mutually acceptable means of payment, which distinguishes the former from the latter. There is no 'world currency' because there is no authority (a world government, for instance) that all countries accept and which can, therefore, issue such a currency.

The difference between internal trade within a nation and international trade can therefore be described as follows: in internal trade there are two parties, two goods and *one* currency; in international trade there are two parties, two goods and *two* currencies. That is, when a country trades with another country, let us say India and the United States, there is a transactions between goods going from India and goods coming from the US, but an exchange between rupees and dollars as well. Let us look at these two operations sequentially.

Confining ourselves first to goods let us note that many goods manufactured in India by different producers will be going to the US and similarly there will be a flow of variety of goods from the US to India. When these transactions are totaled up at the end of the

year, if the value of exports from India to the US turns out to be equal to the value of imports from the US there will be no additional 'payments' problem. But that, of course, is very unlikely. There will be either an excess of exports from India or of imports from the US. If the value of exports exceed the value of imports as determined in terms of a globally accepted currency, India will have a 'favourable balance of trade'; if the value of imports exceed the value of exports as determined in terms of a globally accepted currency, an 'unfavourable or adverse balance of trade' exists.[21] If Indian exports to the US exceed Indian imports from the US, America will have to make a currency settlement. Americans will pay dollars to India and India will be quite happy. On the other hand, if the Indian imports from the US exceed Indian exports to that country, India will offer rupees to the US and the US may turn round and say: "Your currency is not acceptable to many countries of the world and so we are hesitant to take rupees from you". India then will have a typical 'balance of payments problem' or even a 'balance of payments crisis' if it is serious.

Why is this so? The basic issue here is that there is no global currency acceptable to all countries and that is because there is no global authority government to provide the required backing to an international currency.

This is a long standing historical problem which we shall not try to trace. We shall deal with the contemporary situation after briefly mentioning the immediate historical background.

In 1944 when it was clear that the Allied Powers, UK and USA, would soon win the Second World War, an international conference was held to discuss how the post-War

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21 Favorable and unfavorable in this context are expressions coined several centuries back when a country having an excess of exports had gold flowing into it and this was considered to make the country wealthy. But if more goods are going out of the country than goods coming in, there will be a net loss of goods in the country. Is that particularly 'favorable'? On the other hand payment problems arise when there is an excess of imports over exports and that may turn out to be worrisome. In any case, we shall follow the conventions in this regard.

payments problem would be handled. An institution with the name International Monetary Fund (IMF) was set up. The corpus of the Fund was to consist of national currencies which each of the member countries would contribute. If, subsequently, a member country faced a balance of payments problem it could draw the required currency from the Fund to settle the problem and pay back later. It was thought that this arrangement would result in a basket of stable currencies and that that would enable countries to go in for greater international trade.

The IMF still exists as the only international monetary system, but its performance has not been particularly noteworthy. What actually happened after the Second World War was that the US dollar emerged as the *effective* global currency, initially because the dollar was readily convertible into gold till 1971 and subsequently because of America's economic and military power.

We are not interested in all these historical aspects, some of which we shall return to in Chapter 9. Let us concentrate on the national economy and see what options it has if and when it faces a balance of payments crisis. The standard procedure is for it to make changes in the external value of its currency. A two-country situation is the simplest one although international trade is essentially multilateral and a two country analysis will not capture all complexities.

Let us go back to the India-US trade and consider what India can do if she comes to have a persisting unfavourable trade with the US. A distinct possibility is to *devalue* the rupee in terms of the US dollar. This means that after devaluation more rupees will have to be paid to get a dollar. How does this help? Americans who were buying Indian goods will now be able to buy more such goods for every dollar they are spending because the Indian goods are priced in terms of rupees. Hence there is a distinct possibility that Indian exports to the US will increase. Think of an American family wanting to visit other parts of the world as tourists. If they hear that the Indian rupee has been devalued in

terms of the dollar, all other currencies remaining as before, a visit to India will become quite attractive to them because with the same amount of dollars they can now stay in higher priced and hence a more comfortable hotel, or stay in the same hotel as before for longer and do more sightseeing. When American tourists come to India and spend dollars here, it is the equivalent of India exporting more goods to USA and getting paid in dollars. On the other hand, imports from the US will become more expensive for Indians and India's imports from that country will get reduced. Devaluation, therefore, will not help immediately with the balance of payments crisis, but by changing the patterns of trade, it may reduce dollar payment problems subsequently.

An open economy will have to deal with other problems such as the movement of capital into and out of the country being a major one. But these are better dealt with when we turn to globalization in the next chapter.

Chapter 9

The Global Economy

In a sense when we considered the 'Open Economy' in the last chapter we were already into the 'Global Economy' because today's global economy is based on what used to be called the 'International Economy' consisting of several national economies dealing with one another in terms of the movements across their borders, of people, goods and capital. Some of the economic issues of such movements have already been noted, but since there have been some changes during the past two or three decades, let us look at some of these new developments in each one of them.

Movement of People

Movement of people from one place to another, of course, goes back to the earliest phases of human civilization. In fact, the spread of civilization is closely related to migration of groups of people from one geographical territory to another. We don't have to spend time speculating when such movements became inter-country or international or when people started thinking of the globe as a single unit for human habitation. However, certain significant periods of recent vintage may be recalled. After Christopher Columbus accidentally landed in the 'New World' on his *Westward* voyage to reach the 'Old Worlds' of the *East* there was a fairly large-scale migration of people from Europe to the new territories that have come to be known as the Americas, both North and South. These invaders pushed out many natives of these territories from their *homeland*. Many native inhabitants were also killed. European or White colonies were established there, especially in the Northern territory. Subsequently some of these colonies became independent nations such as the United States of America. Along with the free movement of the whites, there was also a forced movement of Blacks who were brought from Africa to the new White settlements to work and live there as slaves. There was

another fairly large scale movement of whites, mainly English, eastwards to Australia where, again, they subdued the natives and converted it into another white colony.

There have been other large migrations also, including from India. Workers moved (or were taken) from India to the West Indies, South Africa and Ceylon as well as to Malaysia and many islands of the East. At one stage there was a flow of people from India to Persia (now Iran) and to different countries of the Gulf region. This latter flow still continues, but only on a more limited scale.

It seems safe to say that the era of large-scale movement of people from one part of the world to another to become settlers there has come to an end. There are still instances of individuals and families who leave their native land India and migrate to other parts of the world such as U.S.A., U.K., or Australia to settle there. There is a similar flow of immigrants from many countries of the pacific region to the more affluent parts of the world. From Africa there is a movement of peoples into Europe and USA, while there is emigration from Eastern Europe to USA.

The character of human movement from one country to another has substantially changed during the past two or three decades. It now takes two forms. The first is of highly skilled people, technicians and business persons who now move about frequently and stay in a country other than theirs for short periods. Phenomenal technical progress and changes in business practices are mainly responsible for such movements. The second consists of people who visit other countries as tourists. Indeed, tourism has become a major international industry. These two forms of human movements are part of the process of globalization. It may be noted, however, that global movement of people has not become smoother in the era of globalization. If you have travelled around recently on vacation or visits you would have noticed how terribly cumbersome, tedious and irritating the procedures to secure visas for entry into other countries have become.

Movement of Goods

Movement of goods from one part of the world to another also has a long history. What was once a voluntary, slow and small group effort picked up enormously and came under a wide range of organizational patterns. Changes in production and transportation were partly responsible for the increased volume of inter-country trade. Colonial domination and imperialism were other responsible factors.

As we have already noted in the previous chapter, international trade is crucially dependent on the means of payment as there is no global currency in terms of which balance of trade adjustments can be made. In the late 19th and the early part of the 20th centuries gold was used for this purpose and that phase was known as the period of the Gold Standard. It had problems of its own and we have made brief references to the attempts made towards the end of the Second World War to deal with matters of inter-country transactions and to promote global trade. If countries are considered to be economic units they can benefit from trade just as other units can benefit through exchange.

Hence in recent years there have been many coordinated attempts to bring about freer and increased movement of goods (trade) among the countries and nations of the world. Apart from the payment problem there are other important matters also to be discussed and resolved to achieve that objective. Let us try to understand some of them.

A major problem is that domestic economic policies may not be compatible with trade with other countries. Consider a concrete example. For reasons that we have already examined, as countries grow and develop there will be a tendency for agricultural production to become relatively less important. Technical progress may also reduce the number of workers necessary to produce the required volume of agricultural goods. However, in practically all human settlements agriculture has become a way of life

closely associated with land and the rhythm of productive activities. Those who have been associated with agriculture for generations may be reluctant to move out into other ways of obtaining a livelihood. Under such conditions governments may be forced to resort to a variety of interventions to deal with such situations in the form of political interventions in the sphere of the economy. Price support for agricultural goods is the most common among them. For this reason agriculture in the United States and Europe has become a highly protected and subsidized activity. To protect agriculture or agriculturists these countries set up high tariffs walls also.

But there are less developed countries for which agriculture is the major economic activity and agricultural products the only goods they can export. Tariff walls of the richer nations stand in the way of poorer countries exporting their agricultural products. Who should win – in such a situation; the richer countries who preach free trade but practise protection, or the poorer countries?

There are also instances that work in the opposite direction. At the level of ideas such as the concept of human rights, there is greater global awareness now and the use of child labour in production and its relation to international trade have becomes a highly contested and debated issue. A fairly large proportion of Indian exports is from the small scale sector in which petty production is a standard form of organization as we saw in Chapter 6. Carpet making is a good example. In view of its organizational structure as a household industry, participation of children in carpet production is not unusual. Should Indian carpets, therefore, be prevented from entering the United States which claim to put a high premium on human rights?

Another contested issue is the protection of the environment which has become a legitimate global concern. To insist on adjustments in production and trade in relation to global warming or global pollution of air and water, how should a country's share be assessed – in terms of its total contribution, or in terms of the total divided by its

population? If it is the former, countries like China and India will be among the top ones; if the latter, the USA will be way ahead of any other country.

After several years and 'rounds' of discussions, bargaining and negotiations, an agency known as the World Trade Organization (WTO) was set up in the early years of the present century. Most countries of the world have become members of this body mandated to move towards freer and hence larger international trade taking into account the special requirements of less developed countries to ensure that human development becomes universally actualized.

There is also a more basic factor which has a bearing on international trade – the post War changes in global production patterns resulting from a new form of the organization of production through the Multi-National Corporation (MNC) also known as the Trans-National Corporation (TNC) as was briefly indicated at the end of Chapter 6.

Transnational Corporations as new Global Players

Multinational or Transnational corporations are business enterprises whose activities are not confined to a single national economy or its geographical boundaries. During the colonial days there were such entities like the East India Company which were registered in the metropolises of the home countries but doing business in both the metropolis and the colony. More recently too, there were companies closely associated with a particular country, but doing business in many parts of the world. Thus, General Motors, though involved in other parts of the world, was in a legal sense, a US corporation. Similarly, Philips was Dutch, Siemens was German, Nestle was Swiss, and Sony was Japanese. Apart from the fact that they were registered in these respective countries and were owned by shareholders in each one of them, their national identities were also underscored by the fact that their production activities were confined to their own countries.

Two major changes have come about since the Second World War. Immediately after the War, the USA, as one of the few if not the only country, that economically benefited by the War, took on the responsibility of the post war building up of the ruined national economies in Europe and Japan. In Europe, though Britain and France were part of the Allied Powers who won the War, their economies were as much in ruin as the vanquished Germany's and Italy's.[22] Under the Marshall Plan USA made capital available to its European partners, knit them together under the military North Atlantic Treaty Organization (NATO) and stationed American soldiers in key positions in Europe as well as Japan. These were all essentially official government arrangements.

But the American administration also made use of the opportunities such aid provided to boost American private enterprise. Initially the effort was to promote the export of goods manufactured in the USA to different parts of Europe. But as the economies of the European countries began to pick up, it was found more advantageous to set up production plants in different European centers, especially of bulky items like motor cars.

The Ford Automobile Corporation provided the clearest example of this new production strategy. In the early part of the 20th century Ford had launched an experiment in large scale production by bringing literally under one roof the entire manufacturing of the different parts of the automobile and then assembling them into the finished product and launching them on to the road. Ford thus demonstrated to the world at large a new style of industrial management of a complex production process and of mass production. However, productive capacity remained rather limited by contemporary standards.

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 It must be recalled that though the Soviet Union bore the brunt of the German onslaught, it withdrew from the alliance after the War. It, along with the East European countries, Poland, Hungary, East Germany and others whom it defended during the War and reclaimed after the defeat of Germany then constituted a separate economic, military and political Block against the US led post-War European coalition. The Soviet Block was the bulwark against the US ambition to exercise hegemony and remained so during the Cold War period of the 1950s through the 1980s.

But when extremely large scale mass production of cars became necessary, it was found advantageous to reverse the process and to have the different parts of a car manufactured in different suitable countries and to have the assembling done where the final product was to be delivered. Thus, in the 1960s and afterwards, Ford Escort which was assembled as a car in the UK and Germany had its parts produced in more than a dozen countries such as USA, Canada, France, Spain, Italy, Switzerland, Austria, Denmark, Belgium and even Japan. The new strategy was to locate production where the cost of production was the lowest because of the differences in the wage rates and taxes, as well as to take advantage of the concessions offered by the governments of these countries to attract investment for industrial production.

A large corporation whose economic strength matched the GDPs of small countries had bargaining power with their governments. From the corporation's point of view the spread of production base was also a risk diversification strategy: if there was a strike in one country, or a rise in wage rates in another, or a currency instability in a third, then the spread of the production plants gave the corporation the chance to cover these risks.

Thus a new *international division of labour* was brought about by the decisions and actions of a few large-scale American corporations which, in this process, also became effectively *transnational* units. This also had other major consequences, both economic and political. A major economic consequence was the close collaboration between a large foreign corporation and one or more small companies in the host countries. The large corporation was willing and eager to assign to their collaborators part of an industrial process, such as the production of windshield wipers or mirrors for cars. There would be detailed specification of the design; raw materials would be provided; credit could be advanced; and the entire output would be bought up: glorified arrangements similar in principle to the putting out system of *bidi* production that we saw in Chapter 6.

Second, though the entire decentralized production process was controlled by a highly centralized management team, there was to be movement of goods from one production location to another. How was this movement to be interpreted? Was it to be considered as *internal* movement of semi-manufactured goods from one site to another within a *single* firm or as the *international* movement of goods from one country to another? The standard practice followed in most instances of this kind has been for the Corporation to claim that such movements are to be given the former interpretation and to be administratively priced. Such prices are referred to as 'transfer prices'. And it is estimated that these intra-firm movements of goods at the global level constitute approximately one third of international trade now.

Third, involvement in production in various countries draws transnational corporations into currency transactions of these countries, placing them in a position to influence the relative prices of their currencies, especially of small countries. This, again, has direct bearing on global trade. A change in the external value of a country's currency leads to changes in the country's terms of trade, thus affecting both its exports and imports.

It also means that trading in currencies itself can become a quick way of making profits. Multinational corporations that generally produce and trade in goods have realized this and have recognized that the most traded 'good' in the global economy today is *currency*. The volume of transactions is shooting up literally from day to day. In 1990, $500 billion worth of currencies were traded *per day* which shot up to $1,500 billion in 1998 and to a whopping $3.2 trillion in 2007! Possibly global arms transactions take the second place.

Apart from actual trading there is now also a growing trend towards forward trading of currencies. The procedure, highly speculative, is for a trader to anticipate the value of a currency a year or two from now and strike a deal for the purchase/sale of a specified quantum of that currency on a future date. Actual transactions and future transaction of

currencies take place every second of the day and night ably assisted by the latest technological developments in communications, including computer trading and robust ways of maintaining records.

The New Global Economy – Territory of Finance

With currency trading brought into the arena of global movement of goods, we have already moved out from international trade in goods to the global flow of finance (remember, finance is the market for risk). But before we take up global finance as such, we must make a special mention of the growing trade in services which has also been rapidly growing during the past few decades and has been closely associated with revolutionary changes in the ICT, information and communication technology or simply as IT, information technology.

If the history of the old type computers is also taken into account, the IT industry is some 80 years old, going back to the 1930s, and interestingly enough was closely associated with International Business Machines (IBM). But the explosion in the industry came much later, in the 1970s when Programming Languages came into wide use, or even as late as the 1990s which saw the World Wide Web and the Internet coming into use. It is not surprising then that there is a close connection between IT and 'globalization', a term that came into common use also in the 1980s and the 1990s. In fact, in those early days there were many who vehemently asserted that globalization was a technological phenomenon. It took a while for people to understand globalization's inner economic features which did not come to public attention as obviously as some features of the 'IT Revolution'.

The connection between IT and services is that the IT has taken over many of the tasks that people used to render with very little mechanical aid. The IT, therefore, has become particularly visible in government and large corporate bodies where it has introduced a

fairly universal language for communications, not only in the present, but through the preservation of records linking the past, present and future as well. Another achievement of IT has been the manner in which it can deconstruct complex tasks into independent bits which can then be passed on in a split second across space (amounting almost to an annihilation of space in this respect) and to variety of people and agencies. It has, thus, brought in a new kind of spatial division of labour, facilitating the spatial dispersion of production (as in the case of the automobile industry already referred to) as also a spatial dispersal of services. Consider a few examples. It is now possible for students in any part of the world to listen to a lecture by a professor in some distant land and interact with her. Similarly, a consultation with a physician is possible without travelling long distances across national boundaries to get to his consulting room. A company can now *outsource* its telephone services to a location across the globe. Medical transcriptions can now be orally transmitted from one part of the world to another where they can be typed out and sent back over email. A bank can have a professional in any part of the world to reclassify its mortgages. Through such and many more ways, globalization of services is increasingly taking place with consequent transfer of funds, small and large, across national boundaries. Thus services rendered by citizens of one country, but paid for by another country become the former country's exports and hence enter into international trade calculations. It is not surprising, therefore, that India's corporate bodies that deal with IT services such as Tata Consultancy Services (TCS) and Infosys Technologies, have become global players almost from their early days and have become visible export earners for India. A group of individual global service providers is also rapidly growing.

We can now turn specifically to the movement of capital in the global economy. The first aspect to note in this connection is a further transformation of corporate bodies that have been involved in activities across national boundaries. In spite of their transnational or multinational involvements these giant bodies such as General Electric, British Petroleum, Toyota Motors in the goods sector; Citigroup, Bank of America, J.P. Morgan in

the banking and financial sector, and many more have remained closely connected with the country of their registration because through share holdings exclusively by the citizens of the respective countries, their ownership remained country specific for long. The shift came in the 1980s when the shares of these corporations came to be listed in capital markets in other countries also, enabling citizens of foreign countries as well to become *owners* ('sleeping partners' to be sure) of these multinationals. What is more significant about the multinationals becoming *trans*-nationals is the emergence of a global capital market. It is such a major transformation that *The Economist* in the early 1990s noted:

"Twenty years from now economists will think of the 1980s not as the decade of the international debt crisis, nor of the dollar's boom and bust…All these mattered, but none of them marked the decisive change in the forces that drive the world economy. Yet, the 1980s did witness such a change. During these years many of the boundaries between national financial markets dissolved, and a truly global capital began to emerge. It is for this that the past decade will be remembered".

This is the second of the two major changes that came about after the Second World War, the first being the international division of labour and productive activity, a reference to which was made earlier in the chapter.

Against this background let us continue our examination of the changes that came about in the 1980s and 1990s which led to the emergence of the global economy. A brief reference was made in Chapter 5 to the manner in which the USA, its banking and financial institutions came to be flooded with funds from other countries and had to seek opportunities in different parts of the globe to utilize them. American investors, especially the giant corporations and the financial ones among them were to do a hop, step and a jump wherever there were opportunities to make profits. The US banking and financial institutions were also starting to push the *'securitization'* process for which

additional markets had to be found. For instance, America's securities transactions with foreigners amounted to just 3 per cent of the country's GDP in 1970 which moved up to 8 per cent in 1980. But in 1990 it was 93 per cent. These figures further indicate the growth of the financial sector within the US economy and the rapid spread it was coming to have across the globe. Foreign direct investment (FDI) – that is, capital invested throughout the world, crossing national boundaries—nearly tripled in the 1980s. Growth of financial assets, most of which was based on credit and risk, was even more spectacular. During 1980 to 2007 world's financial assets nearly quadrupled in size relative to global GDP and were about 350 per cent of that total. Indeed, a recent writer makes a picturesque description of that situation comparing financial sector with the goods and services 'the real economy' sector, to two different planets and remarking: "Planet Finance is beginning to dwarf Planet Earth". If the purpose of finance is basically to service the real economy, that observation implies not only that the two were drifting apart, but that the servant was turning out to be the master!

Apart from this twist in the economic realm there were political factors that facilitated the flow of these funds to different parts of the globe. For close to four decades after the end of the Second World War the Soviet Union and the Soviet Block acted as a brake on the capitalist, and specifically the American tendencies to spread globally. But there were internal problems within the Soviet Block and by the 1980s these began to be quite visible. When Poland came out of the Block it was considered an isolated instance. Then Hungary came out and in 1989 the Berlin Wall that separated the two German countries, West Germany the show case of European capitalism and East Germany the staunchest ally of the Soviet Union, was brought down from the Eastern side. Finally early in the 1990s the Soviet Union itself disintegrated and the political and military power that kept capitalism at bay was gone. Equally significant was the fact that from the middle of the 1980s China which from the late 1940s onwards had brought about a socialist transformation of its own by closing its massive economy to the rest of the world decided to open up to global trade, and indeed, to welcome the flow of capital, including

from the USA, till then its bitterest enemy.[23] By the late 1980s and the early 1990s it therefore appeared that the world had become ready for a new phase in history and a new global economic order under American hegemony and driven by American MNCs. That is what has come to be known by the neutral title 'the global economy'. The fusion of economic and political interests in the globalization agenda was unambiguously, if bluntly, stated by Thomas Friedman, a staunch defender of the new faith: "The hidden hand of the market will never work without the hidden fist… And the hidden fist that keeps the world safe for Silicon Valley's technologies to flourish is called the US Army, Air Force, Navy and Marine Corps". Globalization is more than an OPM War!

We can now turn to the central aspect of the global economy – the global circuit of capital in many forms. Let us note that part of the movement of capital across national boundaries is in the form of goods, capital goods such as machinery and tools. Part of it will also be in the form of people, designers, engineers, business consultants and so on. But essentially it is in the form of funds, via banks and other channels and, therefore, in dealing with capital movements we are in the realm of funds or finance. Since the movements are across national boundaries they involve national currencies as well.

Movement of Global Capital

We shall look at the movement of global capital from the point of view of the country *into* which the capital flows, usually referred to as the 'host country'. From its perspective capital flows may be divided into three categories: Foreign Direct Investment (FDI), Foreign Portfolio Investment (FPI) and External Commercial Borrowings (ECB). In the case of many host countries there is a fourth category consisting of remittances and perhaps even deposits of its citizens staying outside, the non-residents.

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23 I remember waiting in the late in the 1980s in the Shangai airport for a connecting flight and speaking to an American academic who had come to teach in China. I asked him what he was going to teach and his reply was: "The working of the capital market"!

In the case of the FDI, there are three principal participants. The most active of them is the owner of the capital – the one who calls the shots, so to say – usually an MNC and its bankers. The second is its collaborator in the host country, typically a native corporate business concern. The third is the government of the host country. In some instances the second is dispensed with; such was the case in China during the initial stages where foreign capital came in to collaborate with state owned production units. The foreign owner of the capital comes in with long term interests to participate in the productive activities of the host country, ready to 'sink in' capital and make it immobile for a while. The expectation is to make profits taking advantage of the conditions in the host country, particularly wages which are lower than in the home country. It may be couched in more appealing terms such as transfer of technology for development or training of local workforce in the host country. The motive of the collaborator is also to improve business prospects. The government's role is to ensure that all legal conditions are satisfied and the terms of business, especially the timing and modalities of the repatriation of profits are spelt out. Note that even if the government is not directly involved in the business aspects, movement of capital between countries invariably implies foreign exchange transactions, and the government, ultimately, is responsible to manage these. Often in order to attract foreign capital the government may offer a variety of concessions: land at subsidized prices to help set up the plant, tax holidays etc. In most instances, the bargaining power is likely to be with the foreign concern as it can always indicate that it has other alternatives to consider. FDI has some advantages for the host country: it brings in capital, technology and foreign exchange: the foreign concern cannot easily pull out once it gets going; it creates some skilled jobs etc.

FPI, on the other hand, is the attempt by foreign capital to enter directly into the host country's financial market by purchasing shares of the companies of the host country, thereby getting a share of the profits being generated in the host country. The entry is by a variety of funds such as pension funds, endowments of institutions, which are not

eager to or are not legally permitted to enter into productive activities, but must have avenues to generate satisfactory profits for their corpus. Such investments are by and large by Institutional Investors and are referred to as FII. They can come in and go out easily and they make strategic use of their 'power to withdraw' in their dealings with the host government. For the host country the advantage is that FPI brings in foreign exchange, but the ease of exit makes it a risky option and can easily add, and in fact generate volatility in the external value of the currency. The domestic business community and those who are interested in the performance of the domestic stock market welcome FPI as its entry is sure to boost share prices, though FPI can make the stock market also quite volatile. The large scale entry of FPIs into the stock market tends to delink the performance of the domestic companies and the value of their shares.

Commercial borrowings, mainly by private concerns in the host countries, are resorted generally by importers who require credit accommodation and foreign exchange to make their purchases.

The experiences of countries that allow the flow of foreign capital into their economies differ a great deal and yet a few general observations are possible. Where, as in China, the government had a well-considered strategy of over-all development and thus was possible to assign a specific role to foreign capital, FDI was helpful to assist in the process of industrial growth and diversification. However, in most other parts of the world, including to a large extent in India, inflow of foreign capital is an integral part of a larger 'liberalization' package, a part of which is considered to be a 'rolling back of the state' from the economic realm and leaving the development process increasingly to the market forces. In effect it has meant foreign capital collaborating with the *private* industrial sector. Within that context the major increase in industrial production has been of goods that high-income groups favour. The production and import of such goods sold through modernized shopping centres and new malls have brought about a feeling

of abundance, variety and glamour in most countries that have opened up their economies to the globalization forces.

Resulting from this has also been an increase in aggregate 'growth'. Some increase in total output cannot be denied following the increase in trade and inflow of capital, but in most instances the increase in the growth rate has not been accompanied by any corresponding increase, but has often resulted in a *decrease* in employment. Hence many countries have been facing 'jobless growth' an expression that has come into use after the recent phase of globalization. The second consequence is that the sectoral composition of growth (discussed in some detail in the previous chapter) has favourably changed more in the services sector (S-Sector), not so much in the manufacturing (M-Sector). It means not only that the services sector including trade, finance, hospitality, entertainment etc. may have expanded, but also the distinct possibility that much of the rise in growth rates may be illusory.

That leads to another feature of globalization which has been the experience globally as well as in most countries including capitalist USA, socialist China and India that claims to be a mixture of the two is of increase in economic inequalities among the population. Globally it is seen in the following long-term tendency. The income gap between the top 20 per cent of the global population and the bottom 20 per cent was something of the order of 10 to 1 in the early part of the 20th century. By 1960 the gap had increased to 30 to 1 and by 1990 to 60 to 1. Towards the end of the last century, that is the less than a decade of aggressive globalization, the income gap had shot up to 75 to 1. This is because the nature of growth had been such that the incomes and wealth of those at the top increased while the conditions of those at the bottom did not improve or even became worse. The tendency towards further enrichment of the rich has continued. Forbes Magazine that traces and celebrates this aspect reported about 2006: "This is the richest year ever in human history" as the number of billionaires had risen 19 per cent to 946 over the previous year's 793 and their combined net worth climbed by $900 billion

to $3.5 trillion, adding "never before in human history has there been such a notable advance". Around this time the income of the top 1 per cent of Americans was equal to that of the bottom 60 per cent. What an irony that from that height a decline and fall started the very next year which left over 9 per cent of workers unemployed even four years after that fiasco and poverty hit its highest level since records began.[24]

Another glaring feature of the present phase of globalization also may be noted, that of the poor socialist China lending to rich capitalist USA! The USA is one of the richest countries of the world and the people of America consume the choicest of the goods from all over the globe. But they have to import these goods from other countries. The rest of the world is only too willing to export what Americans want. The trade between America and the rest of the world is facilitated by the fact that the American currency, the US dollar, is acceptable to all countries and so the Americans have no foreign exchange constraints on their international trade. So they can go on a buying spree. But when American imports exceed American export, she is indebted to the rest of the world, and America today has the highest debt in the world. How does America maintain this situation? Here's where the Chinese come to America's rescue. China has an *export surplus* with the USA, and instead of asking the USA to pay up immediately, agrees to lend the amount by holding large amounts of US government's IOUs, in the form of US Treasury bonds. Why does China do this? Because in spite of USA being the biggest debtor country, the US dollar is still the most acceptable 'reserve currency' i.e., the best way to hold external surpluses. Strictly speaking the value of the US dollar should be adjusted downwards to correct the imbalance, but that will not be acceptable even to China because the value of her surplus holdings will also come down! This is one of the reasons for the leadership the USA exercises in the present stage of globalization. It is a

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24 We may note too that 2006 was a 'golden' year for India too. The number of Indian billionaires (reckoned by global standards) went up from 22 to 36 with their total wealth shooting up by $90 billion. India also overtook Japan as the Asian country with the largest number of global billionaires. The number of billionaires in India has continued to grow.

complex situation and can change only when the US reduces its consumption of foreign goods in addition to lowering consumption in general and China changes her production and international trade patterns by producing more for the internal market and less for the American market.

Another aspect of globalization is the power that big MNCs exercise through what is known as 'Intellectual Property Rights' (IPR). One way that big corporations can protect themselves against their rivals is by 'patenting' any technological innovations they make which means that they will have exclusive rights over the technology itself and the resulting products. A big pharmaceutical company, for instance, comes up with a new medical product over which it has exclusive rights in the market place. The whole thing may be based on very familiar medical practices widely prevalent in developing countries such as India. A typical example is the use of *neem* or turmeric for medical purposes which everybody uses in our country. But if an American pharmaceutical company comes up with some drug that uses these basic ingredients, it can claim IPR and prevent anybody else from producing medicines using them as the principal items. This is, of course, subject to legal proceedings, but these will have to be done in America, according to American laws. You can see the effective control that big money can exercise over many common and daily practices and use of products. Note also that the so called 'free trade' between countries is circumscribed by many such provisions, overt and covert.

We must also note the uneven temporal and spatial aspects of globalization. The temporal ups and downs are most clearly seen in the case of the USA. There was a big stock market crash there in 1987. Its impact continued for some years and at the beginning of the 1990s the US economy and the global economy were considered to be facing a recession, the severest since the Second World War. Towards the end of the decade came the upswing associated closely with the IT revolution of the period and hence commonly referred to as *the dot.com boom* which however, was short lived. The

early years of the present century looked gloomy. But soon came the housing and real estate boom peaking in 2006 to be followed, as we have seen, by the big financial crisis that started in 2007 and became the meltdown of 2008-09.

In Asia the 1980s were celebrated as the decade of the great 'East Asian Miracle' where those who marveled at the miracle saw liberalization and the 'free market' bringing unprecedented growth in South Korea, Taiwan, Hong Kong and Singapore with Thailand and Indonesia sharing the prosperity. India would soon initiate the process in the early 1990s. But a financial crisis of major proportions started in Thailand by the end of the decade and shocked many of the Asian countries, including the ones that experienced the 'miracle'. About the same time, Russia which, after the fall of the Soviet Union had switched over to the 'free market' policy came under a currency and foreign exchange crisis. We know too that Iceland, Ireland and Greece were practically ruined as a result of joining the globalization bandwagon.

Global Capital vs Nation States

A legitimate question that can be raised is whether the economic power that capital brings into the process of globalization cannot be subdued, tamed and directed by the political power of the state. If economic power is based on ownership of property and is exercised through the market which has been seen to work on the principle of *exclusion*, isn't the power of the people, in democracies based on adult franchise, based on the principle of *inclusion* stronger? Cannot such a state use the potentials of globalization to bring about *inclusive growth*?

These are very deep philosophical questions that are related to one's understanding of power and, indeed the nature of human beings and their social relationships. I do not

claim to have the competence to deal with these questions and yet cannot escape from the responsibility to provide at least some clues on how to tackle them.

The economics we have tried to trace is the nature of social relationships that result from the private (i.e., individual as opposed to social) ownership and the unequal distribution of the means of production that has come to have the widely recognized name 'property' and of wealth in all its forms. Private ownership of property and its unequal distribution, let us note, are certainly not the primordial state of affairs. It is the result of centuries and millennia of historical evolution based on laws enacted by people organized as national communities. Though economics may claim to have its own field of enquiry, it cannot pretend that other fields such as history, jurisprudence, politics and other closely related subjects do not exist or that they are irrelevant for its own enquiry. All fields of studies – disciplines as they are called – are segments carved out almost arbitrarily from a larger totality called society with its interactions, more properly called communities, whose boundaries appear to be gradually dissolving.

Let us list some of the general characteristics of the social organization of production we have been dealing with. First, as we have noted throughout this exploratory tour of ours, is the private ownership of property. Let me clarify here that the reference to 'private property' is NOT to personal belongings, but to the *means of production*, land, the gift of nature and the produced means of production which in their monetized form find expression as *capital* and are owned and controlled by a small section of the population through social organizations that have evolved over a long period of time.

Second, it is our presumption, validated by the facts that we know through experience, that when property is privately owned it is not likely to be equally divided. So we accept the unequal distribution of privately owned means of production as the second feature of the socio-economic system we have been dealing with. For historical, cultural and even religious reasons, this unequal distribution implies that there are some households

who do not possess any means of production, and so their survival depends on selling their labour power as a commodity to those who are eager to use it.

Third, we have noted that exchange is a fairly natural form of inter-unit interactions related to, and arising from production and the division of labour that appears to be an innate human inclination.

Fourth, there is the emergence of money as the medium of exchange and the basis of valuation. We looked into *money* which has no intrinsic value of its own and thus a pure quantity with command over everything else, becoming a central agent in production and gaining power over all forms of property. When land was the main means of production in an earlier form of the organization of production, more of it conferred additionally social status and power on those who controlled it. When property became monetized, it also made it possible for those who owned property to accumulate more property or wealth by increasing production and by monetizing the product through the exchange process which results in commoditization of everything that can be exchanged. Accumulating wealth through the production-exchange process and the love of which can become a goal in life is a fifth feature of the social organization we have been considering.

The evolutionary process that was going on entered a decisive phase when technological innovations brought about revolutionary changes in the organization of production. For long production, especially of non-agricultural goods, had remained a small scale activity undertaken by households using their own labour and simple tools also produced by labour. But the introduction of steam as the basis of productive activity changed the character of production altogether. Production metamorphosed into a large scale activity in factories physically separated from dwelling places. More important still, it provided an opportunity for those who owned property to convert the labour power of those who did not have anything else to sell into a commodity and to be hired for wages. For those

who owned property this offered a new avenue to make profits because only a portion of the value of goods produced was passed on to 'workers' as wages, the rest being retained as the reward for ownership. The means of production used in industrial production became 'capital' and its owners 'capitalists'. And in due course it appeared quite natural for people, even those who have means of their own to work for somebody else and earn 'salaries' thereby escaping many of the hazards of organizing a productive activity of their own. Equally, when machinery for production required a huge amount of monetary investment, it seemed to be quite an innovative idea to gather up surplus, via intermediaries if necessary, from those who had it and use it to employ others and to accept all the risks of large scale production with long periods of gestation. Laws had to be made to protect the rights of owners, lenders and even workers.

Within a short while it appeared to many that the 'system' that emerged was the natural and the right way to organize production, impersonal human relationships created by industrialized production appeared to be natural too. Many theoreticians – economists, political scientists, sociologists, philosophers – put forward arguments and theories to legitimize it. The common theme in these *apologetics* was that the system guaranteed freedom of individual choice, to set up shop, to select occupations and above all for consumers to decide, without any external pressure, how to spend their money in supermarkets. Religious writers went to the extent of claiming that the system was divinely ordained!

What was overlooked, by design or default, was that the system that appeared so legitimate, moral and effective had a crucial aspect that was hidden. By its very structure it favoured ownership and owners, the capitalists, whose profit motive drives the system by transferring to them a share of what those who labour produce. Not that this system, capitalism, is the first economic order that compensated owners at the expense of the workers. The land-based economic order from which capitalism emerged in most parts of the world, known as 'feudalism' did exactly the same: those who worked the fields

had to part with a share of the product, often as the first charge on production, to those who claimed ownership of the land. However, this transfer of the product from workers to owners was quite visible under feudalism – the movement of corn from the field to the landlord's barn could be clearly seen.[25] The same phenomenon under capitalism becomes hidden partly because workers, including salary earners accept a contract freely, but mainly because all production relationships are mediated through money which hides and impersonalizes many aspects, especially the nature of relationships. Incidentally, the transfer of part of the produce from the workers to owners whether directly as under feudalism or indirectly through the mediation of money as under capitalism is known in technical expression as '*exploitation*'. In both instances the crucial issue is that the wealth of one group is the result of the deprivation of the other. In one instance it is quite visible; in the other it is hidden by the 'veil of money'.

If we view the capitalist system in this manner we will be able to have a better understanding of some of its features. Capitalism, for instance, is known, and rightly so, for its innovative activities in production. That is what the technical changes and progress of the past couple of centuries show. This results from the constant urge of capitalists to find new ways to make profits and to be ahead of their competitors. Those who are first in the field make profits because of the monopoly they come to have by virtue of the legal protection that patent rights provide and the cost reductions that they achieve. After a while the new technique will come to be of common use and so enterprising entrepreneurs will have to think of and implement something new. This process of 'creative destruction' as a writer has put it, is one of the main positive features of capitalism.

Competition that eliminates lethargy and inefficiency is another positive aspect of the capitalist system. But note that the competition is not between consumers and

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25 Look up the relationship between households A and C in Chapter 3.

producers, or between buyers and sellers; as we have already seen in Chapter 4, this rarely happens. It is between producers and producers, between sellers and sellers, in other words, among the profit seekers.[26] However, a capitalist producer who does not compete for profits can hardly remain a producer; a seller under capitalism who does not strive to make profits will soon be weeded out. The quest for profits will take unexpected turns also. If finance becomes profitable, there will be a big rush into it which explains why even companies and corporations that started out and continue to be producers of goods, branch out into finance or currency transactions when they appear to be more profitable. Another common practice, mergers and acquisitions, M & A, to ensure that profits remain at acceptable levels is to buy up others, including rivals and dominate the market.

These focused and strategic activities of the corporations are also the result and reflection of its owners, even the humblest of shareholders hoping to get the highest possible dividends (a share in the profit, that is,) for their shares. They are (possibly you are one among them!) 'maximizers' too. In the quest for higher returns (profits) they have no hesitation in dumping shares of companies that, in their perception, are not 'doing well' and move to others which seem to do so. Ask any corporate executive why the company is so crazy about profits and the answer will be "Our shareholders want it". Shareholders now watch out for quarterly profits and are disappointed if profits are not going up every quarter!

What emerges from this discussion is that the quest and craze for profit is not a *personal* aberration confined to faceless 'capitalists'. It is an essential and innate characteristic of the way production is organized under the capitalist system. (If you have surplus, don't you also look for the highest return on it?) If this is understood, you will understand why capital changes from time to time, from cash to credit to finance to derivatives, for

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26 Recall that barter initially is between two producers, both of whom perceive advantage in it.

instance, and why capital has an in-built tendency to go beyond national boundaries. It also explains why when capital takes the form of finance in a leading country it reaches out to all parts of the globe. In this sense, therefore, contemporary globalization is more than increase in international trade, more than movement of skilled people from one part of the world to the other, more than the transfer of technology, machinery, and 'know-how' from one country to another; it is the hold that capital, finance capital more specifically, is coming to have over economic activities all over the world.

Let us recall also that if finance is just one aspect of the economy, the economy is just one aspect of society. In particular the economy is closely related to the polity, particularly in a capitalist society. Money can be used to achieve power and power can be used to make money. In many countries of the world it is becoming increasingly difficult to draw a distinction between those who exercise economic power and those who wield political power. In a recent writing Joseph Stiglitz, a Nobel Laureate in economics has pointed that in his country, the US, the economy and polity are coming to be dominated by the top 1 per cent of households that account for about 25 per cent of income and claim 40 per cent of the wealth. Though America claims credit to be a democracy, it is turning out to be "of the 1 per cent, by the 1 per cent and for the 1 per cent"! It may not be so glaring in our country – the largest democracy in the world – but you would have noticed that in the Union Cabinet (about which there is published information) there are many *crorepatis* and that 58 per cent of the members of the Rajya Sabha are in the *crorepati club* according to recent official data. Many of them are from the world of business.

The above detour on the nature of capitalism – was it too long or too short? – was in response to a query that was raised earlier about the possibility of the state directing the forces of global capitalism or capitalistic globalization. There is an initial handicap for all states in this regard. They are all confined to particular geographical territories while

capital is intrinsically global. With the prominent exception of China, practically all other countries that experience contemporary globalization have capitalistic economies. This includes India whose performance under globalization we shall be evaluating in the subsequent chapters. It does not mean that in all respects the economies of all these countries are similar. There is rich diversity – look at Japan, Russia, South Africa, Ghana, Iran, France, Mexico, Argentina… With all the differences they have, they are variations of the capitalistic order whose essential features we have noted already. In terms of their political organization they show much greater variety. But to the extent their economies are capitalistic their states as the locus of authority are also capitalistic in the broadest sense: they all deal with the economic and social order based on (the unequal distribution of) private ownership of the means of production. Hence capital from outside a country reinforces the capitalism that is present in the country. This does not mean that governments in these countries can only be passive spectators or are in all respects subordinate to capital, domestic or global. Representing the state, governments do undertake many measures, ameliorative, corrective, and punitive, for the 'common good'. But there is a line it will not and *cannot,* cross. The litmus test of the state in a capitalist order rising above that order is the extent to which it is willing and able to alter the structure of ownership of property: use land reform as a test case.

Let us go back to the comparison made in Chapter 7 of the state as the umpire in a game of cricket. The umpire is part of the game: indeed, the responsibility of the umpire is that the game is played according to *its own* rules. The umpire is *above* the players but he has no authority over the game which is played according to clearly specified rules. An umpire in a cricket game cannot say that the game will be played according to the rules of baseball! That is as close as we can get to a comparison. But no comparison can be perfect and so, let us note one big difference between the umpire of a cricket game and the State: the State frequently becomes a player in the game as well—as owner of productive resources, and as an organizer of production.

The best way to understand the dual role of the State is to go back to specifics. When foreign capital wishes to come into a country, it has to get clearance from its State as we have already noted. The state can lay down conditions and usually does. Here there can be some bargaining and the state in a large democratic country can use the support it has from people's power as backing. But if the state has decided to open up its boundaries to foreign capital it is because it has perceived some advantages for some groups within its territory in doing so and that gives some edge to foreign capital in the negotiation process. Foreign capital's trump card, as has been noted already, is to say that it will gladly move over to some other country on its list, if its demands are not met.

Once foreign capital comes in, an important question is the State's position regarding the interest of capital versus the interests of the people. Democratic governments, under the citizens' pressure will take many steps to protect their interests and welfare. But it will stop short of adversely affecting the interest of capital. Consider concrete instances, again. The State may have an extensive public distribution programme favouring the poor. If a situation arises where the grain stored up for that purpose is rotting, a clear option is to widen the scope of public distribution or increase the subsidy already being given to the poor. But if the choice is between supporting the interests of the poor and not adversely affecting the interests of the large farmers who are responsible for the supply of grains to the State as well as to the market, the State is bound to support the latter. The reasoning will be that nothing can be done that may adversely affect production. It is increasingly true too that the state favours capitalists, mainly foreign capitalists, when it comes to taking over land from small farmers to promote industry. The justification is that the state acquires land for 'public purpose' and that increase in 'production' in the abstract has priority over livelihood concretely.

These instances show that siding with the economically powerful few is the natural choice of the State and that property rights are more important than people's rights.

That, indeed, is the fundamental premise of capitalism and finds expression in its economic theory and polity.

A point of view that supporters of globalization propagate is that many of the economic ills of the present are the result of the State entering into economic activities that are the legitimate arena of 'business' which follows the rules of the market. Hence a major action item of globalization is the 'rolling back' of the State, its withdrawal from productive activity and a reduction in its budget. On this issue domestic capital usually aligns with foreign capital and tries to push the State out as much as possible.

Aren't you reminded of the old story of the camel and the Arab? On a cold night in the desert, the camel seeks the permission of the master to let it have a little space in the tent to protect its nose. The master who knows how dependent he is on the animal allows the nose to be in. A little later as the night becomes colder, the camel pleads for its head to be protected. That is granted too. Then its front legs are allowed in… and so the story goes.

* * * *

Having dealt with a camel story, let us go back to the camel that was brought to your notice in the Introduction. A man who hadn't seen the camel was able to make many substantive inferences about its movements. How do you think he did it? He knew camels, their body structure and behavior and was able to predict their activities, even without seeing them in action!

I have, in the past nine chapters drawn many inferences about the working of the economy to introduce you to the animal whose behavior I am familiar with. But how does one put to the test whether my inferences are correct? Only by stepping out and getting acquainted with the animal that is out there.

So I invite you to take a look at the Indian Economy.

Part IV

THE INDIAN ECONOMY

So far we have dealt with economies in general concentrating on how to probe them. It is time to turn to a specific economy, our economy, to see how far the clues we have used are helpful in that specific context.

We shall try to trace the evolutionary process of the Indian economy starting from the pre-colonial period (say early 18th century) and coming to the early part of the second decade of the 21st century. Inevitably the treatment is sketchy. The thrust will be to trace the transformation that comes about through the interaction of ownership patterns and intermediary processes. That interaction does not happen 'automatically'. Policy changes emanating from what may be described as' politics' play a decisive role both during the colonial period and since Independence. The fact is that politics influences the economy just as economic interests to a large extent shape politics. Real Life Economics is unavoidably political economy.

Chapter 10

The Indian Economy: Evolution and Structure

India with a population of over 1.2 billion (120 crore) according to the Census of 2011 is the second largest country in the world, the first being China. We are now quite used to numbers running into crores (our scams now run into lakhs of crores!) and so the number by itself may not make much of an impression. So let us make a comparison. Put together the populations of the United States of America, the United Kingdom, Germany, Russia, Japan, Indonesia and Brazil – that total is just about equal to India's population! Pretty impressive, isn't it? With over 17 per cent of the global population, but only 2.4 per cent of the globe's land, India has one of the highest densities of population also – 385 persons per square kilometre. No other country in the above list, not even Japan known for its high population density, is as thickly populated as India (Russia's is as low as 9). In fact among the major countries of the world only Bangladesh with a population density of about 1,230 per sq.km and South Korea with close to 500 per sq.km exceed India's 385.

India also deserves attention for two aspects directly related to economics. The first, of course, is the reputation it has recently come to have as among the most rapidly growing economies of the world - something that could not even be dreamt of in the 1950s or even as recently as the 1980s. India can also boast now that it has the largest number of billionaires in Asia.

The second is the equally striking fact that India has the largest number of people in the world considered to be 'living below the poverty line'. Devastatingly impressive too, isn't it?

These facts provide the justification--if indeed any justification is needed--to look closely into the Indian Economy and see whether the discussions of the previous chapters yield any clues about how to evaluate it and understand it.

A clear indication that we have from our expedition so far is that an economy - any economy for that matter - is an ever changing dynamic entity. The economy of India, one of the earliest civilization units in the world could not be an exception: indeed we should be able to use it as a good case study. The only problem is to decide at what point to make an entry into this ongoing process.

Pre-Colonial India and its Economy

We shall follow the standard practice of beginning with the pre-colonial period. The justification for this is that there was a certain relative stability for the economy during that period which stands in sharp contrast to the pronounced changes that came about as a result of India coming under Western commercial impact first and colonial rule subsequently.

In the pre-colonial days there was no *political* entity known as 'India'. In fact, even during the British rule, there was no single political entity in the geographical territory of India: it had two distinctive parts – the Presidencies over which the British exercised direct authority and some 600 'native states' where princely rulers exercised near full authority internally, accepting the external suzerainty of the British.

Such being the case, the best way to depict the pre-colonial Indian economic scene is to recognize that the geographical territory of India during that period consisted of many and diverse *economies* rarely interacting with one another. But each one must have had some internal coherence because they were quite stable for long periods. A foreign scholar who spent several years in India in the second half of the past century studying

the past and present of the Indian economy stated: “The outstanding feature of the economy of India before the advent of British power was the self-subsisting and self-perpetrating character of the typical units, the village”. Karl Marx also referred to the ‘unchangeableness’ of Indian and Asian *economic* units in contrast with the constant changes in the *political* order.

Within the village economy producing essentially food grains and vegetables, the land was under the control of a few, but cultivated by the many. When the legal basis of ownership remained unspecified, tradition possibly sanctioned and supported by religion, decided practically all daily routines. One of these which remained in vogue for a long time was a hierarchical order that divided the population of the village into ‘castes’. The few at the top claimed to have the (ownership and) control over land, but were prevented from taking up any manual work. By contrast, vast majority at the bottom who were expected to do manual work, especially cultivation were prevented from owning land. It must be obvious that customs and even religious authority were interpreted, propagated and defended by those at the top. In between those at the top and those at the very bottom, including those who were considered to be outside ‘civilized society’-- the ancestors of those now designated Dalits – there were intermediate castes who too had customarily assigned economic responsibilities as carpenters, smiths, weavers, oil pressers, barbers and many more. In addition those at the very bottom were the ones considered to be outside ‘civilized society’, outcastes, the ancestors of those now designated Dalits. The typical unit within the village economy was the household and each household was hereditarily assigned these tasks according to its caste status. An economic interpretation of the village structure on the basis of the principle of division of labour is possible, but will be rather far-fetched because the arrangement did not have the basic freedom to enter into exchange that division of labour presupposes.

While there was, thus, no division of labour in the strict sense of the term, there was a fairly well laid out division of the produce. The functionaries were not paid for piece work, but at harvest time were entitled to specified quantities of grain and whatever other goods were raised (coconuts, for instance).

Those who were directly involved in cultivation had their share too, but the major portion of the harvest went to those who claimed ownership of the land. A part from their share would go as tax to higher political authorities.

There were major variations in terms of the manner in which land was controlled. We shall see more about this when we take up the changes that the British brought about. Hence we shall briefly refer to two other aspects of the traditional order. The first was the presence of 'the commons', both land and water sources such as ponds. Both these granted free access to members of the village community, to feed their cattle, for instance, and to collect firewood or branches of trees for minor construction. Similarly the fish in the ponds could be caught by any member of the community who cared to do so.

The second aspect was the economic contacts beyond the village other than taxes. The standard route was through the production of handloom cloth and oil within the village. The surplus of these found destination in nearby human settlements – towns – which depended a great deal on others for food and other necessities of life. These contacts would, over time, lead to the establishment of trade and thus for the village economies to become less isolated.

There were other factors too that led to changes in the structure of the economy. During the Mughal rule, tax collection began to be very oppressive. Tax collection was not done by the administrative personnel of the state. The procedure was one of 'tax farming' that resulted in many powerful people in different parts of the country being authorized

to collect taxes and to pass on a significant portion of it to the political hierarchy. The movement of the army with many soldiers, horses and vast quantities of tents, baggage etc. was another 'external' factor that disrupted the local economies. The actual producers had the fruits of their labour siphoned off partly by the local lords and partly by those from far off places who claimed to have authority and powers.

Entry of the Colonial Traders

It is into this sort of chaotic and gradually disintegrating economic order that the European colonial trade made its entry. Colonial trade had no impact on the organization of production and distribution as long as the colonial merchants were interested only in a few things such as spices and special varieties of cloth like calico and muslin. But compared with the limited quantities of goods that the European countries produced during this period, India was a land of variety of goods and was not in need of anything from outside. Hence the foreign traders soon recognized that without a firm footing within the country trade would not make much progress. Their governments encouraged them in this regard and soon European political and military rivalries began to find expression in India too. War between colonial rivals continued in India until the end of the 18th century when the (British) East India Company which had trade links with India from the early part of the 17th century succeeded in driving out its rivals and in establishing itself as an economic and political power in the void left by the decay of the Mughal Empire. From then on the Indian economy began a perceptible process of transformation.

At about the same time major changes were taking place in Great Britain also. The process of the capitalist transformation of the British economy was taking place and by the middle of the 18th century Britain was entering into what has come to be known as the Industrial Revolution. Through the pattern of trade between India and Britain and the political authority that the British soon established in India, the Indian economy

came to be soon established as a feeder to British growth and expansion. Specifically, Indian economy's role was to supply raw materials to the rapidly expanding capitalist production in Britain and to serve as a market to absorb the goods being churned out in ever growing quantities in the home country.

Before we turn to some details of these changes let us sum up the basic characteristics of the pre-colonial Indian economy or economies. Providing subsistence to producers and non-producers was the main objective of the traditional economy and the operations were largely localized at the village level. Beyond this common element there must have been notable regional variations, especially between dry and wet regions because economic activities were governed, to a large extent, by environmental and climatic conditions. However, it is not right to infer that economy or economies were functioning entirely at 'the subsistence level'. There was indeed surplus production. The surplus generated by the labour of the actual producers and physically transferred to the privileged non-producers became the source of consumption by the latter. A significant portion of the surplus also went out of the village, 'upwards' to the numerous levels of those who claimed authority over the villages, or to the agents of those who actually did. Indeed India was noted for the wealth and splendor of its rulers.

There, probably was no 'conspicuous consumption' except close to the very top and at the top itself, but the major share of surplus got dissipated without supporting much investment activity. The limited investment[27] went into destructive activities such as war -- which was very much of a routine activity in the sub-continent – or into non-productive construction of temples, monuments etc. There was very little in the form of investments that would increase production in the future and consequently there was very little 'growth' over time. The traditional economy, therefore, at best managed to

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 Going back to chapter 1 again, the utilization of labour power in activities that were not meant for current consumption.

reproduce itself from generation to generation without any progress. It was caught in a "low level equilibrium trap" to use a more recent expression, stuck close to the bottom with nothing from within to change the situation.

The economy was set within a hierarchical social framework with a division into castes as its basis. Hence, social differentiation was quite pronounced and affected many aspects of daily life. But it had two fairly visible economic consequences. The first, as already noted, was a form of division of labour affecting economic activities which, however, tended to be hereditary passing from generation to generation and resulted in very sharp social distinction that devalued manual labour and gave higher status to non-workers. The second, to a very limited extent mitigating the former, was that the social structure also specified customary economic entitlements to all sections, to be sure, once again of exceptionally visible differentiation. The privileged entitlement of the lowest rung for instance, was the carcass of dead animals. Rights and duties were clearly specified, more so the latter! But these social and economic arrangements lasted for several centuries, though some changes had started coming in after there was a 'unification' of the territory of India during the Mughal rule. Into such a 'system' entered the colonial power.

We shall attempt a thematic, rather than a chronological assessment of the colonial impact on the Indian economy during the East India Company's direct involvement in the administration of India on behalf of British interest and the formal takeover of India by the 'Crown' (the British Government) as part of the Empire in 1857. This followed what the British then described as the 'Sepoy Mutiny', but which was considered as 'the First War of Independence' by Indians.

Impacts of Colonial Intervention

By far the most important change that the British brought about was a definitive intervention into the arrangements for the ownership and control of land. The foreign

rulers found the ownership pattern of land in rural India ill-defined and confusing and decided to refashion it into a form that had been brought about in Britain in what they had described as the 'Agrarian Revolution'. Basically it was a move to make agricultural land the private property of the cultivating peasants, setting aside the vague and confusing power over the use of land that prevailed for centuries under feudalism. Apparently private property in land led to increase in agricultural productivity that allegedly formed the basis of the 'Industrial Revolution' though this claim has been contested in recent years on the basis of scholarly research. The British were interested in raising agricultural productivity in India as that would form the basis of higher land revenue for the administration. They were equally eager to enlist the support of the rural elite of the country they had occupied.

The method adopted was to convert the erstwhile tax farmers and revenue collectors into private land lords, conferring upon them some, but not all, of the rights of private property in land. The land settlement system effected in Bengal (which was where the East India Company's administrative set up over Indian territories was located) in 1793 came to be known as the *Zamindari System.* The Zamindars were given the ownership of large areas of land on the understanding that they would be responsible for collecting greatly enhanced land revenue from the cultivating peasants and pass it on to 'the state'. In this process the Zamindars lost the judicial and administrative powers they had traditionally enjoyed, which were taken over by the Company administration. The Permanent Settlement (as the new land system was referred to) thus removed a group of people who exercised considerable local power, but who were compensated by the possibility of gaining economically and by the new status they received as friends of foreign power.

The Zamindars, of course had no interest in increasing agricultural productivity which would have meant direct involvement with age-old practices at the local level. Realizing this, the British tried out another arrangement in the South, in their Madras Presidency.

There the British administration decided to deal directly with individual peasants, the *ryots*. Their rights on the lands they occupied were recognized on condition that they would pay a stipulated amount every year in cash instead of the produce from the land itself to the state as land revenue. The settlement came to be known as 'ryotwari system', and with minor modification it was later introduced in the Bombay Presidency as also in the North-East and in the North-West of the country.

An important effect of these land settlements was to make land a formally recognized commodity to be bought and sold under procedures of law and through courts. The significance of this change was not immediately obvious, but would become prominently clear after Independence. But the actual cultivators of the land would soon experience the burden of the high levels of land revenue introduced, and many of them would be forced to sell their land to those who had no interest in cultivation to become 'absentee landlords' enjoying the prestige as owners of properties here, there and everywhere.

Closely related, though not necessarily arising from the land settlements, was the commercialization of agriculture. Spices apart, Indian agriculture was essentially the production of food grains for local use. The British encouraged the cultivation of commercial crops like cotton, jute and indigo as these were required as raw material for manufacture in factories in Britain. This trend gained momentum after the crown took over the administration and India became part of the Empire. Around this time the British economist David Ricardo had put forward the theory of comparative advantage in international trade which indicated that with Britain specializing on manufacture and India on agriculture, trade between the two would be advantageous to both.

The manner in which commercialization of agriculture took place is seen most clearly in the cultivation of cotton. The Deccan region was for centuries producing cotton and much of the output was used within the country by the traditional industry making cloth. In the second half of the 19th century, there was a sudden increase in the demand for

Indian cotton from Britain. The reason was that Britain had relied on the USA for the supply of cotton for long, but this source was abruptly interrupted by the Civil War there. British textile industry (one of the earliest to experience the technical progress that constituted a major factor in the Industrial Revolution) was badly hit and was frantically in search of an alternative source for the supply of cotton. The British textile industry turned to India and the price of cotton went up from two and a half annas (one anna being one sixteenth of a rupee) in 1859 to over ten annas in 1863 – a nearly fourfold increase in four years! In the Central Provinces (which included Deccan) the area under cultivation increased from 376,000 acres in 1861-62 to 691,000 in 1864-65, and the export of cotton from India to the UK increased from around 500,000 bales in in 1859 to close to 1,400,000 bales in 1863. It is reported that in the single district of Bellary (then in the Madras Presidency) the *ryots* made one and a half million sterling by the sale of cotton during the three years of the cotton boom! While these figures themselves are impressive the more significant aspect associated with the boom was the realization that causes other than local needs were beginning to commandeer agricultural production.

Though the cotton boom itself was short-lived, the change in the pattern of cultivation continued. In the last decade of the 19th century non-food crops accounted for a little over one fifth of food grains production; by the fourth decade the ratio had moved up to just a little less than one half. What is important to note is that this reflected a fall in the production of food grains. There was severe shortage of food grains in the country during the Second World War when Burma from where rice was being imported to India until then was occupied by the Japanese. Earlier on during the British rule, India was the scene of many chronic famines.

The combined effect of the introduction of private property regime, commercialization of agriculture and the new form of land revenue to be paid for in cash, imposed heavy burdens on the actual cultivators. One of the consequences of these changes was to make the peasant heavily dependent on credit thereby increasing the presence and

power of traders and money-lenders in the rural areas. The presence of totally landless workers who were being gradually deprived of their conventional entitlements on the one hand and the increasing concentration of land in the hands of the few also led to the beginning and growth of capitalist forms of cultivation as well. A closely related phenomenon was the start of the plantation sector in the country-- tea and indigo in the North East; coffee and rubber in the South.

Simultaneously there were other changes taking place in the economy. The increased role of merchants and trade was prominent among them. The East India Company's main, if not sole interest in the early days was trade. Initially it made use of its monopoly in trade to buy goods in India, import them to Britain and from there export them to the rest of Europe. But the foreign traders needed assistance and Indian traders were all too willing and eager to become their commission agents. The Anglo-Indian cooperation in this sphere led to many ways of destruction of the Indian productive activity in spheres other than agriculture as well.

Trade, ably supported by "theft, bribery, confiscation, taxation – every conceivable method of squeezing money and goods out of the inhabitants" as a writer put it was used as means of the merchants' insatiable quest to accumulate more money. Vivid eye witness accounts of how weavers were forced to deliver certain quantities of goods at certain time and price, all decided by the merchants, and the physical tortures they were subjected to if they failed to honour the deal are available in scholarly works on the economic history of the period. These constituted one aspect of the destruction of traditional productive activity outside of agriculture.

But there were other aspects too. Traditional industries were based on small scale production and by and large for assured local market. The expansion of markets beyond the local areas put the traditional industries at a great disadvantage. Expansion of markets can benefit from economies of scale both in purchase and sales and so small

producers were at a natural disadvantage when big merchants entered the scene. Under these circumstances small producers sought survival by linking up with large producers. In India once the cotton boom was over alternate ways had to be found to absorb the large local production of cotton. Private initiative found a way of dealing with the situation by setting up factories to turn raw cotton into yarn. After the yarn produced in these factories came to the market small scale production of yarn for local use was economically untenable. Consequently local small scale weavers began to rely on mill produced yarn. Thus the local base of the traditional small-scale textile production was destroyed and it had no chance to enter into the larger market or compete with the large producers. In short, traditional small-scale production could hardly compete against the strength of advanced technology and of enlarged and aggressive markets.

To add to this, there was change taking place on the demand side also. A distinguished Indian economist who wrote on the industrial evolution of India noted: 'The newly created Indian bourgeoisie showed itself during the latter half of the last [i.e., the 19th] century extremely ready to accept European standards and to pour contempt on everything Indian". The Indian traditional industry had it from both sides and their disintegration was near complete.

But we must not overlook the fact that while the 'industry' disintegrated, those who bore the brunt of the destruction were human beings: men, women and on many occasions children who were holding on precariously to their traditional patterns of work hoping to make a living. The real tragedy is that much after the British were forced out of this land and "we" took over the situation, and in spite of 60 years of planned economic development a vast section of our people continue to be in similar plight. In the next chapter we shall examine why.

Let us therefore, continue with our assessment of the Indian economy during the colonial period. The early phase of industrialization of India happened during the

colonial period. To some extent it was a circumstantial happening as we have already noted. Though the first cotton mill was started in 1851, progress till 1875 was tardy. But from then on there was a sudden acceleration and by the end of the decade there were over 50 mills, three fourths of them still in the Bombay Presidency. The jute industry in Bengal was started in 1854.

Indian initiative for industrialization received a boost when the Tatas started the iron and steel industry in 1907 which was the entry into the capital goods sector. In this move towards industrialization within the country the initial reaction of the British administration was neutral because of the adherence to the principle of 'laissez-faire', the administrative philosophy of those days which resulted in economic activities, particularly starting and developing industries, being left to private initiative and what was considered to be the impersonal market forces. During the First World War, though, it became clear that the industrialization of India was a strategic necessity and the administration took up some steps in that direction. One of them was to provide some tariff protection to India's 'infant industries' against the powerful competition from established industrial concerns in other parts of the world. For a period then the administration accepted and implemented the policy of 'discriminating protection'. In effect it meant protection against Japanese imports!

These developments meant that by the end of the 19th century the employment in factories and mines (that is, 'the modern sector') was over 500,000 and it crossed 1,000,000 by 1917. But it must be noted that it was out of a total population of some 285,000,000 and the total engaged in the (decaying) traditional industries would have been around 12,000,000 with those in spinning and weaving alone probably 2,500,000.

The economy came to have other new features too. Among them most notable was the introduction of railways. Initially it was very limited to link the port in Bombay to its hinder land. When railway expansion took place it was primarily for movement of

troops, but once introduced it led to far reaching changes in the country and its economy. Introduction of modern banking was another new feature, first as Exchange Banks that financed foreign trade, then the Presidency Banks that held the government's cash balances, and subsequently the amalgamation of these Presidency Banks to form the Imperial Bank in 1921. Along with these developments came the changes in the legal system also, introducing the principle of limited liability, for instance.

Legal and administrative changes of a much larger and deeper impact were also introduced. From the perspective of Indian nationals there was a heavy cost involved, the drain of resources from India which came to be known as 'The Drain Theory' and played a powerful role in the nationalist argument against the British. The British, of course, maintained that the 'Home charges' (as they viewed the transfer of resources from India to Britain) were the cost of providing an efficient administration and of keeping the peace.

A debate as to whether the British administration in India was beneficial to the country naturally followed. What was initially a political debate came to the attention of scholars both Indian and foreign and the debate has continued. Without going into details, let us try to see how the colonial and British rule in India contributed to evolution of the Indian economy.

What attracted the Western traders to India in the initial stages was the wide range of goods produced in the land and its known wealth. Angus Maddison, distinguished British economic historian, after years of meticulous research made available in the early years of the present century data on the distribution of world GDP from the early period of the present era to the end of the 20th century. It showed that in 1700 India accounted for 24 per cent of world GDP -- that's right, almost a quarter of the produce of the whole world! UK's share at that time was a paltry 3 per cent and of the European countries put together just 20 per cent [There was no United States of America then]. The problem for

trade was that these countries had nothing to give in exchange for the goods they wanted from India. But after Western countries started getting precious metals from the New World that they had discovered, colonial trade with India began to increase. What was initially coastal trade started moving into the interior regions. Inter-regional and even inter-country trade was not uncommon in India earlier, but it was of a kind that did not disrupt the normal functioning of the village economies. The isolation of the village economies had begun to be affected because of the expansion of Mughal Empire, but it was still marginal.

One of the palpable effects of the colonial impact was that trade within the Indian border became more extensive *and* intensive. For village economies that had concentrated on production and a *pattern of distribution without trade,* this encounter with trade and monetary transactions was quite disruptive. Trade which for long was initially between merchants from two different countries began to impact the producers also.

With India becoming part of the Empire the internal trade in India also came to be directed from outside. As a modern economic historian has remarked: "With the arrival of the British India found herself placed in an entirely new political situation with the centre of gravity located outside her land"..

There was a deliberate design involved in this external intervention, an intentional attempt to make India's agrarian economy an adjunct to Britain's new and rapidly expanding industrial economy. We have seen how it affected agriculture in India. What deserves to be noted is that the shift away from the production of food grains to commercial crops was not merely a change in the product mix. It had an adverse effect on vast numbers of actual producers in different parts of the country: for many their traditional occupations, means of livelihood and ways of living had completely changed. A few, of course, benefitted also.

A similar disruption happened in another sphere of production of which the best example was the widely spread handloom industry. The flow of machine made textile from the UK and their availability at cheaper prices deprived the handloom weavers of their employment and livelihood. The spinners, in turn, were affected too. Here again, a few--those who were responsible for the import and trade of imported cloth, those who set up local mills and so on—clearly benefitted by the changes. But they were very few. The reduction of employment in the manufacturing sector that resulted from these changes is referred to as 'de-industrialization'.

The land settlement introduced by the British also had the same effect: brought on hardship and privation to the actual producers at the lowest level while enriching the chain of intermediaries and those at the top.

The character of the production pattern and the organization of production changed perceptibly under the British rule intensifying a process which possibly started earlier, and is still continuing as we shall see in the next chapter.

A second factor that significantly contributed to the evolution of the Indian economy during the colonial period was the deliberate shift towards the private ownership of property. During what turned out to be the colonial period for us, Great Britain was also passing through a major socio-economic transformation. The feudal system which decided on the pattern of utilization of land meticulously, but had left the ownership issue essentially to tradition was giving way to increased commercial activity. Under pressure from those who were eager to step up the trade in wool, land had to be 'enclosed' for the rearing of sheep. Commerce itself was based on the private appropriation of the profit from trade. Thus there was a concerted attempt to reduce the power and prestige of the landed gentry and the rapidly rising commercial class succeeded in propagating the advantages of private property. Philosophers too

discovered the role of private property as a condition for self-identity and economists emphasized private property and self-interest as the means to increase wealth for oneself and for the nation. Private property soon came to be the basis for political participation and the legal system too was attuned to it.

British colonialists and administration brought these ideas into India and began to translate them into action. Defining ownership of land and other forms of property therefore was given top priority, privatizing them to the extent possible. This had a major impact on the socio-economic order benefitting a few and impoverishing the vast majority who even in the old order did not have any claims to land and property. The basis of their customary claims on the produce also would disappear although that was a much slower process.

The state itself becoming an owner of land was part of this scheme of things. The forests constituted a large share of the total land of the country where even the concept of ownership was alien. The dwellers in the forests, the tribals, had customary claims on the forest produce and on the forest land for cultivation. Since they moved freely in the forest practising 'shifting cultivation', the forest dwellers did not care for formal or private ownership. Taking advantage of this situation forests were declared to be state property while continuing to allow the tribals user rights. The controversies and conflicts arising from this continue even now.

The relationship between Great Britain and India was not only between two countries, one dominating over the other, but also between two economic systems. Great Britain was passing from being a commercial capitalist economy into an industrial capitalist economy. India was largely a land-based feudal economy whose disintegration had rapidly set in. In the relationship between these two economies – the former where technical progress had stimulated both rapid increase in production and active increase in accumulation and the latter where a traditional order was in a process of transition--

the dynamic capitalist system took full advantage of the latter. Commerce was the activity that brought the two into contact and state power was a supportive participant. Apart from everything the state did to keep the Indian economy agricultural, it did not hesitate to bend its own professed principle of 'free trade' by imposing tariff duties on Indian goods imported into Britain. India thus became a classic case of demonstrating the support that colonialism in one part of the world becoming an invaluable aid for capitalist development in another part. According to Maddison between 1700 and just before the First World War, the UK's GDP (in constant price) increased close to 20 fold: India's GDP increased a little more than two fold. Between 1950 and the end of the century while UK's GDP grew a little less than 3 times, India's GDP grew more than 6 times.

The freedom movement in India was meant to gain political independence for the country as means to shape her economic order and to provide her people a 'richer and more varied life' as the First Five Year Plan document expressed. How the political freedom that came in 1947 impacted the economic situation is taken up in the next chapter.

Chapter 11

Indian Economy – Growth and Transformation

The Planning Era

When Independence came India had a slender industrial base .Millions of her rural people suffered under the weight of a traditional agrarian structure. A long period of economic stagnation, against the background of increasing pressure of population, followed by burdens of the Second World War, had weakened the Indian Economy. There was widespread poverty and want. The partition of the country had uprooted millions of people and dislocated economic life. Productivity in agriculture and industry stood at a low level. In relation to needs the available domestic savings were altogether meagre. The promise of freedom could only be redeemed if the economic foundations were greatly strengthened. The Constitution established equal rights of citizenship, and these had now to be expressed through rising levels of living and greater opportunity for the bulk of the people. It was essential to rebuild the rural economy, to lay the foundation of industrial and scientific progress, and to expand education and other social services. These called for planning on a national scale, encompassing all aspects of economic and social life, for efforts to mobilise resources, to determine priorities and goals and create a widespread outlook of change and technological progress. Thus planned development was the means of securing with utmost speed possible, a high rate of growth, reconstructing institutions of economic and social life and harnessing the energies of people to the tasks of national development.

1950 to 1980: The Planning Era

The above passage from the early pages of the Third Five Year Plan (1961-66) document said to have been written by Jawaharlal Nehru himself provides a succinct account of the

state of the Indian economy at the dawn of Independence. It also indicates the remedies the situation called for and the methods of achieving the objectives.

The method was to be *planned* economic development. In one of my writings of that period I described it 'a great adventure' and said: "A unique experiment, in the annals of mankind both in terms of dimensions and implications is going on in our country. For the first time in history economic development is being attempted in a large, poor and populous country which recognises the political rights of its people to express themselves freely and their economic right to own and use resources in a manner they deem fit."

I was not exaggerating. After 60 years of 'democratic planning' we take it for granted. But in the 1950s it was a contradiction. There were many democracies in the world at that time, but none of them had attempted *planned* economic development because planning was seen as authoritarian and as depriving citizens of their right to use the resources they owned and the basic right of dissent. That certainly was the experience of the two countries that had tried planning, Nazi Germany whose 'planning' had become synonymous with arbitrariness and cruelty and the Soviet Union where planning had brought considerable economic progress, but at the expense of political freedom, and indeed various shades of dictatorship.

Economic planning in India was to be on the assurance given to all citizens that the fundamental human and civic rights enshrined in the Constitution would be honoured and to property owners that their rights would be accepted, but modifications and limitations might become necessary.

Planned development was meant not only to achieve economic growth, but to bring about a transformation that was acclaimed to be necessary to usher in a social order

envisaged by the Constitution in which "justice, social, economic and political shall inform all the institutions of national life".

Even in terms of the economic objectives, successive Five Year Plans have acknowledged that planning was a means to fulfil the constitutional mandate that the State has the responsibility to direct its policy towards securing "that the citizens, men and women equally, have the right to an adequate means of livelihood". A passage in the Second Five Year Plan document annotated it and said: "A society which has to devote the bulk of its working force or its working hours to the production of the wherewithals of life is to that extent limited in the pursuit of higher ends". On this basis in the mid 1950s the country committed itself to a 'socialist pattern of society' which was not meant to be ideological in orientation. The Second Plan document that came out soon after indicated that the planning process recognized both private profit motive and social control. It went on to say: "Essentially this means that the basic criterion for determining lines of advance must not be private profit but social gain, and that the pattern of development and the structure of socio-economic relations should be so planned that they result not only in appreciable increase in national income and employment *but also in greater equality in income and wealth*. Major decisions regarding production, distribution, consumption and investment – and in fact all socio-economic relationships -- must be made by agencies informed by social purpose. *The benefits of economic development must accrue more and more to the relatively less privileged classes of society,* and there should be progressive reduction of the concentration of incomes, wealth and economic power. The problem is to *create a milieu in which the small man who* so far had little opportunity of perceiving and participating in the immense possibilities of growth through organised effort *is enabled to put in his best in the interest of a higher standard of life for himself and increased prosperity for the country" (*emphasis added).

Though our objective is not to evaluate the performance of the Five Year Plans or to make an assessment of India's economic policies since Independence, these passages

from the early Plan documents have been reproduced to indicate what the intentions of the early years had been. One cannot fail to be impressed by the nobility of the objectives—to assure *everyone* of a decent level of living, to lift up the 'small man', to increase production and productivity, to reduce inequalities in income and wealth, not to curb private initiative or to suppress the profit motive, but to insist that all major economic decisions must be made by agencies informed by social purpose and even to remind that economic advancement must be considered as part of the pursuit of higher ends. We shall concentrate on how these objectives have been attempted to be translated into economic activities and how the economic system has unfolded itself over the past sixty years.

The first few years after Independence were devoted to fire fighting operations in the economy (as also in the polity). It is remarkable that in the midst of it all a democratic constitution based on the principle of universal adult franchise became a reality by early 1950. It is worth recalling that B.M. Ambedkar who, as the Law Minister was largely responsible for piloting the draft constitution through the Constituent Assembly warned of the inherent contradiction between the political order based on the principle of 'one person one vote' and the economic order whose basic premise was 'one rupee one vote'. Among the early political achievements was the unification of the country and a 'Union of India' was ushered in consisting of a 'federation of states'.

Once these foundations were laid attention turned to economic matters. Planned development under the leadership of the State was to be the foundation with the private sector having an assigned, but important role. The First Five Year Plan was essentially a compilation of on-going projects and a theoretical exposition of the need to step up savings. The long term strategy for economic growth and transformation was spelt out in the Second Five Year Plan (1956-61) document which was based on the much acclaimed and debated 'Mahalanobis Plan Model' put forward by India's statistician turned planner, P.C. Mahalanobis. The strategy consisted of emphasis on

heavy industry in the public sector to lay the foundation for future large scale development of diversified industrial production; curb on consumption of top income groups by preventing the production of luxury goods such as two-wheelers, refrigerators, cars etc. and prohibiting the import of such items; stimulus for agriculture and the small scale sector to provide employment, protect the small man's interest and to ensure that there was an adequate supply of consumer goods to match the incomes and demand generated by stepping up investment; a centralized investment allocation to ensure that priorities were adhered to and a massive mobilization of savings to match the stepped up investment. The good performance of agriculture during the First Plan period and the availability of the 'sterling balances' generated and held in the UK as payments for feeding UK soldiers and meeting war expenses during the Second World War appeared to give the confidence that a resource gap to the extent of some 25 per cent was manageable.

Except for a couple of theoretical and ideological objections the planning strategy was considered sound. A decade later and afterwards several economists inside the country and more so outside claimed that the import substitution strategy failed to take advantage of the increasing international trade of that period and that the dominance of the State and the power of the bureaucracy stifled the efficient working of the market. But fifty years later after India's industrial base was robustly established, the general view is that the import substitution strategy indeed was quite valid for a large and 'continental' economy whatever might have been the experience of countries like Singapore, Hong Kong and Taiwan whose higher rate of growth was driven by international trade.

But the Second Plan ran into other problems. The good harvest of the late First plan period could not be sustained and food production suffered (as population started growing rapidly as a result of the sharp fall in the *death rate* thanks to public health schemes). Partly because of UK's difficulty to release sterling balances adequately there

was something of a foreign crisis as well. Organized private sector enterprises started expressing opposition to the measures of protection afforded to small scale industries, especially the handloom industry.

During the Second Plan period the government succeeded in abolishing the Zamindari system. But all attempts to go beyond that and even to take any steps towards the "land to the tiller" slogan of the freedom movement were resisted. Even Nehru's attempts to move towards co-operative planning did not succeed. Private property right initiated by the British would be the corner stone of the economic order of India by default.

The Third Plan followed the path laid by the Second Plan. But the steep fall in food grains production in 1965-66 and the need to seek the import of wheat from the USA under its PL 480 programme quietly changed some of the perceptions and commitments. The 'Green Revolution' introduced towards the end of the Third Plan was on the valid premise that the increase in production and productivity of agriculture, especially food grains production was the basis for industrial growth. But it also quietly brought in the notion that where institutional changes had failed, modern technology would succeed. The green revolution had to be confined initially to the big farmers who had land and water available and had the means to buy fertilizers and other inputs. Later the scale neutrality of the new pattern of cultivation was established. However, the green revolution had other consequences. It expanded the market for food grains (more producers were selling) and for inputs, thereby increasing commercial activities and the presence of intermediaries. In 1951 only 600 kg of fertilizers were used for 1000 hectares of cropped area which went up to 7000 kg by 1966. In the next four years it jumped to 13,600 kg and by 1980 to 31,500 kg and has continued to grow rapidly since then. While this was certainly a technological improvement, it also increased the role of markets and merchants considerably in the rural areas. The green revolution also increased the need for credit by farmers and the nationalization of the leading commercial banks in 1969 with a specific mandate to reach out to the rural areas was, among other things, a

response to this need. Once banks started making credit to the farmers it became necessary to have legal ownership of land established and protected. Of course, production also increased – the output of wheat where the high yielding varieties was introduced going up from 22.7 million tonnes in 1960-61 to 30.6 million tonnes a decade later (touching an all-time high of 40.8 million tonnes in 2007-08). Usually the increase in production and productivity is celebrated (rightly so) but the other major changes associated with it are ignored.

But things weren't going well towards the end of the 1960s. The demise of Nehru and the Indo-Pakistan War of 1965, the totally unexpected death of Lal Bahdur Shastri in 1966 after holding of office of Prime Minister for less than two years, the contest for that post between Indira Gandhi and Morarji Desai that followed showed that the Indian National Congress was losing its hold over the polity. This was confirmed during the general elections of 1967 when the Congress lost in its traditional base of Uttar Pradesh in the North, Tamil Nadu in the South and in a couple of other states as well. The political stability required for democratic planning seemed shaken.

On the economic front the continuing foreign exchange crisis led to the devaluation of the rupee which became controversial within and outside the country interpreted as a humiliation imposed on the country in the immediate post-Nehru era.

In the industrial sector the scene was not reassuring either. The initial dynamism shown was gone and there were symptoms of stagnation. The government tried to enforce the protection it had given to the small scale sector by issuing licences to the units in the large scale sector to limit their capacity for expansion. That led to the accusation that the bureaucracy was all powerful ('the Licence Raj'). Some of the large scale units resorted to securing licences not to expand capacity, but to prevent rivals from going in for capacity expansion. The result was a tendency towards effective monopolies on the one hand and scarcity of goods and corresponding increase in prices on the other.

In the meanwhile a draft of the Fourth Five Year Plan was prepared and circulated, but political developments led to it being abandoned. The tension between Indira Gandhi and the set of senior leaders within the party led to the split of the Indian National Congress in 1969 with the former retaining power as the leader of the Indian National Congress (I). Three annual plans followed, but clearly other events had overshadowed economic matters. The country was drawn into a war with Pakistan when its eastern wing declared independence and as a result of the conflict that ensued some 10 million refugees crossed the border into Indian territory. India lent its support to East Pakistan and joined its forces and played midwife in the birth of a new nation, Bangladesh, after inflicting a crushing defeat on the Pakistani military establishment. When the parliament reassembled after the event Indira Gandhi's role in the formation of Bangladesh and in the establishment of Indian military superiority over Pakistan were lauded by the members cutting across party lines. She decided to take advantage of the situation, had parliament dissolved a year ahead of schedule and ordered general elections in 1971.

The strategist that she was, Indira Gandhi decided to place before the electorate a new economic agenda. Early in the 1960s an Expert Committee had estimated that "judged against the standard of consumption expenditure of Rs 20 per month per capita, considered generally to be the base minimum it is obvious that half of the people of India live in abject poverty". The Committee recommended that "the central concern of our planning has to be the removal of poverty as early as possible". The Committee was of the view that acceleration of growth was the best way to eradicate poverty and cautioned against any drastic redistributive measures which would "make the mobilisation of savings for investment far more difficult".

By 1971 there was strong criticism that not enough was being done for poverty amelioration. Indira Gandhi seized the opportunity and made *Garibi Hatao (*eradication of poverty) the main plank of her party's election manifesto. It captured the imagination

of the voters and the Congress (I) came back to power with an overwhelming majority. In the election to the State Assemblies in 1972 the Congress (I) did very well. A new Planning Commission was constituted which consisted of two young and bright economists with the mandate to bring substantial reduction in poverty in five years. Abandoning the Fourth Five Year Plan the new plan was designated the Fifth Five Year Plan. In an *Approach* document that was put out for public discussion it was stated: "The basic objective of the Fifth Plan is to make the maximum possible dent on the low end poverty…." Admitting that even in the early 1970s people living in abject poverty constitute between two-fifths and one half of the population, and reluctant to suggest any change in the ownership and production patterns the planners produced a plan aiming at a 5.5 annual growth rate and a strategy of limiting the *consumption* of the top 30 per cent of the population without any change in income accruals of this group and transferring the resources thus saved to augment the consumption levels of the bottom 30 per cent.

But nothing much came out of the Plan's objectives or strategy. On the contrary, prices started shooting up steadily with a 25 per cent annual increase in the middle of the decade. An attempt was made by the Central Government to take over wholesale trade in food grains, but a show of strength by traders led to the State backing out immediately. This resulted in popular agitations, the declaration of internal emergency in 1975, general elections in 1977 which saw the rout of the Congress Party (including the defeat of Indira Gandhi) and the formation of a non-Congress coalition government, led by Morarji Desai who was known as a Gandhian in politics and not inclined to support any 'leftist' programme in economics.

The Sixth Five Year Plan formulated by the new government decided to have a frontal attack on poverty by initiating a variety of poverty amelioration programmes. To demonstrate the determination of the new government to control foreign companies, the giant foreign corporate Coca Cola was forced out of the country. An elaborate

scheme to give fillip to the small scale industries, and within that category to 'tiny industries', was also announced by the Socialist Party's representative in the coalition. However, none of these schemes really took off because of the sudden collapse of government resulting from internal dissensions within the coalition and personal ambitions of the leaders. Indira Gandhi and her second son Sanjay Gandhi took full advantage of the situation and in the general elections of late 1980 the electorate which had rejected Indira Gandhi as a dictator in 1977, called her back to power.

The 'New Economic Policy' of the 1980s

The political and economic complexion of Indira Gandhi's administration in the 1980s was distinctly different from what it was in the 1970s. With the nationalization of banks late in the 1960s and the launching of 'Garibi Hatao' as the political and economic slogan early in the 1970s, Indira Gandhi had projected something of a 'leftist' image. The open support that the USA had given to Pakistan during the Indo-Pakistan confrontation had driven her closer to the Soviet Union made public by the signing of the Indo-Soviet Treaty of Friendship. Her 'Kitchen Cabinet' of the early 1970s and her close advisors during the Emergency consisted of politicians and bureaucrats with professed leanings towards the economic order of the Soviet Union. During the rushed amendments to the Constitution in the early phase of the Emergency, the most publicised one was declaring the country a 'Socialist' republic.

A decade later things were quite different. Even by the late 1970s with the economic options thrown open by the Janata regime, there was much discontent about India's tardy economic progress in comparison with the many East Asian countries that were showing greater dynamism. There was a feeling publicly aired by Indira Gandhi's new advisors that if planned economic development under the leadership of the State did not have the desired effect of raising growth rates and reducing poverty during a period of three decades after Independence the private sector and the markets should be allowed

a greater role and India should enter more into international trade, reversing, if not abandoning altogether the import substitution strategy. An influential official study reported in 1982 that the Indian economy had become sufficiently monetized and that the growth of financial assets was considerably higher than the growth of income indicating "the sophistication, development and growth of the financial system and hence the overall financial development of the economy".

The alternative suggested did not ask for an abandoning of planned development, but for changing the pattern of growth relying on and favouring the top sections of the population. A national survey by a leading private agency had established that the top 5 per cent of households accounted for close to 50 per cent of the savings and the top 10 per cent to almost 70 per cent indicating also these segments' income levels and resource power. The new argument was that the economy would not grow unless these groups were encouraged to satisfy more of their consumption requirements. It was pointed out too that basic industries (steel particularly) had grown sufficiently to allow domestic production of high end consumer durables such as two wheelers, refrigerators, air conditioners, television sets etc. and that the demand for these goods was assured by the purchasing power of the top income groups -- estimated to be a market of some 75 million people. Thus, a new economic strategy, validated by both supply and demand factors was very much under discussion in the country. The poor were not forgotten either. Increase in production would lead to increase in employment and incomes at the lower levels also. The reduction of the government's involvement in production would allow for greater utilization of public funds for direct anti-poverty programmes.

Sanjay Gandhi's desire to produce a 'people's car' with Japanese collaboration and the launching of the Maruti Udyog in the early 1980s must have provided additional impetus to the new economic strategy.

Rajiv Gandhi entered politics after the death of Sanjay Gandhi in an air accident and became Prime Minister after the assassination of Indira Gandhi in October 1984. To him the rationale of the new strategy was linked up with technological changes that were taking place in the advanced countries and the new economic era of market dominance initiated by Ronald Reagan's administration in the USA and Margaret Thatcher's in the UK. The massive popular support that Rajiv Gandhi received in the elections that followed Indira Gandhi's assassination and Rajiv's take over was interpreted as people's mandate for the shift in economic policy. Food production had started showing steady increase in the 1980s and economic growth which had stagnated for over a decade from the mid- 1960s had picked up too. The much celebrated East Asian Miracle of the period, the significant growth rates in countries such as South Korea, Thailand, Taiwan and Singapore allegedly relying on market forces also lent support to the informal, but natural transition of economic policy in India. Rajiv Gandhi proclaimed that his mission was to take India into the 21st century. Indian and foreign commentators started making references to India's 'consumer boom'. It was claimed that a 'directional change' was imperative. Many of the controls and regulations on production were withdrawn and the question of what to produce was to be decided by those who had the purchasing power. It conformed to the old saying that if the bullock was not going the way you were directing it, direct it along the way it is going. This new path that the bullock had taken was openly declared as the 'New Economic Policy' – NEP -- (imitating the liberalizing turn that Lenin had given to the Soviet economy in the 1920s after the early phase of 'communism' immediately following the Revolution in 1917).

A major plank of the NEP was tax reforms which reduced the rates on corporate and income taxes to provide incentives to the business classes to increase production and to high income consumers to consume more, and hopefully to save more as well. An immediate consequence was an increase in the deficits of the Union Government's budget. Till the early 1980s there was a modest surplus in the revenue budget of the government available to finance capital expenditure. But during the Seventh Plan period

(1985-90) it turned out to be negative and in the 1987-88 budget was an all- time high of 9 per cent of the GDP.

The balance of payments situation too started taking alarming proportions. Import surpluses were growing from the time of the Oil Shock of 1979-80 (another increase in crude oil prices by OPEC) and India had to take a loan from the IMF in 1980 to tide over the situation. Import liberalization to step up internal production which was one of the strategies of the NEP, and reliance on foreign private borrowing was the only way to finance the growing imports. At the same time the global interest rates were also rising – on official debt increasing from 2.4 per cent in 1980 to 6.1 in 1982. Commercial borrowing on even higher rates by private parties in India was also increasing from some $18 billion in 1980 to $56 billion in 1989. By the end of the decade India had become one of the largest debtors among the developing countries.

The situation was not less disturbing within the country either. In 1989-90 industrial production of consumer goods, intermediate goods and investment goods all registered drastic falls. What was even worse, an official study came to the conclusion that the decade in which the growth rate was the highest since Independence (5.6 per cent per annum) the increase in employment was the worst, and this included even the agricultural sector, the largest generator of employment.

In sum, what the NEP of the 1980s, claimed to be a necessary and valid departure from the policies of the previous three decades ended up with unsustainable growth, declining employment and a huge foreign debt.

In the meanwhile, the global economic scene was also changing. Since the end of the Second World War global capitalism had gone through three major phases. The first consisted of the 1950s and 1960s, celebrated as the 'golden age' of capitalism when practically all major capitalist countries had rapid and unprecedented growth, the US had

established itself as the leader of the capitalist bloc in the economic and ideological rivalry against the Soviet bloc and the dollar had emerged as the de facto global reserve currency. In the academic sphere the period witnessed the state *vs* market debate with many scholarly works being done in the USA rigorously establishing the superior claims of the market.

The second phase has come to be known as 'the turbulent seventies' (1970s). The military commitments that the US had in different parts of the world 'to defend freedom' and contain communism meant heavy spending by that country which led to the dollar losing its value against gold. In August 1971 the free convertibility of the dollar into gold had to be abandoned. In 1972 a private academic group in Europe published its report *Limits to Growth* which for the first time scientifically established that the physical resources of the earth would soon run out and that excessive use of various forms of energy was resulting in 'global warming'. These findings challenged the basic premise of capitalism that unlimited growth was necessary and possible. In 1973 the Organization of Petroleum Exporting Countries (OPEC) brought about a sharp fourfold increase in international price of petroleum which embarrassingly established that key global markets in the world were very much under non-market controls. In 1974 the Third World countries that constituted the majority in the United Nations Organization drew up and presented in the General Assembly a charter for a New International Economic Order affirming, among other things, the right of its members to form producer associations and to nationalize foreign enterprises in their countries, once again showing that on many crucial economic matters the power of the market within and across national boundaries would have to be curbed and regulated by state power.

Capitalism had its triumphs also. Working behind the scenes private banks in the United States weaned away the members of the OPEC (who had promised their support to the Third World countries) and offered them attractive terms to hold their new surpluses in the form of dollars. The banks also agreed to help them purchase armaments on

concessional terms. The strategy worked and the US banks closed the decade with significant increases in deposits. Consumers paid higher prices for petrol all over the world which benefited the members of OPEC with dollars flowing out to these countries only to flow back into American banks! The second 'oil shock' of the last year of the decade followed the same pattern making it possible for American private banks to fund not only private enterprises but also governments in many parts of the world.

The third phase of capitalism, the 1980s, was thus the new era of 'globalization', capitalist globalization to be more accurate. Not that capitalism had completely bounced back. The hegemony that the US had exercised so far was challenged by two other capitalist centres, West Germany and associated groups in Europe, Japan, along with South Korea and Taiwan in Asia. Floating exchange rates and frequently varying interest rates posed problems for trade of goods among countries initially, but capitalism has a way of converting adversity into opportunity. The situation provided a golden opportunity for trade in currencies and different forms of credit instruments. The main vehicle of profit making and capitalist expansion from now on would be trade in these highly profitable, though rather risky 'assets' by private agencies of various sorts in different parts of the world.

Towards the end of the decade the USA would be able to re-establish its global supremacy as a result of the collapse of most socialist regimes in Europe and the political unrest in the Soviet Union which by early 1990s led to the disintegration of the USSR as an entity. From then on, therefore, globalization would become a private-public joint project, the private doing much of the work in the field and the public providing strategic support as well as the propaganda, in the latter duty ably assisted by a host of 'intellectuals'.

Powerful support came from the 'international agencies', the World Bank and the International Monetary Fund (the Bank and the Fund respectively). In the context of the

need to put the suddenly liberated former socialist countries on the correct path of market oriented economic programme, all who were convinced that aggressive capitalism was the only workable economic order agreed on what has come to be known as the "Washington Consensus" for the 'transitional economies' (from failed socialism to ever winning capitalism).

When many Third World countries faced debt and balance of payments crises, the same formula for 'Reforms' was recommended to them and in some instances thrust upon them as a quid pro quo for bailing them out. The terms of the formula (which soon came to be known as the Bank-Fund 'conditionalities') were immediate devaluation of the national currency; rolling back the state from economic activities, in particular scrapping of the many subsidies; greater role for the private sector, including foreign private enterprise; and thus essentially a 'market friendly' economic regime. Several Third World countries had no choice except to yield to the 'persuasion' (in effect the pressure) of the powerful international agencies.

Some United Nations' organs pointed out that the problems faced by the developing countries were more the reflections of the economic fluctuations in and policies of the rich countries. One report estimated that if the main OECD countries (Organization for Economic Co-operation and Development, the club of the rich nations) had removed their tariff and non-tariff barriers, exports of the developing countries would have been much larger. The UNDP's (United Nations Development Programme) *Human Development Report, 1992* calculated that global market conditions made developing countries lose economic opportunities worth around $500 billion annually – ten times what they received in foreign assistance.

What was even more noteworthy was that the developing countries themselves had taken the initiative to set up a South Commission to make an evaluation of the global situation and the North-South problems and their impact on the South (developing

countries). Its Secretary General was India's distinguished economist, Manmohan Singh. Its Report, *The Challenge to the South* (1990) documented the growing economic disparities between the countries of the North and the South and attributed them to the enlargement of the North's power vis-à-vis the rest of the world and bluntly stated:

The countries of the North now more readily use that power in pursuit of their objectives. The 'gunboat' diplomacy of the 19th century still has its economic and political counterpart in the closing years of the 20th. The fate of the South is increasingly dictated by the perception and policies of the governments in the North, of the multilateral institutions which a few of these governments control, and the network of private institutions that are increasingly prominent… A network of relationships has been built up among these private entities – banks, investment houses, transnational companies—in the leading developed countries. This has served to strengthen the influence of decisions made by private bodies on world economic activity, and to that extent to limit the effectiveness of governmental policy decisions.

The Report was equally blunt about the role of the international agencies. It noted that the IMF/World Bank policy had left developing countries "with almost no discretion in determining their policies, although both institutions now officially endorse concept of growth oriented adjustment, the truth is that… their increased involvement in domestic policies of developing countries in the 1980s did not promote either growth or equity in the South."

Such, indeed, was the background to the initiation of 'Reforms' in India in 1991.

'Reforms', 1991

Bimal Jalan, an economist who had held many high positions in India's economic administration, including as Governor of the Reserve Bank of India has described the

year 1990-91 as the cruellest in the -post Independence economic history. As we have already noted even in 1989-90 it was clear that there were alarming signals. Then came the political unsettlements in the Gulf region including the annexation of Kuwait by Iraq in August 1990, all of which resulted in many Indians working in these regions having to return to India and the consequent fall in remittances from outside, along with the steep increase in oil prices. India's deteriorating balance of payments situation became even worse.

There were problems of political instability that the country was not used to which also started in 1989. Rajiv Gandhi, discredited by the Bofors scandal relating to military purchases lost in the general election and V.P.Singh who had resigned from the cabinet on the corruption issue formed a new minority government with the support of different parties. His attempt to gain mass support by implementing the Mandal Commission's Report that extended reservation to educational institutions and government services to Other Backward Castes (OBC) resulted in agitations in many parts of the country. The destruction of the Babri Masjid in Ayodhya by the Hindu fundamentalists caused even graver communal riots. Political instability followed and the parliament was dissolved in March 1991.

In the meanwhile foreign debt services were claiming about 40 per cent of export earnings and the foreign exchange reserves had come dangerously low covering only about six weeks of imports. In order to meet international commitments short-term loans had to be frequently resorted to which sent signals to lenders that a crisis was imminent. There were reports that to avoid the crisis gold was being sent out of the country. That, in turn, led to the flight of capital from the Foreign Currency Non-Resident Accounts totalling $1 billion. The country's credit rating was severely affected. Inflation had crossed double digit.

During the election campaign Rajiv Gandhi was assassinated but the Congress Party emerged as he largest party in parliament, though short of a majority. The Party's new leader Narasimha Rao who became Prime Minister in June 1991 appointed Manmohan Singh who had returned to India from the South Commission assignment as his Finance Minister.

Under the circumstances described what would the team of PM, FM and their bureaucrat advisors (most of whom had a stint in one of the international agencies or were impatiently waiting for their turn) do? Despite the position contained in the South Commission's Report about the rich countries, the global private corporations and the international agencies, the consensus appeared to be to go in for the 'reforms' canvassed by them and strongly supported by influential private agencies within the country. These reforms appeared to be a follow up of the choices already made in the 1980s to let the development programme be decided by the 'natural' inclinations of the economy whereby those who had the resources and the forces of the market would determine the pattern and thereby the quantum of growth with the support of capital and interested parties from outside. Indian economic development would no longer be *planned* by the State, but *managed* by those who had a stake in the outcome, not excluding the State whose main responsibility would now be to envisage and encourage new forms of public-private partnerships.

There was another and more compelling reason. What was the alternative? There appeared to be none. "There is no Alternative" (TINA) was put forward as the slogan justifying the steps that were finally taken.

The most pressing task was to make sure that the flight of capital was arrested and that there was no defaulting on payments due. For these two the option was to turn to the IMF for a loan, as was done in 1980, for 'stabilization'. This time around it had to be combined with the *internal* 'structural adjustments' to be supervised by the World Bank.

The rationale of this approach was the notion that *external* problems of economies were but reflections of *internal* malfunctioning. As a writer conveyed at that time, the international lending agencies have a 'Key Message' that was universally applicable: "The primary development objective is maximizing growth by allocating funds based on the criteria of highest money rate of returns, when prices of goods and factors will reflect their respective scarcity values not only in domestic but also in the global context." The message is simple: the free play of market forces both within countries and among them will bring about the true scarcity value of goods and factors and that production and exchange decisions taken on the basis market-revealed prices will maximize growth. This gospel of "Seek ye first Growth" was and continues to be the corner stone of the reform agenda.

There are specific steps to be followed also. For countries faced with external payments problems the inevitable first step is a devaluation of the currency. A reduction in government spending is step number two because high government spending, especially if it is financed by a deficit in the government's budget, internal prices and costs would tend to be higher than their global counterparts. A third step follows, disinvestment of public sector enterprise to reduce the burdens of government and to provide a fillip to private enterprise.

A question frequently raised is how the Bank-Fund duo succeeded in enforcing the conditionalities on India. The answer is simple. India had spent the decade of the 1980s to switch over to the Key Message and so the external agencies did not have a difficult task. As the saying goes, what the doctor prescribed and what the patient desired turned out to be the same medicine.

And so the 'Reforms' started with a steep devaluation of the rupee in two instalments on July 1 and July 3. The second and third steps were also taken in quick succession. In successive budgets measures were introduced to bring down the fiscal deficit as a

percentage of GDP; to abolish industrial licensing for all except a select list of hazardous and environmentally sensitive industries; to reduce the list of industries reserved for the public sector permitting private sector participation in the reserved list; to cut substantially all import duties; to give liberal conditions for foreign capital to come in and participate in India's new pursuit of growth. A policy for disinvestment of public sector enterprises and for the reduction of subsidies was announced. The poor were not forgotten either. As in the past, the Reforms were also dedicated to them. An early official document claimed that the aim of the new policies was "to put the economy on a sustainable path of six to seven per cent growth –and it is essential if we are to break the age-old bonds of poverty which continues to afflict so many millions of our people".

The 'Reforms' were interpreted in many ways within the country and outside. Those who had taken seriously the 'socialist' rhetoric of the early years of planned economic development thought that the change of 1991 was a great betrayal. Their nerves were calmed by the official version that after all the Indian economy had a long tradition of market transactions and all that the reforms were attempting to do was to remove the rigidities and arbitrariness that the bureaucrats had brought into the system through the 'licence raj'. Some rejoiced that at long last the liberating forces of capitalism were being made available to the Indian economy still under the dominance of feudal restrictions especially in the rural areas. A leading member of the ruling party saw it as a restoration of property rights to the people at large. He proclaimed with great enthusiasm and a subtle legal twist: "Hitherto the President of India owned the resources of the country; now let the people have a chance"!

Globally there was great rejoicing that one more 'socialist regime' had collapsed along with the total disintegration of the Soviet Block and a transition from a 'bipolar' to a 'unipolar' world had been peacefully achieved. Academics who were convinced about the universality of the logic of the market could not hide their joy that a country with a long tradition of philosophical reasoning had at last found the truth.

The ‘Reforms’ brought in immediate dividends also. Although India received a substantial amount of foreign official aid during the period of planned development (accounting for over 40 per cent of capital formation in the mid 1960s) private foreign investment was negligible till the 1980s. With the opening up of the economy, somewhat cautiously in the 1980s, it increased from less than Rs 10 crore in the early years of the decade to Rs 315 crore by the end of the decade when opening up was formally accepted. With the ‘Reforms’ foreign private capital that was impatiently waiting to enter into India’s ‘emerging market’ started flowing in, first largely as portfolio investment (FPI), but later as direct investment (FDI) as well. FPI exceeded Rs 11,000 crore by 1993-94, shot up to over Rs 50,000 crore by 2003-04 and exceeded Rs 100,000 crore in 2007-08, although the global meltdown next year brought down the figure to Rs 64,000 crore. FDI was slow to begin with and crossed Rs 10,000 crore only by 1996-97 and reached the peak of Rs 160,000 crore in 2008-09. India which had to face shortage of foreign currency assets every now and then had close to $300 billion in 2007-08.

‘Growth’ began to pick up too. Already the planning processes of the early decades since Independence had lifted the growth rate of less than 1 per cent per annum during the first half of the 20th century to over 4 per cent per annum from 1950 to the mid -1960s. Then, of course, the same momentum could not be maintained during the rest of 1960s and the 1970s. But with the shift in the economic policies in the early 1980s the annual growth rate had shot up to close to 5.6 per cent during the decade. The crisis of the early part of the 1990s reduced the growth rate to 3.4 per cent during 1990-92, but the Eighth Plan period (1992-97) growth more than recovered to 6.5 per cent and kept up the tempo except for a big dip in 2003-04. But the Tenth Plan (2002-07) recorded an annual average growth rate of 7.8 per cent. Though it may not be wise to judge the performance of an economy on the basis of a single year’s figures, 2007-08 showed a growth of 9.6 per cent and the possibility of India moving into double digit growth rate was optimistically being talked about within the country and outside. The global

meltdown of the next year brought down the growth rate for 2008-09, but the manner in which the robustness of the Indian economy was demonstrated in the midst of the devastation in most parts of the globe has given a new sense of pride in the soundness of the 'fundamentals' of the Indian economy.

Till a couple of decades back the rest of the world had viewed India as too poor to be taken seriously, yet too big to be ignored. The image of India has changed. It is a tiger woken up and charging. India is a global power to be reckoned with and will be a superpower by the middle of the century. The words of India's economist Prime Minister are words of wisdom to a troubled world.

India has taken off into self-sustained growth and the market will now lead her to greater heights and glory. The Indian economy has undergone its 'great transformation'.
Or, has it?

Chapter 12

India Today - Wealth and *Ill*fare

Viewing the Economy

To respond to the query raised at the end of the last chapter we must recall two observations about the economy that have already been made. The first is that the economy is about people and about a significant aspect of their social relationships – it is an experiential reality for all of us.

At the same time, and that is the second observation, the economy is also a mental construct, multifaceted and multidimensional, a rather complex entity indeed. It has to be viewed from different angles and levels to grasp it. A couple of illustrations may be helpful.

Suppose that you wish to study a statue. You'd look at it from different angles won't you – from the front, the sides, and so on? This is because the statue has many dimensions and you have to look at it from different perspectives. So is the economy.

Take a more complex example, that of a skein of thread. Ordinarily it looks like a three-dimensional entity. But if you go up to a sufficient height, it may look just like a dot without any dimensions at all! Now, if you unroll it fully and straighten it out, it will look like a straight line which has length, but no width. Three views of the same thing, all correct if you keep in mind that these are partial accounts of a complex entity. The economy is even more complex because there is no such thing *out there* to 'view' or to 'deal with'.

And yet if the economy -- economic issues like growth, inflation etc. – are experiential realities, different groups of people, will perceive it differently as well.

Growth under the Scanner

Keep these observations in mind as we proceed to evaluate the performance of the economy of the past two decades after the Reforms were launched in 1991.

We have seen some facts: that the economy's growth has shifted gears "reaching undreamt of stratospheric heights" as a recent observer has claimed. But what exactly does that mean? Let us try to translate that into "what strikes the eye" so to say.

To a major segment of people, especially to those who live in our rapidly growing cities, it means, for instance, the plethora of new goods being colourfully advertised in the daily newspapers and on TV, and readily available in shops, in the vast shopping arcades and malls. If the 1980s are also included in the period marking the new strategy of growth, think of the many new products since then: colour televisions, mobile phones, lap tops, a variety of kitchen gadgets such as microwaves, food processors and even modular kitchens, home theatre systems… and the list can be made much more inclusive. Most of these are the result of the technological revolution of the period and may have become available even if there was no major change in economic policy. But the rapidity with which they have been increasing could not have happened without appropriate change in economic policy. The same is true about the goods that were available during an earlier period, but as scarce goods, such as refrigerators, washing machines, two wheelers, passenger cars etc. Those below the age of 30 may not even know, but if they know, find it difficult to believe, that even through the 1980s, to purchase a car one had to make a booking and wait in the 'queue' for months even beyond 12, for it to become an 'allotment'.

Think of the wide range of tall modern buildings of all kinds of architectural styles that are becoming symbols of urban India; of the many kinds of luxury apartment complexes

in the cities and the variety of villas far from the madding crowd; of the large and sprawling airports in all our major cities that conform to global standards and the hundreds of aircrafts, domestic and international that land in them and take off from them.

Turn to another sphere. A monthly salary of six digits is no longer uncommon and although an initial salary of Rs 300,000 for a fresh graduate from an IIT or an IIM or the monthly emoluments of a corporate executive of Rs 30,000,000 may raise eye brows, these too are seen as proof that the performance of the Indian economy has been outstanding even by international standards. One of its corollaries is that more wealth is made through financial transactions and that the 'sensex' has become the reliable indicator of the health of the economy. It is now possible for investors in stocks to become richer (or poorer!) by Rs 2 lakh crore *in a single day!* Judged by the colourful full-page advertisements appearing in our newspapers, often claiming the front page, luxurious living is the creed of a section of the Indian people.

Let us take one segment of this amazing performance for a more detailed scrutiny - that of passenger cars. As late as 1988-89, almost a decade after Maruti Udyog started production in India the total production was only 178,000 units. A decade later, in 1999 production had gone up to 533,000. By early 2000 foreign direct investment was permitted in the automobile industry (consisting of all forms of four wheelers, three wheelers and two wheelers) and the production of passenger cars almost doubled to 1,178,000 units in 2004. From then on production started making big jumps. In 2010 India produced 2,815,000 cars, overtaking the USA and becoming among the largest producers of cars in the world (China, Japan, Germany, South Korea and Brazil being the top ones). As of 2010, again, India is home to 40 million passenger vehicles (cars and commercial vehicles). The sale of cars (domestic and imported) is projected to increase to 5 million in 2015 and to 9 million in 2020.

From the total figures let us turn for a moment to the processes that lead to the phenomenal performance. We noted in the previous chapter that it was decided in the 1980s that the sure way to revive India's stagnant economy of the 1970s was to let the pent up demand (obviously of the well-to-do section of people) to guide production. More people started booking cars. This increase in demand was matched by increase in supply (of the new Marutis in addition to the old Ambassadors and Fiats). By the early 1990s supply caught up and queuing for cars was no longer necessary. The pay scale revision of the late 1980s made it possible for many more people to enter the car market. More families started owning cars, including used cars for which organized markets started emerging. With both husband and wife working (thanks mainly to the growth of the IT industries) two cars for a family became necessary and affordable. When the incomes increase and the family grows, a third car, a bigger family car gets added. And there are many agencies that encourage borrowing for the purchase of expensive items. Buy now and pay later is the dictum.

There are many more families following the same sequence, more or less. Then there are the corporates who, of necessity, have to make frequent additions to their fleet of cars, of different sizes, shapes and brands so that protocols are adhered to. And then there are the taxi companies to cater to the needs of those on short visits to the cities for a variety of justifiable reasons. It does not take much of an effort to trace the rest of the 'developments' that take place --hotels of different 'stars', clubs, pubs, gyms, multiplexes, saloons, all employing people on graded scales, adding to the ever expanding prosperity.

But let us stick to the motorcar segment. With cars increasing day by day, roads *have to be widened.* That is 'public' requirement arising from 'private' prosperity. But resources available to the public bodies, whether city corporations or the state are limited and the funds required enormous. There is a remedy, however - to leave it to private parties to fund the project, allowing them to collect tolls once the road expansion project is

completed, thus converting 'public' highways into 'private' roads. These roads may be passing through villages in the neighbourhood of the big cities and so traffic signals may become necessary along the road from the city to the new, large and modern airport. The traffic lights would soon cause delays, irritation and impatience. As a 'public service' an elevated highway connecting the city and the airport *without* traffic lights would have to be taken up. More public-private projects would be the answer. One step follows the other. There is compelling reasons for each step.

There may be 'unintended consequences' too. Big projects have to be taken up by big agencies, domestic of foreign. There will have to be tendering and contracting and due 'considerations' have to be shown at different stages of these processes. Widening of roads calls for more land to be taken up and may result in cutting down of trees, knocking down of petty shops and acquiring of land. In the meanwhile the growing number of applications for the registration of cars leads to pressure in the registration offices and 'facilitation fees' of various sorts may be the only way to ease the pressure.

Growth as a Social Process

The rather detailed narrative given above brings out two important facts. The first is that 'growth', though frequently is expressed in terms of numbers is essentially a process, a societal process. When unraveled it brings to the fore a variety of matters that otherwise remain hidden. The second is that as a process it impacts different sections of people differently apart from having tremendous ecological implications. To go a step further, 'growth' confers wealth to some; distress and deprivation to others. *Even more starkly, growth is a social process which generates simultaneously wealth for some and poverty for others.*

Hence we must trace it further by entering more into the process itself; by probing who benefits by it and who loses; and what explains this often unexamined, but crucial social dimension of 'growth'.

A first step we can take to *enter into* the growth process is to disaggregate the numbers themselves into more detailed categories as was shown in Chapter 8. The Planning Commission's *Mid-term Appraisal of the Eleventh Five Year Plan* (2007-12) indicates that Agriculture and allied activities grew at 3 per cent per annum during the Seventh Plan (1985-90) that is the immediate pre-reform period, 4.8 per cent during the Eighth Plan, 2.5 per cent during the Ninth and 2.3 per cent during the Tenth. In the first year of the Eleventh Plan (2007-08) the growth of the sector was 4.7 per cent, but in the subsequent two years it dipped to 1.6 per cent and a miserable 0.2 per cent. The performance of the sector reflects the drastic reduction in public investment as a result of the decision to 'roll back the State' from economic activity. In the second major sector with manufacture leading, (but also including mining, electricity and construction which in recent years have been accounting for about 20 per cent of the workforce) the growth rates for the Seventh (Pre-Reform) and Eighth, Ninth and Tenth Plans (Post-Reform) periods have been respectively 6.6 per cent, 7.3 per cent, 4.3 per cent and 9.0 per cent. During the first three years of the Eleventh Plan, the figures have been 9.3 per cent, 3.9 percent and 9.3 per cent. Finally, in the Services Sector, employing the rest of the workforce (approximately 20 per cent) the growth rates have been 7.4 per cent in the Pre-Reform Seventh Plan and 7.3, 7.9 and 9.3 per cent in the Post Reform Plans and 10.5, 9.8 and 8.3 per cent in 2007-08, 2008-09 and 2009-10 respectively.

To get a better idea let us supplement these figures with the *share* of the three sectors in GDP. Agriculture accounted for 32.5 of GDP in 1984-85 which came down to 17.2 in 2008-09; Industry's share in GDP grew from 26.0 per cent in 1984-85 to 28.2 per cent in 2008-09. More recent figures indicate that this increase has not been sustained. By contrast, the share of the Services Sector shot up from 41.5 per cent in 1984-85 to 54.9

per cent in 2008-09. The Service Sector also accounted for some 60 per cent of the *increment* in GDP since the 1990s.

If these figures are tiring, let us sum up the findings in plain prose. The alleged post Reform quantum jump in the growth rate of the Indian economy did not have any significant impact on the performance of the traditional agricultural sector which still employs the bulk of the work force, but has drastically brought down its share in the GDP; in the Industrial sector which was thrown open to the rest of the world and into which foreign capital was expected to flow in, there has been no impressive change in the growth rate, and the sector's share in GDP has only very marginally increased. So, the 'miracle' of post-Reform growth has been confined largely to the Services Sector, where the growth rate has remained high and its share in GDP has made an eye catching increase from a little over 41 per cent in the pre-Reform period to 55 per cent in 2008-09. Since the sector's share in the workforce has not increased, it is fair to state that much of the celebrated post-Reform growth reflects a bloating of the earnings of those in that sector. That sector is a heterogeneous one and only a small segment of it has high and growing earnings. If that is any indication, it is reasonable to infer that, '*growth' in the post-Reform period is little more than the increase in earnings of a small minority of people in the country.* What an illusion!

To see the contrast between the growing affluence of a minority and the abysmally low earnings of the vast majority of the people in the country, turn to the findings of an official Committee of the Government of India which in its Report in 2007(said to have been one of the best years of economic performance as the growth in 2006-07 was 9.4 per cent and 2007-08, building on that high performance, an all-time high of 9.6 per cent) stated bluntly that *77 per cent of the population were living below Rs 20 per day.* On the other hand, the Planning Commission would claim that only less than a third of Indian's population now is 'below the poverty line', which in turn would raise further questions about what the indicators of poverty are. While these internal debates

continue, according to a widely accepted 'Global Hunger Index, 2011' out of the 81 countries with poor food security status, our beloved country ranks 67 with even Rwanda in Africa faring better. Among 187 countries ranked in the Human Development Report 2011, India comes in at a dismal 134. There are physical indicators that reveal the pathetic plight of millions in our country. The head count ratio of nutrient deprivation is as high as 44 per cent and that of calorie deprivation about 75 per cent of rural population stated a study a couple of years back. In urban areas where the expenses of earning income such as transportation and clothing are high, women workers are often left with no choice except to economize on food. Another report, from no less an authority than the World Bank, stated that 42 per cent of children in India suffer from malnutrition and that almost half of the world's underweight children are in India. Look at even more 'objective' figures. The per capita availability of food grains in the country was 510 per grams per day in 1990-01 which dropped to 443 in 2006-07 and to 417 in 2007-08 which, of course, was a particularly bad year for agriculture. You will notice that these are *average figures of availability* which by themselves do not say anything about how much any person or group of people was able to access. But if per capita availability had come down so drastically, one can safely infer that much less would have been accessible to those at the bottom. The Planning Commission itself admitted that "a low and stagnating income among the poor has meant that low purchasing power remains a serious constraint to household food and nutritional security, even if food production picks up…." And *quarter million* farmer suicides between 1995 and 2010!

Suffice it to say that despite decades of planning and years of Reform both of which have substantially raised growth and took the economy to a much higher trajectory during the past six decades, Indian economy still remains what it was in the past, a vast ocean of very low incomes; with a small island of affluence. What the Reforms have done is to increase the prosperity of the few, at best leaving the many untouched and in fact making the situation at the bottom desperate. This is not to say that there has been no

“trickling down at all”; some crumbs indeed fall from the table. But there is a bit of a paradox even in this. Even as the dishes on the table are getting increasingly filled up, fewer crumbs are falling down. A scholar put it thus: “Total poverty declined at a rate of 0.85 percentage points per annum in the pre-reform period while the corresponding figure for the post-reform period was 0.7”.

To proceed further, let us recall the problem we have been tracking. From the time of Independence the professed aim of economic policy in the country has been the eradication of mass poverty and providing the opportunity to ‘the small man’ to have a higher standard of life for himself. A high rate of growth was considered to be the surest means to achieve this objective.

In less than a decade of planning the rate of growth of the economy was lifted from the abysmally low figure of less than 1 per cent per annum during the last half century of colonial rule to over 3 per cent, and even higher for a while. By the end of the 1970s it was felt that planned economic development driven and directed by the state was neither accelerating growth nor substantially reducing poverty and a directional change was called for. After making ad hoc changes in the 1980s, a sudden and major change was brought about early in the 1990s. Frequently referred to as ‘the Reforms’ this change handed over the pace and pattern of growth to be decided by private initiative and the purchasing power of the well-to-do coordinated by the market, domestic as well as global. A higher growth target of 6 to 7 per cent was considered necessary “to break the age-old bonds of poverty which continues to afflict so many millions of our people”.

In a period of two decades that target has been achieved and exceeded in spite of exceptionally high adverse global conditions. However while the high growth rates have glaringly increased the incomes and wealth of a few, the economic conditions of the majority have only become more precarious.

It is this apparent paradox that calls for explanation.

The Paradox Examined

Right at the beginning of our expedition we had laid down the clues to comprehending the complex terrain called the economy. We had stated that the "Who gets What" question depends on the "Who does What" question which is decided largely by the "Who owns What" question. We must now see whether these clues can be directly put to use to make sense of the 'paradox' we have encountered.

"Who does What?"

"Who does what?" is of course, the colloquial expression for what in academic terminology is referred to as "Occupational Distribution of the Workforce" to which we turn our attention now. One of the main sources for information on this aspect is the relevant sections in the Reports of the Census of India. The data collected during the 2011 Census in this regard have not yet become available. So the figures that follow relate to 2001 and some updates based on large-scale official sample surveys subsequently..

For a broad picture we turn to the 2001 Census studies. According to them "Agriculture and Allied Activities" claimed close to 57 per cent of the workforce; the rest are in "Non-Agricultural Activities". It may be useful to note that this shows a big change from the immediate post-Independence decades when the figure in agriculture stayed unchanged at 72 per cent for three decades or so. The big fall came between 1991 and 2001. The 57 per cent consisted of 33 as 'cultivators', slightly over 20 as 'agricultural labourers' and the rest as engaged in 'livestock, fishing etc.' Cultivators dropped from 50 per cent in 1951 while there was no major change in agricultural labourers.

The ‘Non-Agricultural’ category is divided into six sub groups of which ‘Manufacturing’ accounted for 12.4 per cent (divided between “Household Industry’- 4.2 and ‘other than household industry’ 8.2). The others are ‘Mining and Quarrying’(0.7); ‘Construction’(3.8); ‘Trade & Commerce’ (12.4), ‘Transport, Storage and Communication’ (3.9); and ‘Other Services’ (9.5). Note that only ‘Trade & Commerce’ claims more than 10 per cent which means that there is not a great deal of significant diversification in the ‘Non-Agricultural Activities’. Also worth noting is that ‘Household industry’ still accounts for about a third of ‘Manufacturing’. Available figures show that the only groups whose shares have gone up since 1951 are ‘Construction’ and ‘Trade & Commerce’ the former moving up from 1.1 per cent and the latter from 5.2 per cent.

Now you probably have a better understanding of ‘Who does What’ in our country. Let us concentrate a bit on the agricultural sector now. (You may want to go back to the early chapters and look up the different types of households indicated there.) The first thing that strikes is that agricultural labourers constitute over a fifth of the workforce. Most of them are landless households (Type C in our earlier classification) and are largely descendants of those who were traditionally prevented from owning land – today’s SCs or Dalits. The Census and related papers provide further information about ‘cultivators’. They are either those who own land (Type A) or those who lease land to cultivate it. A division of cultivators according to the size of their holdings is the most striking (even shocking) aspect that emerges. In 2003, those holding less than 1 hectare classified as ‘marginal cultivators’ constituted 80 per cent of the total. And this was a sharp increase from 60 per cent half a century ago. If ‘small cultivators whose holdings are 2 hectares or less are also taken into account, the two together exceed 90 per cent of cultivators.

Yield and earnings from land will depend on a variety of factors, primarily the availability of water for cultivation and what is being cultivated, food crops or commercial crops, for instance. But it is not unreasonable to say that the crops or earnings from 2 hectares will be required to provide the basic necessities of life for a household of 5 members. If that

is granted, it means that over 90 per cent of our cultivators live at the border of subsistence! Since cultivators form 33 per cent of the work force, those cultivating less than 2 hectares, thus constitute about 30 per cent (90 per cent of 33 per cent) of the total workforce. Add to it the agricultural labourers (20 per cent of the workforce) whose condition is not likely to be better than that of small and marginal cultivators; we are led to infer that 50 per cent of the total workforce of the Indian economy and their families have precarious existence.

Even in the Non-Agricultural Activities, especially household industry, construction, trade & commerce, together accounting for over 20 per cent of the workforce, the vast majority are likely to be at the mere survival level - possibly another 12 to 15 per cent, thus raising the figure of those at precarious existence to more than 60 per cent of the total.

The workforce of the country is also divided into two broad categories: those in the 'organized' sector and the rest, that is, those in the 'unorganized' sector (Also referred to as 'formal' and 'informal' sectors). This classification is frequently referred to, but not much examined with the attention it deserves. The classification received recognition in the early 1970s when the International Labour Organization (ILO) launched a series of studies on 'informal' workers.[28] The Government of India in 2004 set up a National Commission for Enterprises in the Unorganized Sector whose final *Report on Conditions of Work and Promotion of Livelihoods in the Unorganized Sector (*August 2007) is the best source we have on this crucial aspect of the Indian economy which suffers from benign neglect even now.

[28] I had recognized the significance of the group of workers under this broad category in my PhD. Dissertation of 1962, already referred to in Chapter 6, and my subsequent studies in the rest of the decade, resulting in my *Indian Economic Crisis: A Diagnostic Study,* 1969. See also my *The Economy, 1992,* especially chapter 7 and 9 where using data available in the late 1980s I had classified 90 per cent of the workforce as being in the unorganized sector. For want of an appropriate designation I had referred to the households of this category as the 'core sector' of the Indian economy. I had concentrated on the production units, 'the petty producers' of Chapter 6.

Making use of data relating to 2004-05 the Commission stated that as high as 92 per cent of the workforce, defined as those who do not have employment security, work security or social security, to be in the unorganized sector. As the mandate of the Commission was specifically to study the enterprises in which or through which these workers functioned, the Report went on to say: "The unorganized private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with less than ten total workers" were included in that category. Elaborating it further, the Report included all those who are engaged in agricultural activities other than in plantations and in corporate and cooperative farming; the bulk of small retail traders (including the many forms of street vendors); those who work in much of the household, cottage and village industrial units; and the vast array of those engaged in personal services; all of them as constituents of the unorganized sector.

Indeed the list is more inclusive. For even in the 'organized sector' there is an 'unorganized' segment- those who do not have the legal protection and service and security conditions that characterize 'formal employment: the contract workers, the temporary workers, the part-time workers who can be seen not only in the private sector, but also in different employment providing agencies of the government, in some instances as high as a third of the total employees. If these are also brought in, the workers who are or should be characterized as 'unorganized' may be closer to 95 per cent.

This is the reality of India. Over 90 per cent of the workforce in the country, consequently also a similar proportion of the total population, have insecure living conditions. We should not translate this automatically into earnings because earnings of *all* in the unorganized sector are not necessarily low. In fact, the informal conditions that pervade the sector provide opportunities for exceptionally high earnings also. Hence it is

best to say, as the Commission's Report does, that apart from generally *low* income levels (for the vast majority) the unorganized sector is also characterized by 'vulnerability'.

There is another way of looking at the 'informality' phenomenon and that is to view it as shaped by the organization of production. This is because the general economic situation makes it necessary (for the sake of survival, that is) for large numbers of 'workers' to engage themselves in 'production'. Production has been put within inverted commas because it includes all forms of ensuring a livelihood for the 'worker' and those dependent on him/her, including trade and personal services. The tiny cultivators we saw are of this category, most of them at any rate, because that is the only option they have to make a living. Most of those who turn to petty trade are also exercising the Hobson's choice; all forms of 'unskilled' services must also be included in the category. If all these groups who cannot find work easily and are forced to employ themselves are brought together, another way of characterizing the Indian economy is to state that it is dominated by 'self-employed' workers.

The Commission's Report while acknowledging that the Indian economy is dominated by the self-employed also concedes that "there is some fuzziness in this concept" and that it "conceals more than it reveals". Part of the problem is that some of the self-employed, specifically noted as 'own account workers' employ one or more workers, apart from the fact that most of them also rely on the services of the members of their families. Without going into details of these aspects we shall concentrate on the chief characteristics of self-employment. The distinguishing feature of self-employment is that one's own labour power, physical and mental, is an asset, often the only asset that the concerned worker has. He/she is free to use it as he/she likes. Hence when pressed by the need to provide livelihood for oneself and members of the family this asset is put to use as extensively and intensively as is found necessary. The Russian economist Chayanov who examined this aspect referred to self-employment as an instance of 'self-

exploitation'. This form of self-employment is something that one is driven into by the whip of hunger. Over 55 per cent of non-agricultural workers in India are self- employed of this kind, over 90 million in 2004-05. In the rural areas there are more women than men as self-employed, which include those engaged in 'household industries' such as *bidi* making. An important aspect of this form of self-employment which in the urban situation finds expression mostly in the form of petty trade is that the so-called 'independent worker' easily comes under the pressure of bigger traders and money lenders.

If we bring the 'self-employed' within agriculture which will include at least the marginal, if not the small cultivators also, it can be stated that self- employment is numerically the predominant occupational pattern of the workforce in India. At the lowest level of the workforce is the group that is described as 'casual workers', those who do not even have the minimum capabilities to set up shop of their own and take up work as and when somebody offers it to them.

Before concluding the discussion on self- employment we must recall our observation made in Chapter 6 that there is an 'upscale' segment to it made possible by recent technological changes. You find them mostly in the IT industry, higher skilled men and women who work on their own, aided by their laptop and their mobile phones.

Disparities are a problem not only between the organized and unorganized sectors, but within the organized sector too where relevant data are more readily available. Here is a statement that a member of the Planning Commission shared with the public: "Throughout the eighties, the share of wages, that is blue collar wages, in Indian manufacturing was about 30 per cent. During the '90s it started dropping from 30 to about 20 to 23 per cent. By 2007 it was less than 10 per cent. We are talking about a cut in the share of wages in the Gross Domestic Product of the manufacturing sector of an order going down by two thirds in the course of 20 years. The profit share which was

about 25 to 30 percent in the '80s and rising slowly in the '90s, was 62 per cent of the GDP of manufacturing by 2007-08, the remaining gap on the other hand is the white collar workers' share which was going up…".[29]

Globalization impacts the work and earnings of different groups of workers. Highly trained workers are employed by some MNC or thrive by working for one of them as 'self-employed'. Globalization and liberalization have been affecting the traditional workers too. It works somewhat indirectly. Though the share of workers in large-scale industry has been steadily increasing since Independence, of late a process of 'informalization' has set in. Informalization has received an impetus since liberalization because big factories find it to their advantage to sub contract work to units in the informal sector (broadly units that employ less than 20 workers) than to employ more workers. Informal firms and workers have grown substantially: workers from around 16 million in 1996 to over 36 million in 2000. Between 2000 and 2005, there was a significant decline in wage employment in general. But the decline led to an equally significant increase in all categories of workers, the sharpest being among rural women which can only be interpreted as a distress-driven phenomenon.

Some of these aspects that have bearing on the lives of the vast majority of the workers and population in the country are hardly brought to light. *The Report on Conditions of Work and Promotion of Livelihoods in the Unorganized Sector* appears to have been shelved too!

"Who owns What?"

The true colours of the Reforms and of 'globalization' which is their basis are becoming visible for those who wish to see. If we keep in mind that globalization, *capitalist*

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29 Abhijit Sen, "Inclusive Growth", Professor Ventakaraman Memorial Lecture, Bangalore, April 2010.

globalization to be more specific and accurate, holds together two opposing tendencies, it will be easier to grasp why this is happening and yet why it remains rather hidden also. To be sure, capitalist globalization provides opportunities for some to have hugely rising incomes and rapidly accumulating wealth – the colloquial expression "to mint money" may be more appropriate. We may note a reversal of the path too. In the early stages of capitalism an increase in current earnings (income) was the requirement for accumulation of wealth. Income was derived through transactions, which in turn was based on production. Wealth consisted of tangible assets.

Today with wealth having become *claim* to assets and these claims generating second, third and even more rounds of claims, all in paper, or increasingly digital, direct chasing of wealth is quite possible and is rapidly becoming the legitimate order. Trading in 'proxy wealth' is the recognized route and is being carried out literally every moment. The frenzy associated with it is quite visible in share markets all over the world. The enormous difference, growing day by day, between bloating transactions in claims on the one hand and physical goods on the other is the proof. Wealth leads, income naturally follows. That is what finance does: it converts real wealth into digital wealth; multiplies it instantaneously through transaction, thus providing new avenues and forms to intermediation; and, alas, systemic risk of collapse goes up multiple times too though it remains hidden till it strikes.

What is being suggested is not that only those who have wealth to begin with can accumulate more wealth. One comes across many "rags to riches" stories: of brilliant students coming from poor backgrounds doing well in an IIT, absorbed by an MNC on a high salary immediately after graduation, being prudent with the surplus he has and slowly, but steadily going up the ladder. But note that only certain kinds of skills have commercial value. There are also true stories of those who had no asset base or any special skills, but picked up 'the tricks of the trade' and quickly reached the top. There are also those, who do nothing much except to purchase a lottery ticket and win the

fabulous first prize! If these true but exceptional stories are indeed treated as exceptions, then the rule is that *those who have wealth to begin with will come to have more wealth.* Please note too that in a country such as ours where no citizen is guaranteed anything (other than the right to vote) anyone who has a surplus is guaranteed that it can be doubled in a few years by leaving it in a bank for safe keeping! In our economic system the 'normal' way to become wealthy is to start wealthy.

That is the top end of the spectrum. At the bottom the reality is quite different. Survival itself is a struggle for casual labourers, the agricultural labourers, and for many of the self-employed, including many of the marginal cultivators together constituting one half of the workforce (and their families). And these are the people who by their back breaking efforts keep the nation going. They are the ones engaged in genuinely productive activities and the basic forms of commerce, making a 'profit' hardly sufficient for their limited needs. And the 'growth' that the Reforms claim to have taken to a higher rate is not to be seen at their levels.

It is these two opposing tendencies and experiences that the system holds together. In one of them there is rapidly growing wealth and a great deal of excitement and shouting. In the other, hard work, tightening of belts, frustration and despair. The unprecedented changes taking place are visible to all; but the unnoticed reality is that very little of these changes is reaching vast millions in the country.

Why so?

Providing simple explanations to complex phenomena is not sound but in this case the problem itself suggests explanations. Lack of access to resources is seen as the principal reason for the plight of the casual labourers, the agricultural labourers, the marginal farmers and the low-end self-employed. Thus physical strength and mental agility alone are not sufficient to become productive or to make an adequate earning through

services. Consider recent (2005) official figures on asset distribution. At the all-India level over 8 per cent of the households had assets worth less than Rs15,000 and 47 per cent (or close to half) of the households less than Rs 100,000.These assets include the value of the plot of land where they dwell and any implements like shovels, sickles and any other durable item they possess. Only a little over 7 per cent of the households are shown to have assets worth Rs 800,000 or above, but they claim over 46 per cent of all assets. Within this group, of course, there is sure to be wide disparity. In the rural areas, 1 per cent of cultivator households and 18 per cent of non-cultivator households belong to the lowest category with less than Rs 15,000 worth of assets. In the urban areas10 per cent of the self-employed and 20 per cent of the non-employed (obviously casual labourers) are in that category. It may be noted too that 18 per cent of the self-employed in urban areas are in the top group claiming as high as 69 per cent of the assets of the self-employed category. Urban contractors, for instance will come in that category.

Land and buildings form the main component of assets of cultivators accounting for 88 per cent and if machinery and equipment are also included it will turn out to be 92 per cent. Among the non-cultivators land, buildings and machinery account for 80 per cent of assets. Land, buildings and equipments together account for 81 per cent of the assets of all urban households put together, thus showing how tremendously important land and buildings (or real estate) are in the asset structure of the Indian economy. Financial assets constitute only 2.2 per cent of the total assets in the rural sector and even in the urban sector it is only 9.4 per cent of all assets. And yet what a lot of noise finance makes!

Available figures also show that the top 1 per cent of households accounts for 16 per cent of the total wealth, and the top 10 per cent 53 per cent, while the share of the lower 50 per cent is 8 per cent and that of the bottom 10 per cent is 0.2 per cent.

To sum up the position that the people of our country face after two decades of Reforms, we may slightly modify the famous words of Charles Dickens regarding 19th century England: “It is the best of times” (for a few) and “It is the worst of times” (for most).

We may briefly consider the role of the state in the present situation. Two broad comments may suffice. In 1991 it was a minority government of the Congress Party under a new leadership that was responsible for initiating the Reforms. Loyalists to the ‘Nehru tradition’ were sceptical about it. The main opposition party, the BJP vaguely opposed it. In the elections to four major State Assemblies, the Congress Party lost heavily which was interpreted as popular opposition to the new policies. But once launched it was not easy to reverse the step, and obviously the Reforms had the support of the business community. Hence the Central government decided to press ahead although to appease popular sentiments, it was decided that the Reforms had to have a ‘human face’.

In 1996 the Congress Party was voted out of power, but the coalition governments that followed were more interested in survival than about economic policies. The BJP that came to power in 1998 with the support of some regional parties decided to continue the Reforms as its support base was the local middle class and commercial groups that favoured the Reforms. As the growth rates began to pick up and in 2004 the Party accepted ‘India Shining’ as its slogan for the general elections, it became evident that the Reforms had been endorsed by the two major parties and many regional parties as well. Hence the Reforms came to have the status of *national* economic policies with only the Leftist parties opposing them. Even they had to give in to some extent as they were in power in West Bengal and had to go along with the rest of the states. When the Congress Party came back to power heading a coalition and Manmohan Singh became Prime Minister, the matter was finally settled. The ongoing reforms had become State

policy. And the 'good' growth performance of 2004 to 2009 in spite of external shocks appeared to certify that the path chosen in 1991 was validated.

The fact is that the 'directional change' initiated in the 1980s had handed over the economy to the big business groups and to the upper income section of the population who found in global capital a more effective support than that of the Indian State. By and large State policy now is to pretend that the state is still driving the bullock! India's economist Prime Minister has the unofficial standing as the chief economic advisor to the leaders of global capitalist powers.

Occasionally embarrassing situations arise. A typical instance was allowing 100 per cent foreign direct investment in the pharmaceutical industry in India as a 'green field' expecting that it would lead to the production of generic versions of drugs at affordable prices. But foreign pharmaceutical companies succeeded in converting the permission into 'brown field' by taking over leading Indian drug manufacturing companies and making drugs more costly! The government is exploring ways of making prior approval mandatory for takeovers in selected areas – in the future, of course!

The second comment is that the government has been taking up some widely advertised programmes meant specifically for the poorer sections. The Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) is the major one among them which assures 100 days of work on payment to one member of rural households everywhere in the country. This is a step in the right direction and long overdue.[30] Free and compulsory education for children up to the age of 14 enshrined in the Constitution and was mandated to be implemented within a decade has finally been enacted into a law. A policy to make food available to the poor at a highly subsidized price is seriously under discussion. When distress suicide among farmers came to be reported from many parts

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 In 1971, I had had recommended a rural public works programme.

of the country concessional loans were made available to a class of farmers. Some form of insurance coverage has been brought in for sections of unorganized workers. Over time these schemes, if effectively implemented, may make conditions "incrementally less intolerable" as a writer tellingly expressed it for those who survive. But they pale into insignificance compared to the concessions made available to the better-off sections and the variety of incentives provided to the rich to become richer. As the Deputy Chairman of the Planning Commission stated publicly, "no democracy can afford to be anti-poor"! How very true. He was, of course, seconding the famous pronouncement of former President Kennedy of the USA that a society that does not help its poor will not be able to save its rich.

Colonial Period and Post-Independence Period: A Comparison

In wrapping up this discussion of the state of the Indian economy after two decades of Reforms, it may be interesting to make a comparison of the transition or transformation that the economy experienced during two different periods in to history – the colonial period (examined in chapter 10) and the post- colonial period service Independence (the theme of chapter 11 and the present chapter). There are, of course, big differences. But it may come as a surprise that there are three fundamental similarities.

The first is that during both the periods major changes came as a result of the *opening up* of the economy. Chapter 10 has shown how the unexpected export trade in cotton started changing the economy in more ways than one. Apart from leading to industrial production in the country for the first time, it also had the indirect consequence of opening up the largely isolated village economies and destroying their traditional economic order. It could be argued that it was a case of 'creative destruction' but surely it was destruction.

In the post-Independence period, there was an initial inward looking period that made possible a planned programme of industrial development. But again when the economy was thrown open to external forces, it initiated many sudden changes reaching into even its interior parts.

Secondly, both the colonial period and the post- Independence period saw changes in property relations in the country. The colonial powers initiated a private property regime in the country disturbing but not destroying a variety of community property arrangements dominated by small sections in the community and defining the differential rights of the rest. The British administration, for its own reasons brought in the concept of private property *de facto* implementing it on ad hoc basis in different parts of the country. The freedom movement had ambivalent notions about the future of property arrangements, but accepted the slogan of "land to the tiller". In the post-Independence period even while trumpeting the slogan of the 'socialist order of society' the question of ownership and property rights was tactfully evaded. "Land to the tiller" slogan was allowed to lapse. A feeble attempt was made to introduce cooperative farming, but a hasty retreat had to be made. Ceiling on ownership of land was enacted in many states but with loopholes as large as to let an elephant pass through, as a commentator put it, and so except to make room for litigations nothing much was achieved. Land reforms worth the name, but by no means radical, were enacted only in Kerala under a communist government in the 1960s and West Bengal after it came under Leftist rule in the late 1970s.

However, indirectly, the post-Independent period has encouraged and legally established private property as the standard norm in the country. As was briefly referred to in Chapter 11, this was the result of the commercialization of agriculture and the need to approach banks for loans where the use of land as collateral inevitably led to the need to ensure legal ownership of property whose use rather than ownership was the major

issue till then. Six decades after Independence Indian economy has been firmly based on private property rights.

Thirdly, and most importantly, both the colonial period and the post-Independence period have witnessed the rapid growth and powerful role of commercial activity. What was for long largely a relationship between merchants, domestic and foreign, soon reached the possessors of physically held surpluses in the rural areas. Commerce then linked up foreign and urban consumers and the rural producers. Soon production itself came to be under the domination of trade and commerce broke up a variety of relations of production and led to the growth of a money economy. The processes of intermediation that emerged then led to the next phase of intermediation via the banking system.

Soon commerce, rather than production became the principal route for the acquisition and accumulation of wealth and more ways of intermediation became necessary and profitable. By the middle of the 1980s domestic and private forms of mediation were easily interacting with foreign private processes of intermediation. Quietly but steadily, intermediation through banking and financial personnel and institutions was getting firmed up.

What the 1991 Reforms did was to provide legal sanction to an economic order based on private property and dominated by freely floating financial funds which do not distinguish between what is permissible and what is forbidden. Anything that yields profits is desirable and permissible. That is the bottom line of the new economic order as witnessed by public events on a day to day basis.

CONCLUSION

Towards 2050

Our exploratory expedition is over, but before we say good bye allow me to make some concluding observations.

The deal was that I would take you through the rugged terrain of the economy using Real Life Economics as the clue to exploring that terrain. You are rather tired, I know, but satisfied also, I hope.

My concluding remarks focus on three aspects. First, I shall try to gather up the clues we have used which form the basics of Real Life Economics. Second, so far we have been concerned with the past and the present, but if the economy is an evolving entity we can also take a look into the future. Third, I take the view that Real Life Economics not only enables us to understand what is going on but also provides possibilities to intervene in policy issues that greatly shape the nature of the economy, and indeed affect your life as also of people as a whole.

Basics of Real Life Economics

1. Unlike the present day class room economics which concentrates on abstract logical exercises, RLE recognises that it is a set of clues to study the economy which is an experiential reality for all of us.

2. Since the economy is an experiential reality, it is contextual, historically, geographically and culturally. However the specificities of any economy can be logically traced and examined through substantive logic.

3. To develop the skill of substantive logic of a specific economy the following guidelines can be used:

A) It is the survival instinct of human beings that gives rise to the economy with production as its basic activity. Over time other activities such as exchange emerge and the desire of a few to make profit for themselves becomes the main driver of economic processes. In turn it will bring about major changes in economic and social relationships.

B) Ownership and control over resources are the crucial factors shaping these relationships when one moves beyond the household whose internal relationships are 'natural', pre-economic. Where ownership becomes the basis of economic relationships, much of it can be traced through three probing questions: "Who owns What?", "Who does What?", "Who gets What?" These questions, however, are trivial till the "who" and the "what" in each question becomes contextually specific. Then they become powerful tools of enquiry.

C) The economy is a complex network of institutionalised intermediation. It starts with exchange which develops into the market, or many forms of markets; other institutions follow such as banks and financial institutions of increasing complexity.

D) The process of intermediation is based on asymmetry of information, a common medium for transactions and an authority to sustain it.

E) The economy is a multi-dimensional and multi-layered entity. Hence it must be viewed from different angles and scanned at different levels.

F) The special feature of the Capitalist Economy is the never ending pursuit of profit to accumulate wealth; wealth has lost physical properties and has come to mean value appreciation; value is the conversion of everything into monetary categories achieved through mediated transactions in the market, through banks and finance. The pursuit of profit and wealth results in sacrificing human beings and Nature's endowments. Hence rapidly spreading capitalism is a negation of just and peaceful ordering of society and the 'growth' it brings about is artificial and unjust. It increases inequalities in the economic order, growing wealth for the few and increasing *illfare* for the many. Such a system has the inherent proclivity to destabilize society, especially when its activities become "irrationally exuberant".

Evolution of the Economy

The point made in F above is the summary of the substantive issues dealt with so far. Let us elaborate it a bit. The economy is a historically evolving entity and hence must be traced historically to understand the metamorphosis of the institutional milieu.

The historical evolutionary process can be divided into three temporal formations. The first is a series of diverse local communities concentrating on livelihood issues. By far the longest period in human history consisted of such formations. The second is when settled agriculture became fairly common and consequently land became the primary resource and controls over it the major economic issue. Though this stage too had different patterns in different parts of the world it has come to have a widely accepted common name, feudalism. Feudalism was a hierarchical order with fairly direct relationships between the immediate groups, above and below, in the hierarchy. In that sense it is a system without much mediation. Feudalism was also noted for the generation of surplus beyond the level of subsistence and its appropriation by those who controlled land. They used it for comfortable life and warfare and converted it into physical forms of wealth. However the system also ensured the survival of even those at the bottom on whose life and labour the working of the system depended. Feudalism also saw the emergence of merchants as a new professional class and of trade as a new avenue to make wealth. The wealth making activities of merchants would initiate the process of society coming to be divided into those who were wealthy and those who were poor with many in-between, still working on land to make a living.

From that kind of socio-economic set-up would emerge the third economic formation known as capitalism which would use pooled commercial surpluses to organize large scale production with the help of technical advances of the times and the use of workers who had nothing to sell other than their labour power. The capitalist owners claimed all surplus generated by workers as the share of ownership. They would initially use the surplus to augment production so that capitalism initiated a phase of steadily growing output of a variety of goods, all valued by the market as 'income'. For a while emphasis shifted from trade to production, but the compulsion of capitalist entrepreneurs to sell the growing output not only re-established a link with commerce but also brought back its leading role in the economy. Industrial capitalism and commercial capitalism became

inseparable, their link held together by banking which mobilised the scattered surpluses in the economy vesting it under the control of a few. Thus capitalism became an economic system dominated by the process of intermediation.

The combined economic strength of industrial and commercial capitalism would transcend all geographical and national barriers making its active presence felt in most parts of the world during the nineteenth century and early part of the twentieth century establishing an era of its sway worldwide. Capitalism's path would not be a steady upward one but would be characterized by periodic ups and downs. The period would come to a close with a war among the capitalist world powers that would come to be known as the Second World War.

The second half of the twentieth century would witness major political changes in the world but would also witness the division of the world into two camps: the capitalist camp led by the USA and a collection of countries that had departed earlier in the century from the capitalist path into shades of 'socialism' to form the USSR and its allies in Eastern Europe. However the camps would collapse towards the end of the century.

In the meanwhile the industrial-commercial capitalism would change complexion, and finance – essentially commercialised claims to wealth to make more wealth – that had been growing since the early part of the twentieth century would emerge in the 1980s as the more dominant expression of capitalist power. The remarkable technological progress in the information processing and communication areas during the last decade of the century would make it 'global'. From that decade onwards finance capitalism would become the dominant economic formation globally dragging into its domain most of the countries which still claim to be 'socialist'.

Finance capitalism has its way over practically all aspects of economic activity – production, trade and speculation, the third being the most dominant as it is emerging

as the surest way for *immediate profit*, the goal that now guides capitalism. It succeeds in generating short term prosperity to (national) economies but these apparent booms are followed by long periods of low level economic performance that adversely affects millions and billions who were engaged in production activities. However it still remains unchallenged because even widespread adverse conditions provide opportunities for the rich and powerful to increase their wealth. Thus in all parts of the world, developed and developing alike, finance capital generates billionaires in increasing numbers and pushes more and more human beings into various form of economic vulnerability.

Rapidly proliferating capitalism generates intermediaries (producers of derivatives and associated claims to wealth, traders in such 'instruments', stock market operators and many more), almost without limits. Changes in technology provide the conditions for asymmetry in information to increase almost exponentially, providing intermediaries to take advantage of this situation. Finance capital is intermediation raised to the power of 'n'. It is ironic that dominant economic theories which justify and propagate the capitalist economic order still do not recognise the role of intermediation in economic affairs.

India 2050

From the past and the present let us turn our attention briefly to the future. The 'spectacular' performance of the Indian economy in the recent past and its demonstrated ability to withstand the global turbulence of the past few years has resulted in a new sense of confidence about the future. There are many who do not only hope, but strongly believe that India has finally found the correct path and that if that path is pursued with greater determination the country has a very bright future. The mood is a change from the defeatist pessimistic one of a generation ago.

Among the many optimistic scenarios, perhaps the most daring is the one that claims that by the middle of the century, possibly even earlier, India can become a global superpower, one in a trio, the other two being the USA and China. The parameters of global superpower status are economic strength and military power backed by nuclear capability. Judged by these twin criteria, India will not only be one among the three, but the second, next only to China, if the calculations turn out to be realities – a very different global view than of the past and of the present.

What then are the calculations? First, attention must shift from comparisons based on *per capita* national income to comparisons of *gross domestic income* because *national* power depends on the total, not on the total divided by population. Second, from this perspective a large population too is a source of strength than a cause of weakness and backwardness, when military factors also are taken into account. In a potential nuclear confrontation millions will die, but 'billion nations' – only China and India for decades to come, perhaps even centuries to come – will survive and win!

In terms of GDP India is expected to overtake Japan in the next couple of years. The European Union is an economic power to reckon with but national considerations will cause the Union to collapse: there are already signs in that direction. The United States cannot match China or India in terms of either the r*ate of growth* of GDP or the rate of growth of population. And India is likely to overtake China and come up on top as the most populous country in the world by 2035 or so.

Thus, if the premises are granted India can emerge as one of the three or even one of the two global superpowers by the middle of the century.

Is it likely, though? I doubt because the unstated but major premise of this great expectation is that the prevailing global economic order will continue and gather greater momentum. There were many who would have accepted it on faith till 2008. But the

happenings of the past few years have raised serious doubts about the strident onward march of global financial capitalism. Close to 10 per cent of the workforce in the USA remains unemployed and in business circles the mood is one of anxiety. Unemployment is widespread in Europe as well leading many forms of protests. Private credit rating agencies who are governed solely by the logic of the market have downgraded the American nation's credit standing, leading to political upheaval and raising questions in the minds of the people too about the strength of their nation and its economic order. Popular demonstrations are becoming common and sustained, against Wall Street, the citadel of America's finance capitalists. Europe that came together as an economic union is showing signs of disintegration with nationalist sentiments rising over doubtful economic advantages. China which claimed to be following 'socialism' of a sort in domestic policies, but taking full advantage of the prevailing aggressive capitalist procedures in external dealings is finding it difficult to remain afloat with feet in two different boats.

If we look beneath these disturbing external manifestations, it can be seen that they are only the visible symptoms of a deeper malady – the systemic inability of finance capitalism to sustain itself for long. The analysis in the earlier Chapters have indicated why this is so. To recall briefly, there are two reasons. The first is that in terms of its own logic it can benefit only a few. It is based on the lottery principle: pool resources from a large number and distribute it as differential prizes to the first, second, third. There are, surely, winners who will shout aloud on what a wonderful method it is to make money, but once the basic principle is understood, it will be seen that it is a game of few winners and many losers. Finance capitalism is casino capitalism.

The second problem with finance capitalism is that it is an attempt to make profits quickly through *transactions*-- buying and selling of claims to wealth to make more wealth which results in the neglect of *production* even capitalist industrial production (which itself yields profits through exploitation). Again this is most clearly seen in the

United States. Because it became possible for Americans to *buy* goods *produced* in the rest of the world, American resources could be diverted to making profits through speculative transactions. An increase in production of goods has the potential to benefit **all** (even if that may not be actualized because of the institutional arrangements in society), but an increase, even exponential multiplication of transactions can benefit only a few. That principle applies within nations and among nations.[31] Hence in the long run finance capital is self-defeating because its growth path leads to social destabilization almost immediately. We see the signs in rich and poor nations alike.

A quick comment on capitalism itself as an economic and social order may clarify this issue. In its initial stages capitalism was a liberating process precisely because against the background of the general stagnation of the pervious order it led to substantial increase in output, especially of industrial goods. Listen to these words about the early stages of capitalism: "*It has accomplished wonders far surpassing Egyptian pyramids, Roman aqueducts, Gothic cathedrals…During its rule of scarce hundred years it created massive and more productive forces than have all preceding generations together. Subjection of Nature's forces to man, machinery, application of chemistry to industry and agriculture, steam navigation, railways, electric telegraphs, clearing whole continents for cultivation, canalisation of rivers, whole populations conjured out of the ground – what earlier century had ever a presentiment that such productive forces slumbered in the lap of social labour?"* Some of you may be surprised to know that these words were written in 1848 by none other than Karl Marx (along with his collaborator Engels) who is considered to be the bitterest enemy of capitalism! But its organisational structure of large scale production necessitated also large-scale pooling of surpluses that remained scattered. Through new institutional intermediatory measures such as joint-stock companies and banking the surplus was made available to the few captains of industry. The institutional arrangements led these few to become owners of the additional

31 This was Adam Smith's argument against mercantilism.

surpluses generated through production. This in turn led to concentration of resources of wealth in a few hands. This built-in mechanism of transferring the surplus generated by workers into the hands of the owners has become the dynamics of capitalism. While many of the early writers on capitalism saw only its propensity to increase production, Marx was the one who, while paying glowing tribute to that propensity, expounded the non-linear dynamics of capitalism and its internal contradictions. It is a tribute to Marx's intellectual acumen that he had anticipated that the dynamics of capitalism would result in such heavy concentration of resources and power in the hands of a few that it would lead to crisis in production itself. Thus finance capitalism is digging its own grave. But the beneficiaries of the system including those in power are more determined to continue and strengthen the forces that are propelling the system.

It is necessary to be reminded that we are all within the system and in many ways are its beneficiaries as well. This is the reason for not being able or willing to see its many debilitating aspects. A few examples may help. Retail investors, 'the middle class', are being advised by investment experts publicly through newspaper columns that the best way to 'invest' now is to enter the currency market where, if you are prepared to take some risk you have the possibility of 'making a killing' because of the exceptional volatility of the external value of national currencies, including our rupee. There are many who today find that the easiest way to increase wealth is through real estate transactions. They examine newly advertised housing projects, assess where real estate values are likely to go up, book an apartment or two, and sell them even before the work is completed, making a decent profit. When there are many who take this route, real estate prices go up further, but transactions seldom get reduced as there are others waiting in the queue. Or think of the many other second sale markets that are rapidly growing -- for cars, furniture, household articles and many more items. Transactions are increasing and multiplying which is a major reason for the steadily increasing inflationary pressures in the economy. When that happens, if you are a pensioner living on a fixed income, you are forced to search for higher returns for whatever little surplus you may

have – you literally have to run to stay where you are. Paradoxically even those who are most affected adversely by the system – the millions who are maintained in drudgery by it – cannot afford to reject it because their immediate livelihood so crucially depends on it. This manner of non-apparent dehumanization of **all** who are in it is a characteristic of capitalism.

An Alternative?

It is difficult to visualise how such all-pervasive economic order can be contained or curbed. Is there an alternative? One line of thought initiated by Marx is that as the basic problem is the private ownership of property, only a new socio-economic order which is not based on private property can become an alternative to capitalism. That stands to reason. The only difficulty is to specify the working principles of that successor to capitalism and to indicate how to get there from here. As we have already seen the twentieth century witnessed some bold experiments in that direction starting with the formation of the Union of Soviet Socialist Republics (USSR) late in the second decade of the twentieth century following a revolution and capturing of power by a Party that represented workers. After the Second World War countries of Eastern Europe also came under the new economic and political order known as socialism. After China also overthrew the old order in the middle of the century and joined the socialist camp and a few more countries were added subsequently, in the early 1980s about a third of humanity had come under economic organisations distinctly different from capitalism. But alas, within a decade after that most of them collapsed, including the USSR returning to the capitalist order. China is still struggling to work out a satisfactory alternative.

Without going into details of why the experiments in socialism failed it is possible to identify two related reasons. The first is that where the regime of private property was eliminated what came in its place was the state ownership of property. Marx was clear that for a new socio-economic order to become a reality, the state would have to 'wither

away'. Second, and closely related to the first, the states in these socialist societies consequently came to have more powers than in most capitalist countries which they used partly to improve the economic conditions of the vast majority of the people, but also to suppress civic rights, especially freedom of speech and the right of dissent. Thus instead of withering away, the state, meaning a group of people exercising authority, turned out to be dictatorial. Finally, the people had to throw them out.

The failure of some of these earlier experiments does not mean that all alternatives to capitalism are doomed. These experiments were rather like the early flights into space, the initial foray into a new dimension. The experiments into socialism similarly demonstrated that a deliberately designed economic order – as against a historically evolving one -- is possible. It is important to learn even from their failures.

An important lesson to be learnt is that a powerful and pervasive economic order like capitalism calls for not only a transfer of power and change in property structure, but a major transformation of the social order at different levels. Such a transformation must include changes at the level of individuals, of communities and of authority. Capitalism is based on the assumption that each person is concerned about his or her own welfare and progress, that is, that the economy is driven by self-interest. One's responsibility for one's own economic welfare (and those closest to one) certainly cannot be minimised. But a new economic and social order can become a reality only when a person also recognises that s/he has a responsibility towards one's neighbour as well. It calls for nothing less than a *personal transcendence,* as a contemporary Marxist thinker in India has expressed with rare candour and courage! But a personal transcendence is possible only in a societal context for no one individual is an island. Hence, transcendence is required also at the level of the community, in fact of the many communities to which individuals belong. Questions of the use of resources that are ultimately nature's endowments can be discussed and resolved and constantly re-examined only within such a societal context and framework. Hence a mutually reinforcing, as well as restraining

personal and social transcendence is necessary. It will provide the individual a larger frame of reference required for her/him to find self-expression without destroying the diverse capabilities and innate differences of human beings. Such is a new social order which can be an alternative to capitalism. How production will be organised and what is produced will be shared can be decided only by a community where each is for all and all are for each. Such a community must also have a focus of authority, but not one beyond and above the community, but within it. Hence the third transcendence that is required is the transcendence of authority from exercise of power into meaningful guidance of both individuals and society as a whole.

The alternative to capitalism is frequently perceived as one where the elements of that order are given up: the abolition of private property, the withering away of the state and so on. What is required however is not to negate capitalism, but to transcend it.

Is such an alternative possible? Can it be achieved by human ingenuity and through human capabilities? My response to it is: "Yes, we can". But it calls for determined and sustained effort even while exposing the inherent of weaknesses of capitalism. There is something of a miniature of the alternative order right in our midst. An effectively functioning household, consisting of individuals with pronounced diversities, yet forming a community that takes care of all and where resources are held in common and where authority democratised and accepted. A larger community based on the principles of an 'ideal household' can be an alternative beyond capitalism. It can be achieved by focussed individual and collective effort. It must be noted however that even in a harmonious household a situation may arise where a member says: 'Let me have my share of the property: I want to enjoy a life of my own.' Other perversions from within are also possible. Such is the human predicament.

This expedition is not the place to enter into such deeper ontological and philosophical issues because there are matters that need to be attended to immediately.

What needs to be done?

Can anything be done between now and let us say 2050 that will drastically reduce human misery and pave the way for a new socio-economic order? I take the stand that there are. We have a democratic Constitution that acknowledges and respects diversities but is avowedly inclusive based on recognition of the rights of *individuals* and on the principle of *social* justice. We need only to implement what the Constitution mandates the state (that is us) to do:

(a) That the citizens, men and women equally have the right to an adequate means of livelihood;

(b) That the ownership and control of the material resources of the community are so distributed as best to subserve the common good;

(c) That the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment;

(d) That there is equal pay for equal work for men and women;

(e) That the health and strength of workers, men and women, and the tender age of children, are not abused and that citizens are not forced by economic necessity to enter avocations unsuited to their age or strength;

(f) That childhood and youth are protected against exploitation and against moral and material abandonment.

It is doubtful whether any other country has such a comprehensive and noble economic charter. As the clauses listed above come under Directive Principles of State Policy in the Constitution, they are not guaranteed rights, but Directives that 'We the People' gave to the State when the Constitution was adopted. But now it is clear that the State has not been following the Directive and that during the past two or three decades State policies have been going against the letter and spirit of the crucial clauses (a), (b) and (c). *We the People* have a right and duty to point this out to an insensitive State and demand an immediate Directional Change in its economic and development policies. In the early

1970s I wrote: “The development process in India has not yet become a mass movement. The development process cannot become effective until it becomes a mass movement.” I stand committed to it though four decades ago it was a voice in the wilderness, an idea whose time had not come. Today the mood and the possibilities are much more favourable.

No one person can or should shape a people’s movement. Yet the broad contours of an agenda for directional change in development policy are necessary as guidelines. The following may be considered.

A people’s movement that establishes that the Constitutional mandate to ensure adequate livelihood for ALL citizens, and to see that the operation of the economic system does not result in the concentration of wealth and the means of production to the common detriment should be the first step and the sustaining spirit.

With documentary support it should be shown also that the demand led ‘growth’ process of the past three decades, especially since the reforms of 1991, has had detrimental effects on the livelihood of vast sections of the people, particularly the toiling masses, and that wealth has been perceptibly getting concentrated in the hands of a small group at the top.

Ensuring that everyone has opportunities to earn a living through involvement in productive economic activities should be the essential principle to obtain a change in direction. “No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable. It is but equity, besides, that they who feed, clothe, and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, clothed, and lodged”. Those are the words of Adam Smith whom many people consider to be the patron saint of capitalism! Since the majority of people engaged in productive activities, but with low

living standards are in the rural areas, the focus of development activities should shift to the rural sector. The vulnerable sections in the rural areas have been identified in the previous Chapter. They are the marginal and small cultivators, landless agricultural labourers and the many self-employed people at the margin of subsistence.[32] In order to engage them in productive activities, and to raise their productivity, it is imperative to tap their own accumulated knowledge and skills supplemented by modern technological knowledge and tools. It is important to recognise that there will be wide regional variations in the conditions of work and local environmental features. Therefore tailoring development activities according to the needs of the locality is crucial.

Among our states, Kerala has the best example of designing development programmes involving participation of different sections of the local population taking into account the need for productive employment generation, local infrastructure development, appropriate social security measures, and their integration into a state level strategy of economic development and social transformation. This approach is diametrically opposed to designing a plan of development on the basis of an *a priori* determined 'growth rate' and indication of how it can be achieved.

For such purposes at the all-India level a National Development Corps (NDC) should be launched which should be open to skilled and trained people who are challenged to participate in such efforts. Service of at least one year in the NDC should be made compulsory for all who graduate from colleges and all professional courses. They should be provided a stipend for their services adequate for reasonable living for those who accept service to society as a greater remuneration. In order to provide incentive for

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32 In a recent study K.P. Kannan and G. Ravindran have identified the vulnerable sections in different states of the country based both on economic and social gradation. See 'India's Common People: A Regional Profile" Economic and Political Weekly Sept 17-23, 2011. A two-part article by Amit Basole and Deepankar Basu entitled "Relations of Production and Modes of Surplus Extraction in India" in Economic and Political Weekly, April 2-8, and 9-15, 2011, has also been helpful to identify the occupational characteristics of the rural population.

young people to be placed in rural areas through the NDC, the stipend could be made suitably higher for those opting to do so. Recently retired people from all walks of life should be provided opportunities to be voluntarily associated with the NDC. The NDC, thus, can become the knowledge pool and the power house for national resurgence.

At the level of tax policies, radical changes are called for. On the false assumption that those with high incomes are 'responsible' for production and growth in the country, tax concessions to rich individuals and to corporate business concerns have been a key policy measure since the 1980s. Rajiv Gandhi's 1987-88 budget and the 'Dream Budget' of 1998 both of which dramatically reduced rates of income and corporate taxes have been typical examples. But if it is realized that what the rich have been doing effectively is to distort the pattern of production favouring themselves while denying opportunities even to make a living to those at the bottom of the ladder, tax policies have to be reversed. Progressively higher taxes at the top are the need of the hour.

Recent development policies and fiscal measures designed for them are directly responsible for the increasing concentration of wealth. Hence drastic measures to reduce that concentration made possible through easy accumulation are called for. Increase in wealth results not from increase in production or even incomes anymore. Wealth accumulates through *appreciation of the value* of already existing wealth and the variety of newly generated proxy wealth. As already pointed out it is related to the growing transactions in wealth for which tax concessions are liberally given now such as the concessions to 'long term capital appreciation' and for 'dividends'. All such concessions should be withdrawn and increases in incomes not earned through personal services should be more heavily taxed providing a disincentive for accumulation of that kind.

Secondly, since land still constitutes a high proportion in wealth in rural as well as in urban areas, acquisition of land should be severely curbed. Conversion of land currently used for cultivation for non-agricultural purposes should be restricted. Acquisition of

land by individuals except for residential purposes, and by corporates except for reasons directly related to their productive activities, must also be adequately scrutinised and curbed. These measures will act as a damper on rapidly rising real estate values which form the basis for bloating wealth at the top.

In our context a great deal of wealth, especially land is inherited which leads to wealth increasing from generation to generation. There is no justification for it. Hence suitable inheritance taxes also should be designed and implemented. In the early part of the twentieth century an Italian philosopher-economist, Eugenio Rignano had made a rather radical proposal for inheritance tax which was widely debated even in the English speaking world. According to what then used to be referred to as the 'Rignano Proposal' the rate of estate duty would vary according to the number of transfers. When it is first transferred (to the next generation) by the person who acquired it there should be a modest tax. Subsequent transfers (to successive generations) would attract much steeper tax rates. The impact of the scheme would be to provide a much larger base for public revenue, as also to reduce and finally eliminate the element of acquired wealth. Rignano was referring to wealth of the capitalist class in the form of productive assets such as machinery that would generate output and income: there is stronger reason to apply it to land as a form of wealth whose role is only to generate more wealth.

A re-think on investment and resource mobilization strategies is necessary. "Rolling back the market" from these spheres must be the objective. Public investment must be directed increasingly into infrastructural development and productive activities. On the former, if the private sector is willing to join in, it can be accepted but on terms that are favourable to the general public. In productive activities the top priority must be to the agricultural sector. The resource mobilization strategy also needs to be reconsidered. Resource mobilisation to enable investment on the basis of priorities considered necessary for long term growth was the strategy designed for the Second Five Year Plan. It was based on the 'theoretical' assumption that those who save do not invest and

those who invest do not save. However, in the Indian context there is *prima facie* reason to question this assumption and the strategy of resource mobilisation based on it. In the Indian economy according to official statistics, the household sector is not only the major contributor of savings as also in most other countries, but that sector is responsible for a very high proportion of capital formation as well suggesting that what is shown as savings of the households may include physical asset formation of various kinds.[33] Unfortunately this aspect has not received the attention it deserves. Studies of the growth of the Indian economy seldom even recognise this special feature of the Indian economy. The policy issue that needs to be addressed is whether in a country dominated by household production units who also play a significant role in capital formation, what should be the strategy of resource mobilisation and credit distribution.

That query takes us back to the position that has guided us throughout this exploratory tour – that economics as a field of study must be a set of clues to probe into real life issues. As Einstein famously stated: "Pure logical thinking can give us no knowledge whatever about the world of experience: all knowledge of reality begins with experience and terminates in it."

Good bye!

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33 In the immediate post-Independence period the household sector accounted for as high as60 per cent of capital formation in the country, the rest being largely in the public sector (State). After planned development started with the public sector leading in investment, it came to have the largest share. Just before the Reforms of 1991, the household and public sector accounted for 40 per cent each with the corporate sector still retaining the third position. What has happened since the Reforms is that the household sector moved to the top with unusually over 40 per cent, but the corporate sector becoming the second pushing the public sector to third position. In 2008-09 the corporate sector reached the top with 40 per cent, but the household sector was a close second with 37 per cent of the capital formation. The phenomenon indicates that for a major segment of the producer households the physical investment that they directly make, is the 'savings' as we saw in Chapter 1.

Acknowledgement

This book is the result of an unusual team effort. Like charity it started at home. Sometime in April (2011) during one of our regular morning walks my wife, a zoologist by training, recalled that soon the economic Reforms in the country would be entering the third decade and wanted to know how I would evaluate the changes of the past two decades reminding me that I was sceptical about the shift when it happened. I asked her for her views and she said: "Things are happening; we can see them all around us. But I'm not sure whether they are helping your *aam aadmi.* Why is that? The economy is growing much faster than in the past." I tried to explain that puzzle without using the economists' standard jargon. That was our conversation piece for a few days. At the end of it she said: "This is going to be your next book"!

I protested. I hadn't written a book in more than a decade: during the past year I was under medical treatment: I would soon complete 80. But none of it prevailed. "You get started; I'll help you", she said. Any sensible husband would know what that meant!

After producing the draft of the Introduction and the first four chapters, I decided to share the material with other members of the family and a few close professional colleagues. My brother Abraham who is a retired medical practitioner found the approach refreshing and the matter easy to follow. As the writing proceeded he used his intimate knowledge of the interconnections in a 'system' and his deep philosophical insights (as a trained theologian before he turned to medicine) to help me in many ways. He also drew me back into simpler language whenever I tended to slip into easy professional jargon. My brother John, an academic and activist also took great interest in the work from the beginning. He used his intimate contacts with fishing communities in different parts of the world and involvement with many voluntary organizations and people's movements to see that I stay earth bound.

Our two daughters, Prema in the US and Priya in the UK, though busy with their own professional commitments encouraged me in more ways than one. Priya with her professional knowledge of the information and communication technologies was the one who introduced me into the mysteries of personal computers and helped me to take the first steps in downloading information and data from the internet. Our son-in-law, Was has been a great motivator. Years ago when I was not sure about anything, he told me that I would and should write another book! He went through the early drafts and challenged me to 'stick my neck out' and change the last Section from a summary as I had originally planned, into what it now is.

Last, but by no means the least, my nephew, Amit who is an environmental researcher had several conversations with me about how things hang together that I found most valuable. He also did much of the professional work of putting the bits and pieces of the drafts into a consolidated text.

Thus this book is very much a public offering from a 'household-production unit'!

I owe a deep debt of gratitude to each member of the family for the help and moral support. There were times when I felt I was too tired to go on; but for their encouragement I would have given up along the way. True to her promise Susy, my wife, was with me throughout this adventure and I am most grateful to her.

Among professional colleagues those from whom I have received appreciative and critical comments are M.V.Nadkarni, R.Srinivasan, S.Giriappa, G.Omkarnath and Ninan Koshy. I am fully and solely responsible for the final product, but each one of them knows how much he has contributed to the shaping of this volume. I acknowledge their help and thank them for their encouragement and support.

K.Diana typed some of the chapters. Khaleel Shah of the Institute for Social and Economic Change' Library helped me by locating and processing some of the data I have relied on. Raunaq Singh and Arup Das, our good neighbours came to my rescue when I had trouble with my computer. I thank them all.

A great deal of my learning has come from books and interaction with professional colleagues. The latter include generations of students. I recall particularly the expedition I had with them into the Indian Economy where I acted as their guide. Among those who joined that tour many are now distinguished academics, journalists, analysts, business people and political leaders.

But by far the vast majority of them have gone into diverse avenues in the ordinary journey of life, perhaps without much excitement. During my professional career I had made it a point, when there was any opportunity, to interact with those in such walks of life dealing with a wide variety of daily chores. I always reminded myself that those are the spheres where economic issues are at their authentic best.

I would like to record here my sincere thanks to all from whom I have learned.

C. T. Kurien

About the book

WEALTH and *ILL*FARE is intended for readers who do not have much knowledge in economics, but are eager to know how economic systems function. In particular, it deals with the phenomenon that many find disturbing, the soaring affluence of the few and the continuing misery of the many that is increasingly becoming evident globally and in our country. Ownership and control over resources, different forms of mediation and asymmetry of information are identified as clues for any interested reader to develop skills to study real life economic problems. It is a unique and timely contribution by a reputed practitioner who, over the past half a century, has influenced generations of students and through his earlier writings the general public as well.

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