POLITICAL ECONOMY, IRRELEVANT ECONOMICS AND ECONOMIC GROWTH

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LALA LAJPAT RAI MEMORIAL LECTURES
(Fourteenth Series 1985)

LALA LAJPAT RAI COLLEGE OF COMMERCE
AND ECONOMICS, BOMBAY-400034.

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I am very grateful to Principal Rairikar and the members of the Governing Board of the Lala Lajpat Rai Institute for inviting me today, the birthday of Lala Lajpat Rai to pay our homage and tributes to one of the most outstanding luminaries of Indian polity. His was a selfless life, devoted totally to the service of the country, and his people. He was a man of universal interest, saw the problems of Indian people in totality, and made significant contributions in various walks of life. Essentially a freedom fighter, he was equally alive to social, religious and economic problems of the time and took great interest in educational, social, commercial and economic activities. He was at the same time a freedom fighter, a social reformer, educationist, trade unionist, journalist, banker, writer and all these elements blended so well in his perception of India's problems and vision of India's future. As one of his biographers has observed :

"I liken the Lajpat Rai approach to India's problems to the Triveni Sangam - the mainstream being the Ganga, the bestower of liberation, which must be joined by the Yamuna of social and economic justice and of adaptation to the modern context. Nor may the invisible Saraswati be ignored. Even though, the Saraswati be no longer seen flowing oceanwards, it is a force beneath the soil, or a part of the soil you might say . . . . . Acquaintance with modern socio-economic thought was necessary, but a thorough grounding in India's long history and an acquaintance through living contact with the ways and psychology of Indian masses was the very first requisite." [1]

He strongly believed that the freedom really worthwhile called for a fight on many fronts. While he saw great need for equipping oneself with studies and intellectual equipment, he believed that there could be no substitute for selfless devotion. The intellect must be kept in good trim and should not be allowed to indulge in its own caprice so that it can serve the real matter.

To pay my humble tribute to Lalaji, I have chosen to speak today on a wider subject, not as a narrow specialist that most of us are becoming today, but as one who is deeply interested in India's rapid economic growth, and concerned why we have not succeeded so well. The topic I have decided to talk on is "Political Economy, Irrelevant Economics and Economic Growth" and as the title suggests, I will venture to offer few explanations for our slow growth, some of which are more basic, beyond economic factors, but others where I feel there is compelling need to relearn some of our economics in our own special set of environments.

I

India has recorded, on an average, growth rate of around 3.5 percent in gross national product since the planning process started in the 1951-52. Though the average growth rate achieved during the first three decades of planning has been modest, it is in sharp contrast to estimated annual growth rate of about one percent in the first half of this century.

The annual growth rate in industrial production during the first three decades of planning is 5.8 percent compared to about two percent growth rate during the first 50 years of this century. Within this thirty year period of planning, the growth has been consistent and uniform. In the first fifteen year period, 1951-1965, the average annual growth rate was 7.7 percent which declined to 4.0 percent during the subsequent 15 year period 1965-1980. The choice of base year and terminal year for any meaningful sub-period during these thirty years is a matter of subjective choice for any researcher, and it would yield different rates of growth depending upon what reference dates are. There is, however, a fair degree of consensus among economists that there has been a slowing down of growth rate in industrial production during the latter period compared to the earlier one. This observation has been a subject of intense debate among the economists. But barring few who view it more as a cyclical set back, and who contend that the reversal in the deceleration process has already set in somewhere around middle of 1970s, there is a wider acceptance of the thesis that a certain degree of deceleration has taken place in industrial production since mid-1960s.[2] A subscription to this thesis, by no means, implies that reversal in this trend will not and cannot take place. In fact, the growth rate in industrial production during the Sixth Plan is likely to be above 5.5 per annum, and suggest that we have already broken away from the past decelerating trend, and perhaps reversal of the past trend has already taken place.

The near-constancy of the growth rate in GNP around 3.5 percent, and deceleration of growth of industrial output since 1965, have to be viewed in the larger context that the saving rate (gross domestic saving as percent of gross national product) has increased from an annual average of 9.6 percent during 1950-1955 to 22.5 percent during 1975-1980 and the annual rate of gross domestic capital formation during the same period has increased from 9.9 percent to 21.9 percent. The impressive increase in the growth of investment, however, has not been correspondingly met with increase in output, resulting in increase in incremental capital output ratios, which implies that investment has taken place in more capital intensive projects, but it also implies possible deterioration in the efficiency in the utilisation of capital.

There is not much disagreement about the statistical fact that the incremental capital output ratios have gone up in the Indian economy. Several explanations have been given for this phenomenon. Some of these are :

(1) The prices of capital goods during this period have grown at a faster pace than the price of goods manufactured by this capital. If both capital and output were evaluated at 1970-71 prices, the rate of gross fixed capital formation in the closing years of 1970s may turn out to be same as in mid-1960s. [3]

(2) Large investments have been made in more capital intensive sectors such as petroleum, coal, steel and non-ferrous metals. According to a World Bank study, nearly half of the increase in the average capital output ratios is accounted for by change in the investment pattern. (See Annexure A.)

(3) Rising capital output ratio has been a world wide phenomenon and India is no exception to it. [4]

(4) There is also a feeling that India's industrial production is underreported because of low weightage given to the fast growing sectors.

It is very difficult to state, in absence of detailed studies, whether these factors can comprehensively explain the increase in capital output ratios. But according to some estimates the capacity utilisation in Indian industry which was 85 percent in 1970-71 declined to 74 percent in 1980-81 and was 78 percent in 1983-84. At disaggregative level, the deceleration in output has been particularly concentrated in basic and capital goods industries.

While the above factors partially explain, why, for statistical reasons, capital output ratios during the later period appear to be higher, there is sufficient evidence to believe that there was significant deceleration in public investment in the latter period. The growth rate of fixed capital formation in the public sector is estimated to have substantially come down from 11.3 percent per annum during 1950/51 to 1965/66 to 5.3 percent during the period 1966/67 - 1980/81. Since the public sector is manufacturer of basic and capital goods, a large buyer of goods produced in the private sector and also the main purveyor of infrastructure, the deceleration affected industries both ways, by slowing down demand for their products as well as by not providing enough infrastructural inputs such as power, coal and transport so vital to industrial users.

Apart from deceleration in public investment, other factors which have contributed to slower growth rate are lack of adequate demand for certain industry products, arising from slower growth rate in agriculture, adverse distribution of income and deterioration in the efficiency and perpetuation of ineffecient industrial policy regime as well as implementation mechanism in the country.

The last argument, namely, the inefficiency of the system, though a very important one, has various facets and there is danger that it may sound very plausible since rigorous proof is seldom provided, and subjective hunches and assertions are freely substituted for well reasoned arguments. Inefficiency argument should encompass all participants in the growth process, and several policy matters such as efficiency of government, efficiency of bureacracy, efficiency of policies including policy relating to licensing, import substitution, technology policy, pricing policy, incentives policy, efficiency in administration of these policies, efficiency of entrepreneurs, efficiency of the financial system and efficiency in labour management.

I consider the role of these factors in the growth process very vital, and would like to dwell on them in some detail. They constitute the political economy of growth as both economic and politico-human factors get complexly interwoven, and exercise tremendous impact on the achievement or lack of achievement of given objectives.

Since our endeavour is to explain, why despite an increase in the investment, overall growth of the economy has slowed down in the latter period, we will have to examine

(i) Whether there is continuity of the broad policies and procedures over both these periods, or whether new objectives, new policy instruments and new procedures were devised in the latter period that have proved to be detrimental to growth.

(ii) if the same policies were operative throughout both periods, whether the policies lost some of their significance during the latter period as a consequence of transformation that was taking place in the economy but which was not given due recognition at the appropriate time.

I am of the view that both the above statements have been true and are operative in the Indian economy. I will first deal with those policies that have been present in both the periods.

It has often been stated that Indian strategy for industrialisation was based on import substitution. It provided powerful stimuli during the first period, but as avenues for import substitution diminished, certain dynamism got lost and hence the rate of growth declined. This is too simplistic an argument and fails to recognize that industries produce so many tradeable goods that ultimately a large part of growth in any country, including developed countries, would be based on import substitution. It is quite natural and even inevitable. There is nothing wrong in that so long as both options for import or domestic production of import substitute are carefully weighed, and decision taken to allow the setting up of such industrial unit with minimum amount of protection that is necessary for infant protection. On the other hand, if industries are set up under tall protective walls, without carefully looking into their domestic resource costs, there is danger that inefficient and high cost industries may be set up in the nascent stage, which,in the long run, may fail to provide the necessary momentum to industrial growth. It is not the failure of the policy of import substitution as such, but the manner in which it has been implemented that could exercise a dampening influence on the subsequent growth. Bhagvati and Padma Desai have extensively studied the nature of industries that were set up during the first period and have found that several industries were set up without paying sufficient regard to their domestic resource costs.[5] The same policies are continuing today, and at this stage one cannot say with conviction whether we have learnt our lessons well from our past mistakes.

The licensing policy, and restrictive trade policy have continued throughout the period since planning began, but the context have changed over time. The saving ratio during the First Plan period was 9.6 percent which gradually rose to 12.4 percent during the Second Plan and to 13.9 percent during the Third Plan. The average saving rate in the Indian economy since 1975-76 has been over 22 percent, and one is not sure whether the rationale of licensing and restrictive trade and other policies of the earlier period can be made applicable today. The need and nature of licensing and various restrictions when saving rate was 10 percent and when it is 22 percent should be different and need a close reexamination. If at all, the evidence and discussions with industrialists suggest that the licensing policy, in its implementation, has become more complex, more time consuming and more onerous.

The approach, interpretation and implementation of various policies at the governmental level, however, have been a variable factor, and has exercised considerable influence on the new ethos that has emerged since mid-sixties. Gunnar Myrdal has very eloquently written that all underdeveloped countries, in varying degrees, are soft states. He referred to soft state as one which "comprise all the various types of social indiscipline which manifest themselves by : deficiencies in legislation and in particular low observance and enforcement, a widespread disobedience by public officials and various levels to rules and directives handed down to them, and often their collusion with powerful persons and groups of persons whose conduct they should regulate. Within the concept of the soft state belongs also corruption . . . . .. These several patterns of behaviour are interrelated in the sense that they permit or even provoke each other in circular causation having cumulative effects."[6]

Indian state has been a soft state according to this definition since independence, but over time, particularly during the latter period, it became softer. The analysis of the soft state, as Mydral observed, should not be understood in moralistic terms.

"In regard to social indiscipline, as in other respects, the underdeveloped countries are as they are not because of any inherent evil character traits of their peoples, but as the result of long history, very different from that of developed Western or Commonwealth Countries, during which a particular economic, social and political power structure had developed."

There are good reasons why the state became softer in sixties and seventies. In its anxiety to raise larger resources, the government stepped up the tax rates, widened the net of commodities which were subjected to indirect taxation. On the other hand, in its anxiety to appear more socialistic, government controlled the income of relatively high income groups, the bureaucrats and the professionals, and permitted generous raise in salaries of workers and supporting staff. A large group of people who have positon and wield considerable discretionary powers found that their real incomes were stagnating if not declining, while their juniors and support staff were getting away with raises despite far less responsibilities. Sandwiched between an ambitious master who need their help in realising his ambitions and clients who are ever willing to oblige for buying time or favour, the bureaucrats and professionals, with considerable discretionary powers at their command, have ended up, willy nilly, in evolving a work style and procedures which require more and more permissions on the part of the clients and at the same time enhance the discretionary powers of those who give permissions. This analysis by no means is intended to suggest that there is wide spread corruption in granting such permissions. In fact, I am inclined to believe that the curruption aspect has been highly exaggerated in our system. But the fact is that despite a sincere desire to render better and more efficient service.

government, without realising itself, has succeeded in evolving a system whose performance is contrary to its declared objectives.

The second period was also the period when serious rethinking took place on the basic objectives of economic development. Mahbub Ul Haq raised very pertinent questions around this time. "Has the growth of GNP made a dent on the problems of mass poverty ? Has it resulted in a reduction in the worst forms of poverty - malnutrition, disease, illiteracy, shelterless population, squalid housing ? Has it meant more employment and greater quality of opportunities ? Has the character of development conformed to what the masses really wanted ? " [8] These are very relevant questions, and frankly there were no comfortable answers to give. Developement, Haq wrote, should be defined as a selective attack on the worst forms of poverty. Development goal must be defined in terms of progressive reduction and eventual elimination of malnutrition, disease, illiteracy, squalor, unemployment and inequalities.

The goals of development, very rightly, were redefined or sharply defined, but lot of confusion has arisen in the process, when it comes to evolving appropriate policy measures. Industrial development is expected to satisfy so many objectives simultaneously, employment, backward area development, saving in foreign exchange, small sector development, tribal development, and of course, efficiency. Simultaneous pursuit of several objectives, which are not always compatible with the criterion of efficiency, have given rise to new problems. To illustrate, the objective of backward areas development requires that new units should be set up in the backward regions. There are so many backward districts in the country that whenever licences are to be issued, there are many claimants for the limited capacity that is necessary, and that can be absorbed by the market. To satisfy demand for capacity creation, emanating from various regions, the licensing authorities fragment the capacity and allow say, setting up of six new plants at six different locations rather than allow one or two plants of larger size which would enjoy economies of scale, and would have lower cost of production. The setting up of six units would require creation of additional infrastructure facilities, particularly when the units are set up in backward districts with little infrastructure facilities. Though the cost of creation of infrastructure is an external cost to the firm, such investment in infrastructure are by no means small and would certainly step up the aggregate capital output ratio for the economy. To achieve the goal of regional balance through industry in the initial stages of growth, particularly through the large sized or medium sized industrial units, has very serious limitations if efficiency and competitiveness of the industry are not to be sacrificed. Today excessive concern with regional balance through large and medium industries has resulted into fragmentation of capacities, sacrifice in the economies of scale, and additional investment in the form of infrastructure. The aim, rather, should be intensive exploitation of available infrastructure and exploitation of economies of scale by setting up appropriate sized units at locations where minimum infrastructure is available. This will also reduce the incidence of sickness since units set up on the criteria of efficiency would have much less degree of vulnerability to sickness than other units.

Along with the objective of eradication of poverty directly, came the problem of regulation of large industrial houses in the country in the wake of Dutt Committee Report. The guidelines that government evolved in early seventies for regulating industry covered large number of units where the presence of a representative of the financial institutions was considered necessary at the Board level, and where acquisition of certain amount of shareholding by the institutions was considered desirable. His presence is considered desirable as it would help to develop healthy attitudes toward professionalisation of management, and at the same time, help institutions to better monitor projects assisted by them. In our country, where traditional entrepreneurs have a tendency to look at any manufacturing concern more as a trading activity, rather than an industry where one has to pay continuous attention to technology, modernisation, long term corporate planning etc. this could be considered a welcome move. But this has created certain apprehensions in the minds of entrepreneurs, and might have even slowed down the rate of capital formation in industry.

It would be of interest to study and compare the profitability ratios of the private corporate sector during the second period with the profitability ratios in the first period. The table in Annexure B gives figures for three measurers of profitability since 1960-61, namely, gross profits as per cent of sales, gross profits as per cent of total capital employed and profits after tax as percent of net worth. It is observed that the profits after tax as percent of net worth have been as good as if not better than the profitability rate that prevailed in the early 1960s. The return to promoters and investors have been, on a average, higher in the second period than what it was in the first period. Return on capital employed as reflected in the ratio of gross profits to total capital employed has also been higher during the second period. On the other hand, margin of profits as reflected in the ratio of gross profits to sales have shown some decline indicating growing competitiveness in the

Indian industry. Looked at from private investors' point of view, nothing seems to have happened to profitability that would discourage further investment in industry. But if the efficiency in utilisation of capital is low, and there are factors that still *discourage investment, which I believe there are, they are more* likely to be in the realm of non-economic or phychological factors.

The Sixth Plan is about to be over, and from the information available on the performance of the economy for the first four years, and estimates for the last year, GNP is expected to increase at the rate of about 5.2 percent per annum, the highest rate achieved for any Plan so far. A part of the reason, no doubt, lies in the fact that base year for comparison, 1979-80, was not a good year. Nevertheless, even if adjustment is made for that, the rates of growth in GNP as well as industrial production are likely to be higher than in the preceding Plan. These rates are achieved during the period, when, according to a study based on 417 public limited companies by ICICI, profitability of the corporate sector has shown consistent decline by two criteria and stagnation at satisfactorily high level by one criterion.

417 PUBLIC LIMITED COMPANIES PROFITABILITY RATIOS

Year	Gross profits as percentage of sales	Gross profits as percentage of total net sales	Profits after tax as percentage of net worth
1979-80	11.0	12.3	14.7
1980-81	10.8	12.3	15.4
1981-82	10.6	12.0	15.3
1982-83	10.2	10.8	15.1
1983-84	9.3	9.5	11.0

We do not know how industry responds to changes in these profitability indicators, but they, perhaps, suggest that investment and production are not very sensitive to year-to-year variations in any significant way.

II

The above analysis points to the conclusion that while the efficiency in the use of capital declined since mid-sixties, the overall profitability of the private corporate sector did not decline. If the licensing and other policies were more prompt and permissive, and infrastructural inputs were more easily available, there would have been more investment and also larger output from the existing investment.

The bureaucrats and professionals, perhaps, may not agree that anything is wrong with the way the system works and that they are responsible for contributing to various delays, and decline in the efficiency of capital. Some of them are quite honest about their views and come out with their image of a typical Indian entrepreneur who, they believe, cannot be so easily trusted. There is a certain credibility gap and lack of mutual trust between the Indian entrepreneur on the one hand, and bureaucrat and professional on the other. An entrepreneur is viewed with certain degree of suspicion, and not so much as one who contributes significantly to national product, provides jobs and sustains several families. We all have heard criticisms of businessman's style of working, style of living, unethical practices etc. umpteen times, and these need not be repeated here. These are sweeping generalisations and put every entrepreneur as a single type.

The fact is that today's entrepreneur is not the same as trader-turned entrepreneur of a generation ago. He is not merely a risk taker and investor whose main ambition is to make as much profits in as short time as possible with all the means that are at his disposal. Today he is emerging as a professional who knows management principles, who talks of corporate planning, long range planning and who engages professionals in his industry at senior levels of management. At time he may appear ambivalent. He just cannot escape the ethos prevailing in the country and is perhaps as much a contributor to social indiscipline as victim of it. But he is going through metamorphosis and a new image is emerging. Even in the so called family houses, one finds the members of younger generation professionally well trained and equipped. By and large, the time horizon, over which to expect returns on investment are getting more realistic and longer in case of these new entrepreneurs and they do not approach to manufacturing activities with a typical trader's mentality. He likes to be treated and respected as a professional entrepreneur and just not as a moneyed man. He is just not a crook but he is also a creator. While I agree that there is no single type of entrepreneur, I feel there is insufficient appreciation of the role of entrepreneurs and of the entrepreneur himself in industrial growth. They can be equally patriotic and they may have the same degree of concern for national progress as any bureaucrat or professional would have. They also work quite hard. It is high time the attitude toward entrepreneur changes and their important role in building modern industrial India recognised, and appreciated. Once the credibility and trust are established, procedures could be simplified and compliance with procedures can be speeded up. The entrepreneur should be looked at in the real perspective of country's industrial development.

If there is need to revise our notion of today's entrepreneur, there is equally a need to revise our notions about what factors influence investment. Brought up on Anglo-Saxon economic theory, we were taught that investment is interest inelastic and that interest cost really does not matter in investment decision. This argument is then extended in the case of capital-scarce developing countries to suggest that one must price one's capital at its true scarcity price so that it is allocated to more efficient uses. High interest rates are justified on these considerations. It is high time that this thesis is looked into afresh in the light of some recent data. The following table gives components of value added for 417 companies studied recently by ICICI.

417 PUBLIC LIMITED COMPANIES

	1979-80	1980-81	1981-82	1982-83	1983-84
Salaries and wages as percentage of value added	46.7	46.7	46.5	47.3	48.6
Interest as percentage of value added	13.0	14.4	15.7	18.2	19.0
Depreciation as percentage of value added	12.4	12.1	11.9	12.4	15.3
Profits before tax as percentage of value added	27.9	26.8	25.9	22.1	17.1

The share of interest in the value added has been consistently rising and in 1983-84 it was as high as 19.0 percent, higher than the share of profits before tax at 17.1 percent. The share of of profits has consistently declined.

In a recent study of 40 Companies, IDBI looked into the impact of interest liability in the initial years of working of new companies. Two ratios, namely (i) interest as per cent of net value added, and (ii) interest as per cent of cost of production were calculated. In most of the new companies interest as percentage of value added was more than 35 percent during the first year. More than two-thirds of companies had this ratio above 35 percent in the third year of production.

Interest burden as percent of cost of production was more than 20 percent in the case of 15 companies and was as high as 30 percent and above in the case of 8 companies.

These are quite high figures, and when so many units are passing through recessionary phase and some of them even turned sick, it is time to consider the interest rate structure for industry. I do not think we are justified in taking the traditional view that interest rates do not matter.

In today's business world there are so many uncertainties within which industries have to be set up and operate that wherever possible efforts should be made to reduce uncertainties, or to put it differently, provide as much degree of stability to our policies as possible. I see no reason why trade policies have to be revised every half year or fiscal policies have to be revised every year. Many a projects in the country have been doomed because of frequent changes in these policies. Stable environments help to plan better and encourage extension of time horizon over which one plans to maximise returns. Uncertainties encourage short term maximisation and all ills associated with it. Suggestions of this nature may sound too elementary, but important issues in life need not always be so complicated.

More often it is we who complicate the issues only because we lack courage to think and act upon simple solutions.

NOTES

1. Feroz Chand, Lajpat Rai : Life and Work, Publications Division, Government of India, pp. xxii.

2. See Ashutosh Varshney, Political Economy of Slow Industrial Growth in India, Economic and Political Weekly - September 1, 1984 pp. 1511 - 1517 and all references cited there.

3. K. N. Raj : Some Observations on Economic Growth in India Over the Period 1952-53 to 1982-83, Economic and Political Weekly, October 13, 1984 p. 1802.

4. K. N. Raj Op. cit. p. 1803.

5. Bhagvati J.N. and Padma Desai - India, Planning for Industrialisation, Oxford, 1970.

6. Gunnar Mydral, the Challenge of World Poverty, Penguin Books, 1971, p. 211.

7. Gunnar Myrdal, ibid. p. 213.

8. Mahbub Ul. Haq. Let us Stand Economic Theory on its Head, reproduced in National Herald, April 12, 1972.

PROFITABILITY RATIOS OF THE CORPORATE SECTOR

Year	Gross profits as percentage of Net Sales	Gross profits as percentage of total capital employed	Profits after tax as percentage of Net Worth
1960-61	10.6	10.0	11.0
1961-62	10.5	10.0	10.0
1962-63	10.6	10.1	8.7
1963-64	10.8	10.7	9.5
1964-65	10.6	10.5	9.3
1965-66	10.7	10.1	8.9
1966-67	10.5	9.8	9.1
1967-68	9.2	8.6	7.3
1968-69	8.8	8.5	7.0
1969-70	9.6	9.6	9.5
1970-71	9.9	10.4	10.1
1971-72	10.3	10.7	10.8
1972-73	9.7	10.5	10.4
1973-74	10.7	11.2	11.6
1974-75	11.4	12.8	13.7
1975-76	9.2	10.6	8.2
1976-77	9.0	11.0	7.9
1977-78	9.0	11.0	8.8
1978-79	9.5	11.7	11.5
1979-80	10.1	12.6	14.5
1980-81	9.6	12.0	14.9

B Series

Year	Gross profits as percentage of Net Sales	Gross profits as percentage of total capital employed	Profits after tax as percentage of Net Worth
1979-80	11.0	12.3	14.7
1980-81	10.8	12.3	15.4
1981-82	10.6	12.0	15.3
1982-83	10.2	10.8	15.1
1983-84	9.3	9.5	11.0

Note : (i) Ratios from 1960-61 to 1980-81 are from studies of Reserve Bank of India.

(ii) Figures from 1979-80 to 1983-84 in the B series are based on ICICI study for 1983-84.