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Search for Optimality in State Intervention: Operational Issues in India

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ABSTRACT

The rationale for state intervention in the economy has been largely made on the argument that left to itself the economy would frequently exhibit market failure which could be total as well as partial. Although the necessity of state provision of public goods which the market fails to provide for because of their twin characteristics of non-rivalry and non-excludability, is universally endorsed, however there is an absence of unanimity in the merit of state intervention where the market operates with reasonable efficacy. Proponents of state intervention argues that the free working of the market does not allow the economy to attain any form of optimization of the allocation function or for that matter its potential creative function. On that rationale they argue for exogenous correction administered to ensure better allocation while at the same time enhance the capacity of economy to generate income with the existing resources. However in many instances intervention carried out by that state on the plea of rectifying market imperfections and inefficiencies aggravate the distortions instead of correcting them. Under those circumstances expenditure of scarce public resources remain inefficient and in extreme cases become counter-productive, negating what was initially strived for. Such contradictions in intensions and outcomes is visible at the operational level as attempts are made to achieve the critical balance between growth and employment, employment and education, rural-urban development, public sector investments and private enterprise etc. However growing number of voices demanding appropriate state intervention which are more efficiently administered does put pressure on the powers to be to respond to the requirements of the of the economy. Social development accompanied by increasing maturity, self-introspection, and sensitivity generates democratic forces, which directly confronts obsolete ideas and redundant ideologies forcing a convergence between political rhetoric and actual execution and achievement in the field.

Keywords :

Introduction:

In a free enterprise economy, the unfettered working of the market is assumed to result in the optimal provision of private goods. This is due to the operation of the price mechanism that signals a relatively higher demand for a good over its supply, by a rise in its price. Producers respond by increasing the supply until it eventually equals demand bringing the economy into equilibrium. The ability of the market mechanism to efficiently provide for the necessary private goods is based on the exclusive title of the property that the highest bidder acquires over a good that he had bought. This implies other aspiring consumers are excluded from the consumption of the good that induces them to competitively bid for it.

Public goods, on the other hand, are non-rival and non-excludable[2] which implies that once a good is provided its consumption by someone do not diminish the quantity available to others and also no one can be excluded from its benefits. Thus, an individual can access the benefit of a streetlight or a flood control project without reducing the same benefit that is available to others, which makes their consumption non-rival. Besides, it is virtually impossible to prevent some particular individual from reaping the benefits of the two public provisions making them non-excludable. Thus given its peculiar properties, the consumers of public goods have no incentive to pay for their consumption thus inducing them to behave as free riders. Hence, in the provision of public goods the price mechanism breaks down as the link between the buyers and the sellers is broken resulting in complete market failure. Under the circumstances, all public goods have to be provided for from the state budget making state intervention in this sphere unavoidable.

Although the necessity of state provision of public goods which the market fails to provide, is universally endorsed, however there is an absence of unanimity in the merit of state intervention where the market operates with reasonable efficacy. The rationale for state intervention in the provision of even private goods has been largely provided by the argument that left to itself the existing distortions in an operational economy would frequently precipitate partial market failure. Proponents of state intervention argue that the free working of the imperfect market does not permit the economy to attain any form of optimization of the allocation function where the price pays a critical role in equating the marginal utility in consumption to the marginal cost in production ensuring a convergence of interest of the buyers and sellers. Besides it is argued that most economies, especially developing ones cannot be expected to realize its potential creative function which is facilitated by " …all dynamic forces that leads to technical progress, innovation and ultimately investment" (Kaldor, 1972). This thwarts an economy under laissez-faire from extending and expanding its production possibilities and subsequently prevents it from maximizing its social welfare.

As stated previously, market imperfections and distortions cause partial market failure, which is reflected in market inefficiencies. Investments undertaken on considerations of commercial profitability, more often than not, accrue negligible social returns implying misdirected flow of scarce resources from the perspective of maximization of social welfare. Even investment based on considerations of social returns can be non-optimal given that distorted market prices in imperfect market results in the incorrect estimation of social benefits and costs. Market inefficiency also arises due to the failure of the price mechanism to capture the externalities[3] that are generated in the process of production, distribution, and consumption. The resulting fallout could be under-provision for those goods and services that generate positive externality and over-provision of those generating externalities that are negative.

Thirlwall (2003) talks about missing markets in developing countries that is a manifestation of their structural bottlenecks and also identifies incomplete markets arising out of asymmetric information, adverse selection, and moral hazard which can also result in market inefficiencies. All the above instances provide the state an opportunity to make market intervention so as to influence, direct and even supplement free market forces so that elusive levels of efficiency are attained. In more radical intervention, the state enters the market as a direct producer to compensate for inadequate private effort, as the economy attempts to attain optimality in their allocation and creative functions.

However at the operational level there has been wide spread divergence between the potential dividends that was projected from state intervention and the actual outcome of such interventions. In fact in many cases interventions directed towards the correction of market imperfections has resulted in the aggravation of the problems. Under those circumstances, expenditure of scarce public resources remains inefficient and in extreme cases become counter-productive, negating what was initially strived for. Such contradictions in intention and outcome is visible at the operational level as attempts are made to achieve the critical balance between growth and employment, redistribution and growth, rural-urban divide and employment, and employment and education.

This paper focuses on such instances where state intervention has resulted in the exacerbation of the distortions that was sought to be corrected in the first place.

Growth & Employment:
One of the basic objectives of public intervention in India, as in other less developed countries is to achieve rapid economic growth that is sustainable. This objective however is qualified in terms of the equally important objectives of greater employment generation and a more equitable distribution of income. In India, given the abundance of labour and the relative scarcity of capital a rationale growth strategy would call for the adoption of a production technique that is labour intensive. This would be in consonance with the factor endowment of the country that would facilitate the attainment of optimality in the allocation function.

However, in practice market price of labour is set above its scarcity value due to various implicit and explicit government policies. This includes indulgence towards belligerent trade union activities that hold production to ransom seeking repeated hike in wage-rate without commensurate increase in productivity. The link between productivity and wage is also slackened by the enactment of minimum wage legislation which could be based either on genuine humanitarian concern or could be acts of sheer populism. Similarly aligning wage to educational attainments rather to productivity more often than not causes distortion between the market price of labour and their scarcity value.

On the contrary, cost of capital in the market is effectively reduced below their social cost by a premeditated government policy. Extension of interest subsidies makes capital much more cheaper while rationing of credit at relatively lower interest prevents the price of capital from climbing to their to scarcity value. Similarly, extension of capital depreciation benefit translates into reduced cost for capital. At the international level, maintenance of overvalued exchange rate and low effective rates of import tariffs makes cost of imported capital cheaper.

The distortion between market and social prices, which is aggravated upward for labour and downward for capital, by state intervention, induces the Indian economy to progressively adopt relatively capital-intensive technique of production. This has serious implications where the economy ignores its abundance of labour, and instead opts for more capital in their production process, induced by its relatively cheaper price. Adoption of a capital-intensive technique of production in a labour abundant and capital scarce country constitutes inefficient use of existing resources that has adverse impact on levels of productivity and efficiency for the economy. However of greater concern is the inadvertent compromise of the critical objective of employment generation, which is one of the basic objectives of state intervention. This is evident in the growth process of various less developed countries (LDC) that are experiencing jobless growth characterized by widespread underemployment, deprivation, and income inequality.

Redistributive Policies towards an Egalitarian Society:
In an economy, the distribution of income and wealth depends upon the pattern of ownership of productive resources, personal earning abilities, and accumulated and inherited wealth. As in most LDCs, there is massive inequality in the distribution of income and wealth in India, with a minuscule minority owning most of the physical and financial capital along with land. Besides, most of the income enhancing human capital is embedded in the richer section of the population. In this context, although one of the basic objectives of state intervention is to facilitate the establishment of a more egalitarian society both economically as well as socially, however economics had failed to devise any instrument to precisely determine the state of optimal distribution that is acceptable to the various standards of equity and ethical sensitivity.

While acknowledging this limitation of economics, Musgrave and Musgrave (1989) reiterate the importance of redistribution objective in state policy and recommend its attainment through an assortment of well-directed fiscal interventions. An effective strategy could consist of a highly progressive direct tax[4] regime to finance transfer payments and subsidies for the poor. Such a policy needs to be supplemented by the imposition of high indirect taxes on commodities consumed by the richer sections whose proceeds could be used to subsidise the commodities usually bought by the low-income families.

However at the operational level, fiscal intervention directed towards the attainment of a more egalitarian distribution, often results in an aggravation of the state of inequality. Thus, a well-meaning progressive tax rate structure, in practice becomes regressive as the wealthy households avoid and evade tax obligations using existing loopholes in the taxation structure, whereas the effective compliance of the middle class is ensured with direct tax deducted at source, as are the poor who are covered by commodity taxes.

Again, public consumption subsidies directed towards the poorer sections of the population, although theoretically sound, often results in contradictions at the operational level. In India, benefits of fuel subsidy, which burns a deep hole in the national fiscal deficit often, violate principles of equity. The extensive and indiscriminate public subsidy in LPG is mostly accessed by the rich and middle class, leaving out millions of especially poor rural citizens from the list of beneficiaries. Similarly, indiscriminate subsidy in diesel often blatantly violates all existing principles of equity by inadvertently subsidising the running of the luxury vehicles used exclusively by the super rich. In the agricultural sector, the same distortion is repeated as the existing fertilizer subsidy is often appropriated by wealthy farmers bypassing the marginal cultivators for whom the subsidy is envisaged.

India over the years had adopted various food for work based poverty alleviation programmes, which had played a significant role in fighting acute poverty especially in the vulnerable rural areas. Although such programmes are politically more sustainable with 'the poor getting a hand up rather than a hand out' (Todaro, 2003), but large-scale leakages erode the efficacy of the programmes and severely curtail their potential to make a difference to the poor. The distributional objectives are also defeated as a large chunk of the resources is pilfered by officials in connivance with politicians, middleman and rural functionaries who has in a sense managed to institutionalize the malpractices. The fallout is the creation of corrupt affluent section within the population whose presence is a manifestation of the ills that plagues the administration and execution of such programmes and is a reflection of the failure of the public redistribution programmes targeted to provide a base level support to the most susceptible sections of the society.

As redistributive considerations shifts focus from the relative disparity in income and wealth among the richest and the poorest to the provision of a basic floor level income for the poorest of the poor, the fact remains that despite significant achievements in the provision of basic needs the public redistribution programmes in India, as in other similarly placed LDCs, have aggravated the state of inequality instead of correcting it.

Urbanization, Migration & Employment

Economic growth in countries like LDCs like India is inevitably accompanied by rapid urbanization where each growth zone is powered by giant urban agglomerate which experiences tremendous growth in both income and population. The modern formal sector in such an agglomeration benefits from the externalities that emanates from the forward and backward linkages and attracts the best of all physical, financial and human resources from other parts of the economy. However this cumulative expansion takes place at the expense of the relatively backward areas, as their most productive and enterprising human resources and capital migrate to the growth centre resulting in what is termed as 'back-wash effect' (Myrdal, 1963). The inevitable fallout is the emergence of geographical dualism with the dynamic growth centre coexisting with large segments of underdeveloped areas regions trapped in stagnancy.

However, growth impulses in the dynamic centres are not enduring as ensuing congestion inexorably puts tremendous pressure on the existing social & economic infrastructures, extinguishing the positive economies. The state in India had often responded to this by attempting to create alternative growth centres, either within the greater confines of the existing agglomeration or in an unexploited and unchartered region, where the externalities that created the existing agglomerate are sought to be replicated. However, such strategy fails because more often than not, attempts are made to cluster unrelated industries with no possibilities of developing any linkages. Besides artificially created growth zones are bound to fizzle out if complementary economic & social infrastructures are not simultaneously created.

The explosive growth in the urban metropolis is mostly fuelled by the dynamic informal sector, which employs cheap but highly productive and enterprising labour in small-scale production units. Although this sector provides great impetus for growth, it also induces massive rural-urban migration attracted by the emerging livelihood opportunities. Such a massive influx puts immense pressure on the existing infrastructures in housing, education, health, employment and other social services. Typical manifestations of the intense congestion are increasing poverty, expanding slums, unhygienic living conditions, worsening unemployment, rising urban crime etc. Under the circumstances, the urban bias in the state directed flow of resources aggravates the congestion and its accompanying ills. This is so because although greater injection of resources continues to increase income and employment opportunities in such urban growth centres, that however attracts even greater number of rural migrants into the city, aggravating the congestion and deteriorating the unemployment situation. Thus the Todaro Paradox is activated which postulate that greater employment generation induces higher urban unemployment (Todaro, 1969). In fact, most urban growth centres carry out an enactment of the Harris-Todaro Model which "explain the apparently paradoxical relationship of accelerated rural-urban migration in the context of rising urban unemployment" (Harris and Todaro, 1970).

Thus government strategies to alleviate the woes of the urban agglomerate exacerbate an already bad situation which perhaps could had been avoided if efforts were made to have a more spatially balanced growth in the first place. A revised strategy redirected towards the establishment of adjacent satellite township may work out as a short-term solution. However, in the longer run it is imperative that state intervention facilitate a more balanced regional development so that unfettered migration of human and physical resources into urban growth centres does not make their decay inevitable.

Education and Employment:

Although education is a non-public good and is reasonably efficiently provided by the market there is a case for its public provision. As a merit good, education generates enormous positive externality, which benefits the society over and above the private benefit that accrues to the direct recipient, which in this case is the student. It is the social return associated with education that provides the rationale for its provision from the public budget.

In LDCs, education is viewed as a ticket to vertical mobility and as such, there are a colossal number of people who aspire to access education as a means to a better life. Given this perspective on education, there is enormous social and political pressure in India, to continuously increase the quantum of public provision of education. Acceding to this pressure the state had been continuously investing in education without any project appraisal, expenditure scrutiny, or accountability in service delivery or attainments of objectives. Such an incremental approach in fund allocation has made the existing educational setup gargantuan with hardened arteries resulting in inbuilt rigidities, which significantly reduce efficiency. Symptoms of such rigidities include reduced responsiveness to demands from within the system itself, lack of transparency in functioning, resistance to change etc. Another manifestation of the inherent inefficiency is that the educational system in many ways has detached itself from the society and the economy to whose end it was initially conceived to serve. In the process the credibility of the constituent institutions, the relevance of their programmes and the employability of their out-turns have been severely eroded.

The economic viability of any investment in education is determined on the basis of the returns emanating from the investment. In contrast to the private returns to education, that is estimated as the difference between private benefit and private cost, social returns is determined as the difference between social benefit from and the social cost of education. However, in making an appraisal on public expenditure on education, the educational setup has to be disaggregated into elementary, secondary, and higher levels and the appraisal must be undertaken independently considering the peculiarities and subsequent fallout at each levels.

Extensive studies by Psacharopoulos (1981) in 44 countries reveal that both social and private returns to primary education are the highest among all educational levels. Besides private returns exceed social returns, especially in higher education. Given the high return to primary education and also the socio-economic and ethical compulsion of the attainment of universal literacy, there is unanimity on the need for making significant augmentation in public expenditure in school education. However, public subsidy in higher education has been subjected to intense scrutiny mainly because in its case there is maximisation of private return exceeding social return. Thus, the argument that those who privately benefit from higher education should pay for it instead of being subsidized by the state appears to be sound. This is also consistent with the principle of equity as it has been empirically shown that the better-off has greater access to higher education and under those circumstances subsidy to this sector implies a state sponsored fiscal policy facilitating a transfer of resource from the poor to the rich. This is even more relevant for professional education where the divergence between private return and social return is even greater.

However, from the perspective of LDCs like India that hosts a significant population which is mired in poverty and hence very vulnerable, removal of subsidy in higher education would effectively deal a death blow to their aspiration to higher education, regardless of their worthiness. In that context, an efficient system extending selective subsidy to the deserving low income households would satisfy the canon of equity as it would exclude the rich (who would get richer by accessing higher education) from the purview of state subsidy. Instruments like education vouchers, subsidised educational loans, scholarships and grants qualified in terms of maximum household income etc had been tried and tested in many developed economies with interesting results. Such initiative provides comprehensive case study for the LDCs to decipher and subsequently imbibe.

Mounting educated unemployment reflecting the widening gap between supply and demand of educated labour is becoming more and more evident in states that exhibit relatively slower growth. Increasing outturns, from the state educational institutions respond to a static and jobless economy by taking up employment in position that requires lower levels of educational attainment. This initiates a cumulative downward substitution of labour where higher-level labour replaces those with a lower level of attainment who in turn, exerts pressure on workers on the next lower rung. However, the acquired and embedded skills do not make any impact on productivity levels, as the workers with augmented education & training do not get work commensurate to their knowledge and skills. This implies that the both the social as well as private returns from the existing institutions of higher education remain very low.

Despite the low return, there is enormous political pressure for even greater public provision of higher education as the near non-existent cost of accessing the highly subsidised education keeps private returns viable notwithstanding the fact that the benefits from such educational programmes is meagre.

Increasing allocation in public education which yield low social return, however comes at a heavy price as it involves a diversion of resources from critical area like investment in transport & communication, power infrastructures, basic & heavy industries etc which otherwise would have given a boost to the stagnant economy or provision of health services, subsidized basic consumption items, low-cost housing, primary education etc that would have enhanced the level of social welfare.

Conclusion

Aggravation of existing market distortions can be often traced to the institutional weaknesses of the state because of which it is unable to translate public rhetoric into actual attainment. In most instances, ostentatious programmes sponsored by the state fail to realise their stated objectives as they lack clarity in policy strategies. Often different arms of the state machinery work in cross-purpose to attain critical objectives, which are incompatible ensuring the inevitable failure of state interventions. Besides the constitution of the state apparatus with hardened bureaucratic arteries is often found wanting as it attempts to circumvent market forces. This is evident in the lack of coordination or communication between the different agencies participating in the market intervention, making it ineffective. The absence of profit motive robs the entire exercise of its guiding force making it waver and lose direction. Under the circumstances, the administration of such intervention is characterised by bureaucratic rigidities, absence of initiative, resistance to innovation and rampant administrative and financial irregularities. The failure of state intervention can also be traced to politicians who in many instances respond more to their political constituencies rather than to the national interest, compelling them to adopt a parochial perspective to issues of strategic importance.

However growing number of voices demanding appropriate state intervention which are more efficiently administered does put pressure on the powers to be to respond to the requirements of the of the economy, especially to the interest of the silent majority who are poor, weak and vulnerable. Social development accompanied by increasing maturity, self-introspection, and sensitivity generates democratic forces, which directly confronts obsolete ideas and redundant ideologies forcing a convergence between political rhetoric and actual execution and achievement in the field.

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