UNIT 9 THE MIXED ECONOMY MODEL

Structure

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9.0 OBJECTIVES

This unit aims at familiarising you with various alternative development strategies, and takes up for discussion one particular strategy or model of development, the mixed economy model. After going through the unit, you should be able to:

- Define the mixed economy;
- Describe the development strategy in India;
- Discuss the merits and demerits of the state and the market in economic activity; and
- Analyse the need for and performance of economic reforms.

9.1 INTRODUCTION

Every nation embarking on a development process has to choose the framework and policy measures which will help it to obtain maximum benefits. Howsoever, we may define development; there is no gain saying the fact that the economy has to be given a structure.

Ever since the industrial revolution in England and Western Europe and then elsewhere, the world has seen a new epoch and era of modern economic growth characterised by modern technology, new inventions and levels and rates of growth in Gross Incomes of nations which had never before been reached in human history. It was widely held that this growth engine was zooming at dizzying speed levels due to capitalist mode of production, with free markets and risk-taking by entrepreneurs, the 'captains of industry'. Also, thinkers like Adam Smith, in his classic book "An Inquiry into the Nature and Causes of the Wealth of Nations" published in 1776, extolled the virtue of the 'invisible hand'. According to this principle, people, while attempting to serve their own self-interest in a free enterprise economy are led, as if by an invisible hand, to confer benefits to others, even though it may not have been part of their original intention. Adam Smith also talked of the natural prosperity of people to truck, barter and exchange. This exchange process, whether of commodities or labour or finance or intellectual capital, whereby both buyers and sellers are involved in the exchange, is supposed to lead to gains for both. The sum total of all these exchanges is described in the abstract as a market economy. Of course, in the modern era virtually all exchanges are carried out with the help of the universal medium of exchange, money.

Ever since the market economy has been in ascendance, there have been its critics too. Apart from socialists of all hues, others too have urged the intervention of the state in the economy to stabilise the economy, or to provide welfare measure, or to mitigate the adverse effects of the pure market economy.

In this unit, we shall be concerned with the role that the state and the market can play in an economy and the various arrangements in support of each and the possible relationship between the two.

9.2 RATIONALE FOR GOVERNMENT SINTERVENTION IN THE ECONOMY

In the developed countries, ever since the Depression of the early 1930s, when national output fell, stock markets plummeted, unemployment soared, and banks and financial institutions failed, a large role has been envisaged for the government to stabilise the in-built fluctuations of market economics. Also, in many nations, there has been an expansion of welfare activities of the government such as unemployment insurance, subsidies in agriculture and health programmes for the poor and the elderly.

Role of the Government

The government has many different kinds of functions. Apart from providing the legal framework and enforcing contracts, the government has been seen to be performing four broad types of functions.

(1) Stabilisation function:

This has been mentioned above. From time to time market economies face problems of rising unemployment or inflation or both, apart from benefits in the balance of payment in the international economy. The government steps in with corrective measures and policy guidance to steer the economy back on the growth path. The government may take steps through the budget, or through interest rates or through money supply or policies on the external sector, such as devaluation of the national currency. Stabilisation functions pertain to the overall, that is, macro level of the economy.

(2) Budgetary Function:

This may sometimes be an instrument of stabilisation, but even when stabilisation of the economy is not required, the government does have to have a policy about how much to spend and on what and to determine where the money is going to come from. Thus, the government has to form policies about current and long-term expenditure and about receipts such as revenue from public enterprises, taxation, etc. It also has to determine how much deficits to be seen in its budget, if at all. These policies of the government are known as fiscal policies.

In many ways, budgetary measures and policies pervade all government activities. Whatever activities the government undertakes, it is going to need finance. Thus, public financial or fiscal aspects are the overarching activity of the government.

(3) Allocation Function:

There are certain goods called public goods or social goods, which are not efficiently provided by the private sector. Public goods are goods where there is an absence of rivalry in the consumption of these goods, and it is not feasible to exclude some people from the consumption of these goods. An example is national security. Another example could be a public health care measure like public immunisation programme. The need of these goods is felt collectively as such so that unlike private goods, the market mechanism, which is based on the principle of exchange, does not do a good job of providing these. The nature of public goods is elaborated below.

Related to the case of public goods is the situation of what is known as market failure.

'Market failure' is the collective situation where competitive conditions do not prevail in the market economy or the exchange process is not smooth. This subsumes several situations:

(i) **Absence or breakdown of competition:** This is a situation when one or a few firms control the market in some industry. This means competition is not strong, especially if there are not even potential entrants. Monopolies or oligopolies prevail in such situations;

(ii) **Public goods:** These have been discussed above. What are their characters? First, it is difficult or impossible to exclude individuals from consuming it. Consider a lighthouse at a harbour. If one ship gets the benefit of the lighthouse, it is difficult to exclude other ships form getting the light. This is called the principle of non-exclusion. The other characteristic is called non-rivalry. This means that if one person consumes a certain quantity of the good, the quantity left over for others is not diminished. For example, consider a group of people trying to warm themselves on a winter night by huddling around a fire. If another person comes by, the amount left over by these people is not diminished. Related to this characteristic of non-rivalry is the fact that the additional cost or cost at the margin of providing the good does not go up if the number of people to whom this good is to be provided goes up. A classic example of a public good is national defence. It is difficult to exclude some people and include others on defence against external aggression. Similarly, the costs of defending a population do not go up if more and more people are added. Usually, the markets will under-supply these goods and the government has to step in to provide these goods and services or even to produce.

(iii) **Externalities:** These are situations where the action of one individual or a firm affects others adversely but this individual or firm does not bear the cost or alternatively the action may confer benefits to others but the individual or the firm does not receive rewards or compensation for conferring this benefit. The former is a situation of negative externalities and the latter is called positive externalities. An example of negative externalities is pollution. A positive externality situation would if a person has an apple orchard and provides nectar for the bees of a neighbouring beekeeper.

It is sometimes felt that the government has to step in to control externalities either through legislation such as pollution norms, or through taxes and subsidies.

The other roles of the government are as the producer of goods and services, particularly pure public goods. The government even when not directly engaged in production, can provide incentives through subsidies and prices. The government also regulates business and the private sector in may areas. In many financial markets where there are imperfect information or the markets are not complete, the government provides credit and insurance.

(4) Distribution function:

The government has policies for the redistribution of income. It does so through the taxation system and through direct redistribution of welfare programme. The government may have special income generation programmes for the indigent. Taxes and subsidies, suitably targeted are important instruments for this function.

9.3 THE MIXED ECONOMY

Background

After the Second World War, several developing nations got freedom from colonial domination. They had to decide on a development strategy. For several reasons most of them chose a development strategy where the state had a very important role to play. First, most of these countries had gone through over a century of colonial rule so that by the time they got their independence, the private sector was not developed enough or mature enough to undertake massive investment – often in sectors with no immediate scope for profits on a scale that the development process seemed to require. The state had to step in. Secondly, just about each of the developing nations, apart from having a low national income per head (that is, the average income per person was low) had a highly skewed income distribution, that is, there were islands of riches with large pools of poverty. There were also high unemployment levels. The market, it was felt, could not only not lift the poor out of poverty, but would actually be unjust to people living near subsistence level. Therefore, it was thought that the state had very important role to play. Thirdly, during the Second World War, widespread use was made of control and rationing with administrative consideration taking precedence over market logic in resource allocation. Even after independence, most of these countries continued with controls and regulation in several areas of the economy. Further beginning 1929 and through much of the 1930s, several industrial economies experienced a severe depression when joblessness was rampant and national income not only slowed down in growth, but levels of national income actually fell. The state stepped in a big way in these countries to attempt to cure these problems though massive government expenditures. The theories of the economist John Maynard Keynes advocating state intervention to stabilise the economy were put into practical policy formulation. Moreover, the state stepped in with several welfare measures like social security and insurance. In the U.S.A., President Roosevelt put this package into operation under the name “The New Deal”. At the same time that the West was experiencing depression and unemployment, the then Soviet Union was industrialising at a very fast rate. The country, which was a backward agricultural economy not long ago, was undergoing a transformation at a pace that was the envy of all.

What the industrial western world had taken centuries to achieve, the Soviet Union, or so it seemed, would achieve in decades. Social welfare measures were also not neglected. All these impressed policy makers in the developing nations. A final reason for adopting a developing strategy with a large role for the state seem to be the thinking, widespread at that time was that social science theories, particularly economic theories developed in the west and apparently for the west were largely inapplicable in poor nations. These countries were thought to possess unique social, economic and political features, which rendered western social science useless.

Thus, it was that developing countries embarked on a development strategy that envisaged a large, often dominant, role for the state. This mix of the state and private sector was very broadly, what came to be, called the mixed economy. We still elaborate on it's meaning a little later and discuss its rationale and the merits and demerits of the system. Here we make a small point.

The preceding discussion, and the discussions about the Indian economy before the reforms in 1991 that you must have come across in the media, has probably made you think that the mixed economy is a strategy for development or a model adopted exclusively in the developing nation. Not so. Economists like Paul Samuelson and Joseph Stiglitz, both Noble Prize winners, have described the *American* economy as a mixed economy, in their textbooks. Stiglitz, for example, claims that in the American economy, the state, and many by the private sector undertake lots of economic activities. Moreover, the state influences the behaviour of the private sector by employing a variety of instruments like regulation, taxes and subsidies.

We saw above that the western countries have many welfare oriented policy programmes. For example, Americans had Mediclaim and Medicare policies for providing subsidised health services and health insurance for the poor and old people. Similarly, government expenditure forms a large portion of total national spending. This was even truer of countries like Sweden and Britain in the 1950s to 1970s. Of course, since the 1980s the welfare state has been under attack from critics -- and indeed the state has been in retreat in developed countries as also in developing countries. We will come to this aspect presently.

The second point to remember is that mixed economy does not mean a mix between socialism and capitalism. Although many developing countries that adopted the mixed economy had central planning as well- functioning markets, these were essentially market economies with a role for the state, including that of regulation.

What then is a mixed economy?

A mixed economy does not mean merely a mix of planning and the market, or merely a mix of bureaucracy and private business firms, but the notion is used to denote an economic system characterised by a mix of private enterprises and government owned enterprises. A mixed economy is characterised by the coexistence of private ownership and state ownership of the means of production. The state, apart from ownership of means of production, often had a regulatory role.

The Mixed Economy Model in India

India's principal economic strategy was given a blueprint in the Second five-year Plan. The first Five Year Plan was over the period of 1951-1956. It was mainly a

collection of projects, like irrigation projects. By the time, the second five -Year Plans came along; the planners decided that the fundamental objectives of any planning exercise had to be growth of national income on a sustained basis. There did exist rich farmers and rich people in other walks of life but it was felt that in a democratic society, there were limits to any distribution of wealth and income that could be carried out. Moreover, the quantum of wealth that would be released would be insufficient to better the lives of the teeming millions. So the form had to be growth, and it was hoped that the benefits of growth could trickle down to the people in low socio-economic status. Economist Jagdish Bhagwati has opined that the strategy should be called a 'pulling up' rather than 'trickle down' because it was hoped that the poor would be pulled up in a participative manner in the growth process, and would not merely be expected to passively wait for the benefits to come to them.

The policy makers saw in capital accumulation the main source of growth. Capital here does not mean financial capital. It means machines, plants, and means of production. There are broadly two types of machines, when looked at from the economic angle. One type is that of those machines, which produce goods that consumers will buy. The other type consists of those machines, which produce machines that will in turn produce consumer goods. Industries procuring the former type of machines are called light industries, and those producing the latter type are called heavy industries. It was thought important in the strategy of the second Five Year Plan (the principal architect of the plan model was P.C. Mahoalanobis, and hence the strategy is called Mahalanobis strategy) that there should be investment in heavy industries. Investment here means net addition to the capital stock. Here it does not mean an individual spending money to buy financial assets like shares or mutual fund. It means an aggregate economy level addition to the stock of machine, plants, equipment, etc.,

Now for a machine investment of this magnitude, it was felt that the private sector at the time was simply not in a position to undertake it. Moreover, investment in these and infrastructure involved a considerable lag after which profits would start to flow. Indian private capitalists, who were mostly in trade, finance and speculation activities, it was felt would not be interested. Thus, the public sector had to step in, invest machinery in heavy industries and infrastructure, in fact, to ensure ownership of these industries and occupy the commanding heights of the economy. Also many of these industries were of a strategic nature like Power, Defence, and, thus, for the strategic reasons also it was thought improper for these to be left to the private sector.

There was another plank to the strategy. It was felt that dependence on imports for all type of goods had to be lessened. Foreign exchange was a scarce item, which had to be conserved and not given away to obtain imports. Thus, an important substitution strategy was put into place. Also, it was felt that sufficient scope of experts did not exist and hence an export promotion strategy was not put into place.

Thus, in India the public sector was given charge of the heavy industries, infrastructure, dams, etc. State owned means of production and other state owned firms were guided by an objective of the promotion of social welfare. The private sector was allowed in areas of consumer goods and in areas where economics of scale were not present or important. Big business was tolerated in areas where they could foster technical advance and raise technological capacity. Moreover, the state sought to regulate the private sector through a system of incurring in order to prevent build-up of monopolies and unfair business practices.

Thus, the main areas of state interventions were in the industrial sector. So the mixed economy meant, first, a pervasive role of planning along with market forces, and second, state ownership of the means of production and regulation of private industries. The primary instruments for these were (1) the Industrial Policy Resolution of 1948, and more crucially of 1956 which sought to demarcate areas of private and public industries; and (2) the Industries (development and regulation) Act, 1951 (IDRA), which established the elaborate licensing framework by which the state sought to regulate the private industrial sector.

Agriculture was left totally in the private sector, and there was indirect policy support through investment by the state rather than ownership. The state sought to provide public investment support in key area such as irrigation, research, and extension.

Apart from controls in the industrial area, there were other controls such as (i) price controls; (ii) controls on exports and imports; (iii) controls on capital finance (here it means investment, say in stock exchanges issues); (iv) controls on foreign collaboration and exchange; (v) distribution controls such as in food grains; and (vi) controls in labour polices for example ability to fire and in location

Over time, the government resorted to not merely regulating the private sector but also nationalising, or taking over certain industries like the Burn Standard Iron and Steel company or even banks such as the nationalisation of 14 commercial banks in 1969 and then a further six in 1980. Nationalisation was done both in the name of fighting inefficiency in industries (so that workers' interests were protected) and also when it was felt that these was not acting in the social interests and the deprived social classes were not being served. The government also took recourse to statutorily rationing certain items such as food grains and some other essentials like sugar and kerosene. Finally, there was an elaborate network of subsidies given to various purposes and to several sectors in the economy.

The state adopted logic of planning largely for co-ordinating large-scale investment in the heavy industries and key sectors of the economy. The state was assigned a leading role in investment. A complex and elaborate system of controls and regulatory instruments were created which aimed at consuming foreign exchange and preventing growth of monopoly homes.

Along with these, the state took a policy of fostering small and medium industries, handicrafts, as well as promotion of co-operatives. The state also adopted a regime of administered prices to regulate the inequities of the market system, and to promote stability in the economy. Other than this, the state had a policy to regulate the inflow of private foreign capital while relying on official development assistance from foreign government and multilateral agencies to cover foreign exchange gap and sometimes even budget deficits.

Many economists and policy makers have put forward arguments that just because markets some times fail, state intervention and control need not be the solution. In fact, the economic activities of the state are beset with problems. The collective term for all the limitations and pathologic of state activities is government failure.

What are the problems with government activities, and what limitations does the state have in implementing its policies? Firstly, there are millions of transactions

taking place, innumerable production activities going on. The state just cannot have information of all to formulate a consistent plan model, which will have an impact on the entire economy. The state has limited information and so is constrained in policy matters. Second, the state has limited control over private market responses. For example, the state can channel investment into key areas and desired sectors, but how does it control private consumption? If consumers show a preference for luxury consumption and do not buy handicrafts, then the state, particularly a democratic one, has little policy option to regulate consumption. Similarly, if for investment, the state feels that there should be a certain level of savings but if the people show low saving propensities then the following exercise is to that extent compromised.

Third, government policies are implemented though administrative bureaucracy. The policy makers, however, have very loose control over bureaucrats and government officials. Not only the reach and power of the bureaucracy grow, but individual officials may not honestly and efficiently implement the stated policy or programme, assuming that the policy or the programme itself is intrinsically sound.

Finally, the government faces limitations thrown up by the democratic process itself. In the economy, there are innumerable economic agents. The government has to find ways of aggregating in a democratic manner their diverse individual preferences. The government also has to balance the interests and demands of various pressure groups/ interest groups that unnecessarily emerge in large, heterogeneous and plural societies.

9.4 EVALUATING THE MIXED ECONOMY

The mixed economy model that was put into operation around the mid fifties continued in more or less the same manner till about the 1980s. By the time the 1980s arrived, there was thinking in several industrial nations that there was a need to reduce the role of government in economic affairs; a greater role was sought for the private sector and markets. Similar thinking started taking place in India and other developing nations as well. China of course, had started reforms in 1978.

How successful was the model? We place the discussion in this section in the context of India. What do we understand by success in this context? Should we judge the mixed economy against the background of the stated objectives? What were the basic objectives?

Objectives of the Mixed Economy

Given the fact that India has been a country with a low per capita level and a large mass of poor, landless, unemployed, the basic objective of the mixed economy has always been fostering growth along with social justice. The strategy adopted for fostering growth has been described in the previous section. For social justice, there were attempted land reforms, and since the late 1960s direct employment generation and poverty alleviation programmes, apart from a minimum needs programme which attempted to provide basic needs like sanitation, drinking water and so on.

As far as plans were concerned, subsequent plans were more or less in the same as the Mahalanobis model. But some inherent crises and contradictions soon appeared. The stress on heavy industrialisation and import substitution,

paradoxically led to a situation where it was realised that machinery and capital goods of the manufacture of heavy industries themselves had to be imported. This led to a foreign exchange crisis, and the Rupee had to be developed in 1966. Moreover, unlike some other Asian countries at that time, India did not seek ways of integrating with the international economy and of promoting exports.

Technological aspects of agriculture were not given due attention till about the mid 1960s. The land reforms programme too, was of little success, and there seemed to be little political will in implementing them. By the middle of the 1960s, a technological package was implemented in agriculture, with high yielding variety of seeds, particularly in wheat, along with complimentary inputs. This programme, which came to be called the 'green revolution', eventually proved to be a success and helped the nation become self sufficient in food grains. The programme, of course, had its shortcomings. It led to the worsening of the distribution of rural income and deterioration of the soil quality.

Other problems emerged as well in course of the operation of the mixed economy like concentration of economic power, dismal performance of the public sector enterprises, and very poor levels of social indicators like education and health.

Let us now list some of the major achievements of the model.

First, the economy emerged from colonial rule and managed to attain a respectable growth rate. For the period till the mid 1980s, the rate of growth of population was lower than the rate of growth of Gross National Product. For a large section of the people, there was a perceptive rise in living standards.

Second, India managed to create a large diversified industrial structure. Before independence the main industries worth mentioning were iron and steel and textiles. After independence the pattern of industrialisation diversified and industries in many sectors developed.

Third, India, which used to rely on food aid and food imports, became self-sufficient in food. There were distribution problems, which led to the contribution of endemic hunger among some sections of the people.

Fourth, Indian education policy was a lopsided one with stress on tertiary education. This, however, resulted in the development of a large scientific human resources pool. India made great strides in atomic energy, space and other scientific areas. By the 1980s India had the world's fourth largest scientific human resource pool. While this large pool often was not productively employed in the country and there was a 'brain drain' to other countries, there was the creation of the 'brain' in the first place.

Finally, the pervasive influence of the state in almost spheres of economic activity buffeted the economy from fluctuations.

9.5 IMPACT OF ECONOMIC REFORMS

We have mentioned about the performance of the mixed economy. We have also talked about government failure. The strangulating effect of government regulation, the effect of government regulation, the dismal performance, by public enterprises, and the difficulties at the macro economic level such as growing balance of payment gaps or burgeoning budget deficits, led many

countries across the globe beginning in the mid to late seventies to roll back the government and attempt to integrate more with the global economy.

Many Latin American countries, due to balance of payment difficulties, took recourse to loan from international agencies like IMF in the mid 1970s. These loans came attached with conditionalities, most of which involved a liberalising package. On the other hand, with the coming to power of Deng Ziao Ping in China, 1978, wide-ranging reforms were launched in China beginning in the agricultural sector. In the 1980s Western nations, too, saw a retreat of the state, particularly in Britain and America. When Mrs. Thatcher and Mr. Reagan assumed office, there was a different shift to policies, which involved a smaller role of government. Finally there was the collapse of 'actually existing socialism' in the erstwhile Soviet Union and East European nations by 1998.

Then through the 1980s a climate was getting created in the international economy that the government should restrict its role to providing a few services, there should be minimal regulation, and a greater role for inputs, experts and foreign investment to boost the economy.

The situation in India

Since 1980 there have been some small attempts at reforms, particularly in allowing private firms entry into areas till then received of by the public sector. In1980 a new industrial policy resolution was passed. In 1985 there were some liberalisation in the external side with lowering of custom duties in the case of several items. Also, there was massive lowering of tax rates and simplification of taxation principles. Imports of inputs for manufacturing of products particularly in electronics and two wheelers were eased. Eminent economist Jagadish Bhagwati has described this package, which was then called 'new economic policy', as 'reforms by strength'.

The Indian economy grew at a high rate through the 1980s but by 1990, it was realised that this was made possible by running huge deficits in the budget. Also, there was a crisis in the external front with high balance of payments deficits and low foreign exchange reserves. Thus, India had to go in for a massive loan from the IMF. As a result of this, certain measures were taken as part of the conditionalities. The rupee was devalued and industrial licensing was all but abolished.

Gradually, the reform process gathered momentum and later reform measures were taken in the financial sector such an abolition of the controller of capital issues. In its place, Security Exchange Board of India (SEBI) was established. Later other measures related to banking and finance was taken. More recently the government has taken some steps towards privatisation and disinvestments of public enterprises. What are now needed are reforms in labour laws and the agricultural sector.

9.6 ACTIVITY

1. Discuss the role of public sector banks, and do a comparative analysis of a public sector and a private sector commercial bank, using suitable indicators.
2. Contrast the objectives and functioning of a private firm and a public enterprise in your country.

9.7 CONCLUSION

This unit attempted to discuss the rationale for, and the role of, the government in economic development. It discussed the mix of planning and the market as well as the mix of the public and private and public sectors in developed nations, but more so in developing nations. In discussing the role of government, it discussed the allocation, distribution and the stabilisation functions. The unit also discussed the budgetary aspects of government activities. The unit then went on to discuss market failure, and described how the government can step in to correct market failure.

The unit discussed the modern notion that governments, too, can fail. It traced the evolution of the mixed economy in developed nations, as also the strategy of mixed economy and its efficacy in developing countries. The unit provided an evaluation of the mixed economy and the shortcomings and weaknesses in its functions.

9.8 REFERENCES AND FURTHER READINGS

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