

ECONOMICS FOR MEDIA

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Subject: ECONOMICS FOR MEDIA

SYLLABUS

Economics and Media; Total and Marginal Utility; Fundamental Laws of Economics; Concept of Consumer Equilibrium; Cost and Revenue; Theory and Kinds of Costs; Theory of Supply and Supply Curve; Market and Dynamics of Competition; Types of Competition; Market Equilibrium.

Overview of Post Independence Scenario of India; Genesis of Planning; Industrial Policy Resolution; Outline of Second and Third Five Year Plan; Nehru and Socialism; Socialism and Nationalization of Banks; MRTP & FERA Acts; License Permit Raj and Corruption; Oil Stocks of 1973 and Consequences; Green Revolution and its Impact on Indian Economy; Review of Five Year Plans; Structure of Indian Economy and the Factors Leading to the Changes in this Structure.

Overview of Economic Reforms; Stock Exchange in India; Privatization and Disinvestments; Banking System in India; Corporate Governance and the Criticism against Foreign Investment; Overview of Contemporary Issues: Globalization, GATT, WHO; Implications on the Indian Economy.

Suggested Readings:

- 1. Media Economics: Understanding Markets, Industries and Concepts, Alan B. Albarrán, Wiley.
- 2. Understanding Media Economics, Gillian Doyle, Sage Publications.
- 3. Media Economics: Applying Economics to New and Traditional Media, Colin Hoskins, Stuart McFadyen, Sage Publications.

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 This lecture will answer your query – 'Why economics for students of journalism?'. It's very important that you clear this doubt before trying to understand what Economics is all about?

Why economics?

How much pocket money do you get from your parents? How much do you wish you got? How do you spend your pocket money? Do you blow up the entire amount on movies and MacDonald's? Or are you the types who love reading and set aside a part of your pocket money on buying new books? Perhaps you are a profligate when it comes to spending money and you are perpetually in debt, borrowing money from friends. Please remember, every day of your life, whether you realize or like it or not, economics is a fundamental facet of your life. It is a fundamental facet even of your family's life. The same logic can be extended to the country as a whole. While we boast of civilization, culture, music, dance and Sachin Tendulkar, at the end of the day, it all boils down to money. And as a student of mass communication, when you will go on and make careers in journalism, advertising, PR and related fields, you will find the basic understanding of economics an invaluable ally in dealings with people, situations and crisis.

This being our very first class, let's clear the bugging doubt before beginning with anything else. Why Economics for a student of journalism and communication? Well, that's a good question to begin with. So let's justify to ourselves as to what 'Economic Development and Planning in India' has to do with us. In the globalized world of today, creativity alone cannot help a newspaper, magazine, television channel or news portal survive the rigorous pressures of an increasingly competitive economy. It is not a coincidence that some of the biggest media tycoons of the world are not only good communicators but exceptional businessmen. Take for instance Rupert Murdoch or our very own Pronoy Roy who hails from a strong Economics background, their business acumen and vast knowledge of the subject has indeed been a very significant ingredient of their success.

The world of advertising would have no meaning without the knowledge of economics. Ad guru Alque Padamsee or Prahlaad Kakkar are no doubt the brain waves behind some of the most creative ideas, but their ideas sell because of well-designed marketing strategy which is a purely economic affair.

Thus as a student of Journalism and Mass comm'n you got to be aware that media – its functioning, content and programming are at some point of time or the other, more or less determined by market dynamics. This can be explained at various levels.

1. We must have a fair idea of the structure, trends and issues that could influence the course of Indian economy in

particular and global economy at large. After all these factors influence the 'business' of media.

- 2. Though the content of any media print or electronic, is primarily determined by the social, political, cultural factors et al, economic factors are equally influential when we talk about 'mass' comm'n for instance, Who is the target audience for a tele-serial? An urban middle class youngster, middle class housewife, Gujrati household etc.
- 3. The performance of a medium is also measured in purely economic terms, for instance TRPs of a TV programme and reach of newspaper. After all, Ekta Kapoor's heart beat rises and falls according to the TRPs of her numerous K-serials.
- 4. Media houses have their financial and investment plans to handle. Knowledge of economic planning definitely gives a better edge to a media person.

 In this lecture you will not only define the term 'utility' but also get acquainted with concepts like marginal and total utility, that help in the understanding of two basic laws of utility theory – Law of diminishing marginal utility and equi-margnial utility.

Theory of Utility

Let's now try and define a term that will stay with us for the entire semester! Well, don't you fear. The term is very simple and has even simpler meaning. Have you heard of this word – Utility? I'm sure you must have. We often relate utility to use. But when we are talking of Economics we must be a little more clear and precise about the term. Utility is nothing but the satisfaction or enjoyment derived from the consumption of a particular good or service. Say for instance, you buy your favourite bike. How about Bajaj Freedom or Splendour. And then you zoom on for the first long drive. Next day when your friend asks, 'Hey, how was the ride?', what's your reply? 'Great Yaar!' That's exactly the 'utility' we are talking about. The word 'great' reflects your level of satisfaction.

So economists use the term **utility** to describe the satisfaction or enjoyment derived from the consumption of a good or service. If we assume that consumers act rationally, this means they will choose between different goods and services so as to maximize total satisfaction or total utility.

Consumers will take into consideration

- How much satisfaction they get from buying and then consuming an extra unit of a good or service
- The price that they have to pay to make this purchase
- The satisfaction derived from consuming alternative products
- The prices of alternatives goods and services

And it's here that we come to our next problem, if you may call so. How do we measure satisfaction. Although, satisfaction is something that is very subjective and immeasurable, we got to devise some way of measuring satisfaction in tangible terms. And we shall do that by rating satisfaction. It's as simple as this:

0,1,2,4,5,6,7,8,9.....

So as a consumer when you buy a commodity or a service, you will look at:

What is the price of, say the bike you are buying?

Is it worth the satisfaction you will derive from its consumption?

What's the price of the alternative products? You might as well opt for a music deck instead of bike. But you will compare the price of the two before making a choice.

How much is the satisfaction derived from the consumption of alternative products? This will depend on your needs. You will

compare your requirements for a bike and a music player before making a decision.

Before we begin with the utility theory, we'll acquaint ourselves with a few more terms.

Marginal Utility

Marginal utility is the satisfaction derived from the consumption of the additional unit of a commodity. For eg. You've enjoyed a movie to the hilt when you watched it for the first time. So you decide to watch it for the second time. The amount of satisfaction you derive from the second unit is known as the marginal utility. It's the change in total utility or satisfaction resulting from the consumption of one more unit of a good.

Law of Diminishing Marginal Utility

The **hypothesis of diminishing marginal utility** states that as the quantity of a good consumed increases, the marginal utility derived from that good decreases.

According to this law, the satisfaction we derive from the consumption of additional or successive units of a particular commodity or service diminishes. Let's make this clear to ourselves. When you buy a CD of your favorite album, the first time you listen to the music it sounds heavenly. The second time, great, but not as appealing as the first time. The third time you might sit through the whole cassette but you don't enjoy it as much as the second. This goes on till you actually choose not to listen to the album. The total utility on the other hand increases and is maximum when marginal utility is 0. But there is a time when you choose to go another CD and begin to dislike the CD for the moment. That's exactly when the marginal utility becomes negative and the total utility also starts declining.

Example - A consumer enjoys successive pints of his favourite cool drink. The total and marginal utility gained from each extra pint in shown in the table below. Total utility is maximised when marginal utility = zero. Consuming the seventh pint would create **dis-utility** as total utility falls (marginal utility becomes negative)

Pints of cool drink	Total Utility	Marginal Utility
0	0	-
1	10	10
2	18	8
3	24	6
4	28	4
5	30	2
6	30	0
7	29	-1

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Law of Equi-marginal Utility

According to the law of equi-marginal utility you will spend your money in such a way that the total utility derived from all the goods and services is maximized. So you would go for the best combination wherein the utility derived from the last rupee of the worth of one commodity, say ice creams and chocolates, are equal.

Law of Equi Marginal Returns

A **rational consumer** will spend his/her income in a way that **maximises the total utility** derived from all goods and services consumed.

Consider an example where a consumer has a choice between two goods A and B which have prices Pa and Pb respectively.

Total utility will be maximised when the utility derived from the last rupee's worth of A is equal to the utility derived from the last rupee's worth of B.

Total utility	Marginal utility of	=	Marginal utility of good	=	Marginal utility of
maximised	good A		В		good C
when	Price of		Price of good		Price of
	good A		В		good C

DERIVING THE DEMAND CURVE

Consider what happens to the **law of equi-marginal returns** when the price of good A falls. **The equality now becomes an inequality**, since the consumer now receives greater utility per rupee's worth of A than from good B. In order to restore the equality and to increase total utility a rational individual will consume more of good A.

As consumption increases the marginal utility derived from good A will diminish until the above **equi-marginal condition** has been restored and total utility is maximised. A fall in the price of good A has resulted in an increase in quantity demanded

CRITICISMS OF UTILITY THEORY

Some economists claim that utility cannot be measured objectively. There are also doubts about the assumption of **rational behaviour** among consumers - particularly in a world where consumers cannot expect to have all the information available on the products available in a market.

The importance of consumer feedback

In standard price theory, the **preferences of consumers** are taken as fixed - yet we observe that consumer's behaviour in a market is often influenced by their **interaction with other consumers** and this then affects demand.

A good example of this is the behaviour of consumers who attend showings of a new film at a cinema. Their reaction to a film will often determine how many other people choose to pay to watch the same film. **Consumer feedback** may be more significant than any amount of hype and advertising before a film is released.

Another good example is the feedback of consumers who visit a local restaurant or feedback from people who have stayed at a particular holiday resort. Their experiences may exert a significant influence on the preferences and choices of other consumers. It is little wonder that many successful firms trace some of their success at their willingness and ability to respond pro-actively to consumer feedback.

• This lecture will introduce you to one of the fundamental laws of Economics – Law of demand, consumer surplus and the other intrinsic concepts related to the law like marginal value and demand.

Law of Demand

Law of demand is basically very simple. When the price of a commodity falls, demand increases; when price rises demand falls. Isn't it as simple as that. There exists an inversely proportional relationship between price and demand. You can easily relate it to your life, isn't it.

When there is a slash in the price of a detergent A, all your moms would opt for detergent A. On the contrary when the price of A increases, they would look for some alternative.

Marginal Value and Demand

One of the objectives of this chapter is to derive a demand curve-a relation between the price of a good and how much of it a consumer chooses to buy. We are now in a position to do so. Imagine that you can buy all the eggs you want at a price of \$0.80/egg. You first consider whether to buy 1 egg per week or none. If the marginal value to you of the first egg is more than \$0.80 (in other words, if you prefer having one more egg to whatever else you could buy with \$0.80), you are better off buying at least 1 egg. The next question is whether to buy 2 eggs or 1. Again, if the marginal value of one more egg is greater than \$0.80, you are better off buying the egg and giving up the money. Following out the argument to its logical end, you conclude that you want to consume eggs at a rate such that the marginal value of an egg is \$0.80. If you increased your consumption above that point, you would be paying \$0.80 for an additional egg when consuming one more egg per week was worth less than \$0.80 to you (remember declining marginal utility). You would be consuming an egg that was worth less than it cost. If you consumed less than that amount, you would fail to consume an egg that was worth more to you than it cost. This implies that (if you act rationally) the same points describe both your marginal value for eggs (value of having one more egg as a function of how many eggs per week you are consuming) and your demand for eggs (number of eggs per week you consume as a function of the price of eggs), since at any price you consume that quantity for which your marginal value of eggs equals that price. The relation is shown in Figures 4-4a and 4-4b. Note that your marginal value for eggs shows value per egg as a function of quantity. Your demand curve shows quantity as a function of price.

Figures 4-4c and 4-4d show the same relation for a continuous good. As long as you are consuming a quantity of wine for which the marginal value of additional wine is greater than its price, you can make yourself better off by increasing your consumption. So you buy that quantity for which marginal

value equals price. Since you do that for any price, your demand curve and your marginal value curve are the same.

By the principle of declining marginal utility, the marginal value curve should slope down; the more we have, the less we value additional quantities. I have just demonstrated that the demand curve is identical to the marginal value curve. It follows that demand curves slope down.



Marginal value and points on the demand curve. Panels (a) and (b) show a lumpy good. At any price, you buy a quantity for which marginal value equals the price, so the (price, quantity) points on the demand curve are the same as the (marginal value, quantity) points on the marginal value curve. Panels (c) and)d) show a continuous good. At any price, you buy a quantity for which marginal value equals the price; that is true for every price, so the demand curve is identical to the marginal value curve.

Some Problems. There is one flaw in this argument. So far, I have been assuming that the marginal utility of income—the increased utility from the goods bought with an extra dollar—is constant. But just as the marginal utility of apples depends on how many apples we have, the marginal utility of income depends on how much income we have. If our income increases, we will increase the quantities we consume (for normal goods), reducing the marginal utility of those goods. The marginal utility of a dollar is simply the utility of the additional goods we could buy with that dollar; so as income rises, the marginal utility of income falls.

A marginal value curve shows us what happens when we increase our consumption of one good *while holding everything else constant*. This does not quite correspond to what is shown by the demand curve of Figure 4-4d. That curve graphs quantity against price. As the price of the good falls and the quantity consumed increases, the total amount spent on that good changes—and so does the amount left to spend on other goods. Since the marginal value curve shows the value of a good measured in money, it should shift slightly as the change in that good's price changes the amount we have left to spend on other goods, and hence the marginal utility of money.

A similar difficulty in the analysis arises when the value to us of one good depends on how much we have of some other good. Bread is more valuable when we have plenty of butter, and butter less valuable when we have plenty of margarine. As price falls and quantity consumed rises in Figures 4-4b and 4-4d, the quantities of other goods consumed changes—which may affect the value of the good whose price has changed.

The problems here are the same as in the case of the Giffen good discussed earlier; a change in the price of one good affects not only the cost of that good in terms of others but also the consumer's total command over goods and services—a drop in price is equivalent to an increase in income. A full discussion of this would involve the income-compensated (Hicksian) demand curve discussed in the previous chapter.

A simpler solution, adequate for most practical purposes, is the one we used to justify the downward-sloping demand curve in the previous chapter. Since consumption is usually divided among many different goods, with only a small part of our income spent on any one, a change in the price of one good has only a very small effect on our real income and our consumption of other goods as compared to its effect on the cost of the good whose price has changed. If we ignore the small income effect, the complications of the last few paragraphs disappear. The demand curve is then exactly the same as the marginal value curve; since the latter slopes down (because of diminishing marginal utility), so does the former. The indifference curve argument gave us a downward-sloping demand curve for a consumer choosing between two goods; this argument gives one in the general case of a consumer buying many goods.

Warning. When I ask students taking an exam or quiz to explain why the demand curve is the same as the marginal value curve, most of them think they know the answer—and most of them are wrong. The problem seems to be a confusion based on an imprecise verbal argument. It sounds very simple: "Your demand is how much you demand something, which is the same as how much you value it" or, alternatively, "Your demand is how much you are willing to pay for it, which is how much you value it." But both of those explanations are wrong. Your demand curve shows not how much you demand it but how much of it you demand—a quantity, not an intensity of feeling.

Your demand curve does not show how much you are willing to give for the good. On Figure 4-4d, the point X (price = \$25/ gallon, quantity = 2 gallons/week) is above your demand curve. But if you had to choose between buying 2 gallons of wine a week at a price of \$25/gallon or buying no wine at all, you would buy the wine; as we will see in a few pages, its total value is more than its cost. The demand curve shows the quantity you would *choose* to buy at any price, given that (at that price) you were free to buy as much or as little as you chose. It does not show the highest price you would pay for any quantity if you were choosing between that quantity and nothing.

The height of your demand curve at any price is equal to is the amount you would be willing to pay for a little more of the good—your marginal value. That is true—but not because demand and value mean the same thing. The reason was given in the discussion of eggs and wine a few paragraphs earlier. It is also important; as you will see later in the chapter, the relation between demand and marginal value is essential in deriving consumer surplus, and as you will see later in the book, consumer surplus is an important tool in much of economics. I have emphasized the relationship between the two curves so strongly because it is easy to skip over it as obvious and continue building the structure of economics with one of its foundations missing.

Price, Value, Diamonds, and Water

In addition to the downward-sloping demand curve, another interesting result follows from the analysis of marginal value. As I pointed out earlier, there is no obvious relation between price (what you must give up to get something) and value (how much it is worth to you-what you are willing, if necessary, to give up to get it), a point nicely summarized in the saving that the best things in life are free. But if you are able to buy as much as you like of something at a per-unit price of P, you will choose, for the reasons discussed above, to consume that quantity such that an additional unit is worth exactly P to you. Hence in equilibrium (when you are dividing your income among different goods in the way that maximizes your welfare), the marginal value of goods is just equal to their price! If the best things in life really are free, in the sense of being things of which you can consume as much as you want without giving up anything else (true of air, not true of love), then their marginal value is zero!

This brings us back to the "diamond-water paradox." Water is far more useful than diamonds, and far cheaper. The resolution of the paradox is that the total value to us of water is much greater than the total value of diamonds (we would be worse off with diamonds and no water than with water and no diamonds), but the marginal value of water is much less than that of diamonds. Since water is available at a low cost, we use it for all its valuable uses; if we used a little more, we would be adding a not very valuable use, such as watering the lawn once more just in case we had not watered it quite enough. Diamonds, being rare, get used only for their (few) valuable uses. Relative price equals relative marginal value; diamonds are much more expensive than water.

Consumer Surplus

This brings us to another (and related) paradox. Suppose you argued that "since the value of everything is equal to its price, I am no better off buying things than not buying, so I would be just as happy on Robinson Crusoe's island with nothing for sale as I am now." You would be confusing marginal value and average value; you are no better off buying the last drop of

water at exactly its value but are far better off buying (at the same price) all the preceding (and to you more valuable) drops. Note that "preceding" describes order in value, not in time.

Can we make this argument more precise? Is there some sense in which we can define how much better off you are by being able to buy as much water as you want at \$0.01/gallon or as many eggs as you want at \$0.80/egg? The answer is shown in Figure 4-5a. By buying one egg instead of none, you receive a marginal value of \$1.20 and give up \$0.80; you are better off by \$0.40. Buying a second egg provides a further increase in value of \$1.10 at a cost of another \$0.80. So buying 2 eggs instead of none makes you better off by \$0.70.

This does not mean you have \$0.70 more than if you bought no eggs—on the contrary, you have \$1.60 less. It means that buying 2 eggs instead of none makes you as much better off as would the extra goods you would buy if your income were \$0.70 higher than it is. You are indifferent between having your present income and buying 2 eggs (as well as whatever else you would buy with the income) and having \$0.70 more but being forbidden to buy any eggs.

Continuing the explanation of Figure 4-5a, we see that as long as you are consuming fewer than 5 eggs per week, each additional egg you buy makes you better off. When your consumption reaches 5 eggs per week, any further increase involves buying goods that cost more than they are worth. The total gain to you from consuming 5 eggs at a price of \$0.80 each instead of consuming no eggs at all is the sum of the little rectangles shown in the figure. The first rectangle is a gain of \$0.40/egg times 1 egg, for a total gain of \$0.40; the next is \$0.30/egg times 1 egg, and so on.



Marginal value curve and consumer surplus for a lumpy good. The shaded area under the marginal value curve and

above the price equals the benefit to you of buying that quantity at that price. It is called *consumer surplus*.

Summing the area of the rectangles may seem odd to you. Why not simply sum their heights, which represent the gain per egg at each stage? But consider Figure 4-5b, which shows a marginal value curve for which the rectangles no longer all have a width of 1 egg per week. Gaining \$0.40/egg on 3 eggs is worth 3 times as much as gaining \$0.40/egg on 1 egg.

Finally, consider Figure 4-6a, where instead of a lumpy good such as eggs we show a continuous good such as wine (or apple juice). If we add up the gain on buying wine, drop by drop, the

tiny rectangles exactly fill the shaded region A. That is your net gain from being able to buy wine at \$8/gallon.

This area—representing the gain to a consumer from what he consumes—has a name. It is called *consumer surplus*. It equals the area under the demand curve and above the price-area A on Figure 4-6a. You will meet consumer surplus again—its derivation was one of the main purposes of this chapter. Its traditional use in economics is to evaluate the net effect on consumers of some change in the economic system, such as the introduction of a tax or a subsidy. As we will see in Chapters 10 and 16, it is also sometimes useful for helping a firm decide how to price its product.

Your consumer surplus from buying wine at some price is the value to you of being able to buy as much wine as you wish at that price-the difference between what you pay for the wine and what it is worth to you. The same analysis can be used to measure the value to you of other opportunities. Suppose, for example, that you are simply given 2 gallons per week for free, with no opportunity to either sell any of it or buy any more. The value to you of what you are getting is the value of the first drop of wine, plus the second, plus ... adding up to the whole area under your demand curve-region A plus region B on Figure 4-6a. The situation is just the same as if you bought 2 gallons per week at a price of \$8/gallon and were then given back the money. Area A is the consumer surplus on buying the wine; area B is the \$16/week you spend to get it. The total value to you of the wine is the sum of the two, which is the area under the marginal value curve; total value is simply the area under marginal value.



Marginal value and consumer surplus for a continuouos good. A is the consumer surplus from Beijng able to buy all the wine you want at \$8/gallon. B is what you pay for it. A+B is the total value to you of 2 gallons per week of wine. B+E+D is what you would pay if you bought 2 gallons per week at \$25/ gallon.

If area A plus area B is the value to you of being given 2 gallons of wine per week, it is also the largest sum you would pay for 2 gallons per week if the alternative were having no wine at all. Figure 4-6b shows that situation. Your surplus from buying 2 gallons per week for 25/gallon is the value to you of the wine—areas A plus B on the previous figure, equal to C + E + B on Figure 4-6b—minus what you spend for it. You are spending 25/gallon and buying 2 gallons, so that comes to \$50/week—the colored rectangle D + E + B on Figure 4-6b. Subtracting that from the value of the wine (C + E + B) gives a surplus equal to region C minus region D. Your surplus is positive, so you buy the wine. This is the case mentioned earlier in the chapter where you would rather have a price/quantity combination that is above your demand curve than have nothing.

Odds and Ends

Again the Equimarginal Principle

You are consuming a variety of goods; being rational, you have adjusted the amount you consume of each until you are consuming that bundle you prefer among all those bundles you can buy with your income. Consider two goods-apples and cookies. For each, consider the marginal utility to you of an additional dollar's worth of the good. Suppose it were larger for apples than for cookies. In that case, by spending \$1 less on cookies and \$1 more on apples, you could get a better bundle for the same amount of money! But you are supposed to have already chosen the best possible bundle. If so, no further change can improve your situation. It follows that when you have your optimal bundle, the utility to you of a dollar's worth of apples must be the same as the utility to you of a dollar's worth of cookies-or a dollar's worth of anything else. If it were not, there would be a better bundle with the same price, so the one you had would not be optimal.

Since that may seem confusing, I will go through it again with numbers. We start by assuming that you are consuming your optimal bundle of apples and cookies. Suppose apples cost \$0.50 each and cookies (the giant size) cost \$1 each. You are consuming 4 cookies and 9 apples each week; at that level of consumption, the marginal utility of a cookie is 3 utiles and the marginal utility of an apple is 2 utiles (remember that the marginal utility of something depends both on your preferences and on how much you are consuming). A dollar's worth of apples is 2 apples; a dollar's worth of cookies is 1 cookie. If you increased your consumption of apples by 2, your utility would increase by four utiles; if you then decreased your consumption of cookies by 1, your utility would go back down by 3 utiles. The net effect would be to make you better off by 1 utile (4 - 3 = 1). You would still be spending the same amount of money on apples and cookies, so you would have the same amount as before to spend on everything else. You would be better off than before with regard to apples and cookies and as well off with regard to everything else. But that is impossible; since you were already choosing the optimal bundle, no change in what you consume can make you better off.

I have proved that if the marginal utility per dollar's worth of the different goods you are consuming is not the same, you must not be choosing the optimal bundle. So if you are choosing the optimal bundle, the marginal utility of a dollar's worth of any of the goods you consume must be the same. In other words, the marginal utility of each good must be proportional to its price. If butter costs \$4/pound and gasoline \$2/gallon, and a dollar's worth of butter (1/4 pound) increases your utility by the same amount as a dollar's worth of gasoline (1/2 gallon), the marginal utility of butter (per pound) must be twice the marginal utility of gasoline (per gallon)—just as the price of butter (per pound) is twice the price of gasoline (per gallon).

This is now the fourth time I have derived this result. The third was when, in the process of showing that the marginal value curve and the demand curve are the same, I demonstrated that you consume any good up to the point where its marginal value is equal to its price. While I did not point out then that marginal value equal to price implies the equimarginal principle, it is easy enough to see that it does. Simply repeat the argument for every good you consume. If marginal value is equal to price for every good, then for any two goods, the ratio of their marginal values is the same as the ratio of their prices. Since marginal value is marginal utility divided by the marginal utility of income, the ratio of the marginal values of two goods is the same as the ratio of their marginal utilities.

This may be clearer if it is stated using algebra instead of English. Consider two goods X and Y, with marginal values MV_x , and MV_y , marginal utilities MU_x and MU_y , and prices P_x and P_y . We have

 $MV_x = P_x;$

 $MV_v = P_v;$

 MV_x [[equivalence]] $MU_x/MU(income)$;

MV_v [[equivalence]] MU_v/MU(income).

Therefore,

 $\mathbf{P}_{x}/\mathbf{P}_{v} = \mathbf{M}\mathbf{V}_{x}/\mathbf{M}\mathbf{V}_{v} = \mathbf{M}\mathbf{U}_{x}/\mathbf{M}\mathbf{U}_{v}.$

The left hand side of this equation corresponds to "the price of an apple measured in oranges" in Chapter 3 (minus the slope of the budget line; apples are X, oranges Y); the right hand side is the marginal rate of substitution (minus the slope of the indifference curve).

This is the final derivation of the principle in this chapter, but you will find it turning up again in economics (and elsewhere). The form in which we have derived it this time makes more obvious the reason for calling it the equimarginal principle. A convenient, if sloppy, misstatement of it is "Everything is equal on the margin."

It is important, in this and other applications of the equimarginal principle, to realize that it is a statement not about the initial situation (preferences, market prices, roads, checkout counters, or whatever) but about the result of rational decision. You may (as I do) vastly prefer Kroger chocolate chip cookies (the kind they used to bake in the store and sell in the deli section) to apples; if so, you may buy many more cookies than apples. What the equimarginal principle tells you is that you will buy just enough more cookies to reduce the marginal utility per dollar of cookies to that of apples.

Continuous Cookies

It may occur to some of you that there is a problem with the most recent argument by which I "proved" the equimarginal principle. I originally defined the marginal utility of something of which I have n units as the utility of n + 1 units minus the utility of n units; since marginal value is derived from marginal utility, it would be defined similarly. Applying this to my example of 9 apples and 4 cookies, the marginal value of an apple involves the difference between 9 and 10 and the marginal

value of a cookie involves the difference between 4 and 5. But the change that I considered involved increasing the consumption of apples from 9 not to 10 but to 11, and decreasing the consumption of cookies from 4 to 3. Unless the marginal value of the eleventh apple is the same as that of the tenth (which it should not be, by our assumption of declining marginal utility) and the marginal value of the fourth cookie the same as that of the fifth (ditto), the argument as I gave it is wrong!

The answer to this objection is that although I have described the marginal utility of an apple or an orange as the difference between the utility of 10 and the utility of 9, that is only an approximation. Strictly speaking, we should think of all goods as consumed in continuously varying quantities (if this suggests applesauce and cookie crumbs, wait for the discussion of time in the next section). We should define the marginal utility as the increased utility from consuming a tiny bit more, divided by the amount of that tiny bit (and similarly for marginal value). Marginal value is then the slope of the graph of total value; in Figure 4-7 it is A V/A Q. If, when we are consuming 100 gallons of water per week, an additional drop (a millionth of a gallon) is worth one hundred-thousandth of a cent, then the marginal value of water is .00001 cents/.000001 gallons, which comes out to \$0.10/gallon. The argument of the previous section can then be restated in terms of an increase in consumption of .002 apples and a decrease in consumption of .001 cookies. Since we do not expect the marginal value of cookies to change very much between 4 cookies and 3.999 cookies, the argument goes through.

The precise definitions of marginal utility (see the optional section of Chapter 3) and marginal value require calculus-the marginal value of apples is the derivative of total value with respect to quantity. Since I am not assuming that all of my readers know calculus, I use the sort of imprecise language given above. Precisely the same calculus concept (a derivative) is implicit in such familiar ideas as speed and acceleration. You might carelessly say that, having driven 50 miles in an hour, your speed was 50 miles per hour-but you know that speed is actually an instantaneous concept and that 50 miles per hour is only an average (part of the time you were standing still at a stop light, part of it going at 50, part of it at 65). A precise definition of speed must be given in terms of small changes in distance divided by the small amounts of time during which they occur, just as a precise definition of marginal value is given in terms of small changes in value divided by the small changes in quantity that cause them.

Economics and Time

In talking or writing about economics, it is often convenient to describe consumption in terms of quantities—numbers of apples, gallons of water, and so forth. But 100 apples consumed in a day are not of the same value to me as 100 apples consumed in a year. The easiest way to deal with this problem is to think of consumption in terms of rates instead of quantities—6 apples per week, 7 eggs per week, and so on. Income is not a number of dollars but rather a number of dollars per week. Value is also a flow—6 apples per week are worth, not \$3, but \$3/week.

If we think of all quantities as flows and limit ourselves to analyzing situations in which income, prices, and preferences remain the same for long periods, we avoid most of the complications that time adds to economics. Many of these complications are important to understanding the nonstatic world we live in. But in solving a hard problem, it is often wise to solve the easier parts first; so in this section of the book, the problems associated with change are mostly ignored. Once we have a clearly worked-out picture of static economics, we can use it to understand more complicated situations-and will, starting in Chapter 12. Until then, we are doing economics in a perfectly static and predictable world, in which tomorrow is always like today and next year is always like this year. That is why, in drawing indifference curve diagrams, we never considered the possibility that the consumer would spend only part of his income in order to save the rest for a rainy day; either it is raining today or there are no rainy days.



Total value and its slope. $\blacktriangle V/\measuredangle Q$ is the average slope of total value between A and B. As $\bigstar V$ and $\bigstar Q$ become very small, A and B move together, and $\bigstar V/\bigstar Q$ approaches the slope of total value at a point-which is marginal value.

Problems associated with time and change are not the only complications ignored at this point; you might find it interesting to make a list as we go along, and see how many get dealt with by the end of the book.

One advantage to thinking of consumption in eggs per year instead of just eggs is that it lets us vary consumption continuously. There are severe practical difficulties with changing the number of eggs you consume by 1/10 of an egg at a time what do you do with the rest of it? But it is easy enough to increase the rate at which you consume eggs by 1/10 of an egg per week—eat, on average, 5 more eggs per year. Thus lumpy goods become continuous—and the consumption of continuous goods is, for mathematical reasons, easier to analyze than the consumption of lumpy goods. We can then define marginal utility and marginal value in terms of very small amounts of apples and cookies without first converting the apples into applesauce and the cookies into a pile of crumbs.

There is a second problem associated with time that we should also note. In describing the process of choice, I talk about "doing this, then doing that, then . . . " For example, I talk about increasing consumption from 4 apples to 5, then from 5 to 6, then from . . . and so on. It sounds as though the process happens over time, but that is deceptive. We are really describing not a process of consumption going on out in the real world but rather something happening inside your head—the process of solving the problem of how much of each good to consume. A more precise description would be "First you imagine that you choose to consume no apples and consider the resulting bundle of goods. Then you imagine that you consume 1 apple instead of none and compare that bundle with the previous one. Then 2 instead of 1. Then Finally, after you have figured out what level of consumption maximizes your utility, we turn a switch, the game of life starts, and you put your solution into practice."

If you find it difficult to distinguish time in the sense of an imaginary series of calculations by which you decide what to do from the time in which you actually do it, you may instead imagine, as suggested before, that we are considering a situation (income, preferences, prices) that will be stable for a long time. We start by spending a few days experimenting with different consumption bundles to see which we prefer. The loss from consuming wrong bundles during the experiment can be ignored, since it is such a short period compared to the long time during which the solution is put into practice.

Money, Value, and Prices

Although prices and values are often given in terms of money, money has nothing essential to do with the analysis. In demonstrating the equimarginal principle, for example, I converted cookies into money (bought one less cookie, leaving me with an extra dollar to spend on something else) and then converted the money into apples (bought 2 apples for \$1). The argument would have been exactly the same if there were no such thing as money and a cookie simply exchanged for 2 apples.

We are used to stating prices in money, but prices can be stated in anything of value. We could define all our prices as apple prices. The apple price of a cookie, in my example, is 2 apples that is what you must give up to get a cookie. The apple price of an apple is 1 (apple). Once you have the price of everything in terms of apples, you also have the price of everything in terms of any other good. If a peach exchanges for 4 apples, and 4 apples exchange for 8 cookies, then the cookie price of a peach is 8.

There are two ways of seeing why this is true. The simpler is to observe that someone who has cookies and wants peaches will never pay more than 8 cookies for a peach, since he could always trade 8 cookies for 4 apples and then exchange the 4 apples for a peach. Someone who has a peach and wants cookies will never accept fewer than 8 cookies for his peach, since he could always trade it for 4 apples and then trade the 4 apples for 8 cookies. If nobody who is buying peaches will pay more than 8 cookies and nobody selling them will accept less, the price of a peach (in cookies) must be 8. The same analysis applies to any other good. So once we know the price of all goods in terms of one (in this example apples), we can calculate the price of each good in terms of any other.

This argument depends on an assumption that has so far been implicit in our analysis—that we can ignore all costs of buying and selling other than the price paid. This assumption, sometimes called *zero transaction costs*, is a reasonable approximation for much of our economic activity and one that will be retained through most of the book. Exceptions are discussed in parts of Chapters 6 and 18. It is not clear that the assumption is reasonable here. Imagine, for example, that you have 20 automobiles and want a house. The cookie price of an automobile is 40,000; the cookie price of a house is 800,000. It seems, from the discussion of the previous paragraph, that all you have to do to get your house is trade automobiles for cookies and then cookies for the house.

But where will you put 800,000 cookies while you wait for the seller of the house to come collect them? How long will it take you to count them out to him? What condition will the cookies be in by the time you finish? Clearly, in the real world, there are some problems with such indirect transactions.

This brings us to the second reason why relative prices—prices of goods in terms of other goods—must fit the pattern I have described. Trading huge quantities of apples, cookies, peaches, or whatever may be very costly for you and me. It is far less costly for those in the business of such trading—people who routinely buy and sell carload lots of apples, wheat, pork bellies, and many other outlandish things and who make their exchanges not by physically moving the goods around but merely by changing the pieces of paper saying who owns what, while the goods sit still. For such professional traders, the assumption of zero transaction costs is close to being correct. And such traders, in the process of making their living, force relative prices into the same pattern as would consumers with zero transaction costs—even if they never consume any of the goods themselves.

To see how this works, imagine that we start with a different structure of relative prices. A peach trades for 2 apples and an apple trades for 4 cookies, but the price of a peach in cookies is 10. A professional trader in the peach-cookie-apple market appears. He starts with 10,000 peaches. He trades them for 100,000 cookies (the price of a peach is 10 cookies), buys 25,000 apples with the 100,000 cookies (the price of an apple is 4 cookies), trades the apples for 12,500 peaches (the price of a peach in apples is 2). He has started with 10,000 peaches, shuffled some pieces of paper representing ownership of peaches, apples, and cookies, and ended up with 2,500 peaches more than he started with—which he can now exchange for whatever goods he wants! By repeating the cycle again and again, he can end up with as many peaches—and exchange them for as much of anything else—as he wants.

So far, I have assumed that such a transaction—the technical name for it is *arbitrage*—has no effect on the relative prices of the goods traded. But if you can get peaches, in effect, for nothing, simply by shuffling a few pieces of paper around, there is an almost unlimited number of people willing to do it. When the number of traders—or the quantities each trades becomes large enough, the effect is to change relative prices. Everyone is trying to sell peaches for cookies at a price of 10 cookies for a peach. The result is to drive down the price of peaches measured in cookies—the number of cookies you can get for a peach. Everyone is trying to buy apples with cookies at 4 cookies for an apple. The result is to drive up the price of apples measured in cookies and, similarly, to drive up the price of peaches measured in apples. As prices change in this way, the profit from arbitrage becomes smaller and smaller. If the traders have no transaction costs at all, the process continues until there is no profit. When that point is reached, relative prices exactly fit the pattern described above—you get the same number of cookies for your peach whether you trade directly or indirectly via apples. If the traders have some transaction costs, the result is almost the same but not quite; discrepancies in relative prices can remain as long as they are small enough so that it does not pay traders to engage in the arbitrage trades that would eliminate them.

I have now shown that the price of peaches in terms of cookies is determined once we know the price of both goods in apples—precisely, if transaction costs are zero; approximately, if they are not. By similar arguments, we could get the exchange ratio between any two goods (how many of one must you give for one of the other) starting with the price of both of them in apples, or in potatoes, or in anything else. The equimarginal principle then appears as "the ratio of marginal utilities of two goods is the same as their exchange ratio." If 2 apples exchange for 1 cookie, then in equilibrium a cookie must have twice the marginal utility of an apple.

I used money in talking about values as well as in talking about prices. Here too, the money is merely a convenient expository device. The statement that the marginal value of something is \$0.80 means that you are indifferent between one more unit of it and whatever else you would buy if you had an additional \$0.80. Just as in the case of prices, the money serves as a conceptual intermediate—we are really comparing one consumption good with another. The arguments of this chapter could be made in "potato values" just as easily as in "dollar values." Indeed potato values are more fundamental than dollar values, as you can easily check by having a hamburger and a plate of french-fried dollars for lunch.

It is often asserted that economics is about money or that what is wrong with economics is that it only takes money into account. That is almost the opposite of the truth. While money does play an important role in a few areas of economics such as the analysis of business cycles, price theory could be derived and explained in a pure barter economy without ever mentioning money.

A similar error is the idea that economists assume everyone wishes to maximize his wealth or his income. Such an assumption would be absurd. If you wished to maximize your wealth, you would never spend any money except for things (such as food) that you required in order to earn more money. If you wished to maximize your income, you would take no leisure (except that needed for your health) and always choose the highest paying job, independent of how pleasant it was. What we almost always do assume is that everyone prefers more wealth to less and more income to less, everything else held constant. To say that you would like a raise is not the same thing as to say that you would like it whatever its cost in additional work.



• This lecture will help you understand the concept of consumer equilibrium and how it is reached.

Consumer Equilibrium

The condition that exists when the last rupee spent on one good provides the same marginal utility as the last rupee spent on every other good. In consumer equilibrium, income is allocated between the purchase of different goods in such a way that the level of utility cannot increased, that is, utility maximization has been achieved.

Consumer equilibrium exists when a consumer selects or buys the combination of goods that maximizes utility. This is achieved by equating the marginal utility-price ratio for each good consumed or by equating the ratio of prices and the ratio of marginal utilities. In other words, buyers are willing to pay relatively higher prices for goods that generate relatively more marginal utility.

How Equilibrium is Reached

In my analysis of consumption I have tried to do two things. The first is to show how rational behavior may be analyzed in a number of different ways, each presenting the same logical structure in a different language. The second is to use the analysis to derive three interrelated results.

The simplest of the three, derived once with indifference curves and once with marginal value, is that demand curves slope down—the lower the price of something, the more you buy. In both cases, the argument depends on declining marginal utility. In both cases, there is a possible exception, based on the ambiguity between a fall in price and a rise in income; in both cases, the ambiguity vanishes if we insist on a pure price change—a change in one price balanced by either a change in the other direction of all other prices or a corresponding change in income. It also vanishes if we assume that any one good makes up a small enough part of our consumption that we may safely ignore the effect on our real income of a change in its price.

A second result is that the value to a consumer of being able to buy a good at a price, which we call consumer surplus, equals the area under the demand curve and above the price. At this point, that may seem like one of those odd facts that professors insist, for their own inscrutable reasons, on having students memorize. I suggest that instead of memorizing it, you go over the derivation of that result (eggs and wine) until it makes sense to you. At that point, you will no longer need to memorize it, since you will be able to reproduce the result for yourself. It is worth understanding, and not just for passing economics courses. As we will see in later chapters, consumer surplus is the essential key to understanding arguments about policy ("should we have tariffs?") as well as to figuring out how to maximize profits at Disneyland.

The third result from these chapters is the equimarginal principle, which tells us that, as a result of our own rational

behavior, the ratio of the marginal utilities of goods is the same as the ratio of their prices. In addition to helping us understand consumption, the equimarginal principle in this guise is one example of a pattern that helps us understand how the high salaries of physicians are connected to the cost of medical school and the labors of interning, why we do not get ahead by switching lanes on the freeway, and how not to make money on the stock market.

Popcorn-an Application

In Chapter 2, I asked why popcorn is sold at a higher price in movie theaters than elsewhere. While we will not be ready to discuss possible right answers until Chapter 10, we can at this point use the idea of consumer surplus to show that the obvious answer is wrong. The obvious answer is that once the customers are inside the theater, the owner has a monopoly; by charging them a high price, he maximizes his profit. What I will show is that far from maximizing profits, selling popcorn at a high price results in lower profits than selling popcorn at cost!

To do this, I require the usual economic assumption that people are rational, plus an important simplifying assumption—that all consumers are identical. While the latter assumption is unrealistic, it should not affect the monopoly argument; if the theater owner charges high prices because he has a monopoly, he should continue to do so even if the customers are all the same. Here and elsewhere, the assumption of identical consumers (and identical producers) very much simplifies our analysis. It is frequently a good way of getting a first approximation solution to an economic problem.

The theater owner is selling his customers a package consisting of the opportunity to watch a film, plus associated goods such as comfortable seats, clean rest rooms, and the opportunity to buy popcorn. He charges his customers the highest price at which he can sell the package. Since the customers are identical, there is one price that everyone will pay and a slightly higher price that no one will pay.

In order to decide what to put into the package, the owner must consider how changes will affect its value to the customers and hence the maximum he can charge the customers for a ticket. Suppose, to take a trivial case, he decides to improve the package by giving every customer a quarter as he comes in the door. Obviously this will increase the amount the customers are willing to pay for a ticket by exactly \$0.25. The owner is worse off by the time and trouble spent handing out the coins.

Suppose the theater owner decides that since he has a monopoly on providing seats in the theater, he might as well charge \$1 for each seat in addition to the admission price. Since everyone wants a seat, the consumer is paying (say) \$4 for an admission ticket and another \$1 for a seat. That is the same as paying \$5 for admission. If the customer is not willing to pay \$5 for the movie, he will be no more willing when the payment is divided into two pieces; if he is willing to pay \$5, the theater owner should have been charging \$5 in the first place.

Now suppose the theater owner is trying to decide whether to sell popcorn in the theater at \$1/carton or not sell it at all. One advantage to selling popcorn is that he gets money for the popcorn; another is that customers prefer a theater that sells popcorn to one that does not and are therefore willing to pay more for admission. How much more?

Figure 4-8 shows a customer's demand curve for popcorn. At \$1/carton, he buys 1 carton. The shaded area is his consumer surplus-\$0.25. That means (by the definition of consumer surplus) that the customer is indifferent between being able to buy popcorn at \$1/carton and being unable to buy any popcorn but being given \$0.25; the opportunity to buy popcorn at \$1/ carton is worth \$0.25 to him. Making the popcorn available at that price is equivalent to handing each customer a quarter as he walks in the door; it makes the package offered by the theater (movie plus amenities-including popcorn) \$0.25 more valuable to him, so the theater owner can raise the admission price by \$0.25 without driving off the customers. The owner should start selling popcorn, provided that the cost of doing so is less than \$1.25/customer. That is what he gets from selling the popcorn-a dollar paid for the popcorn plus \$0.25 more paid for admission because the opportunity to buy popcorn is now part of the package.



One theater customer's demand curve for popcorn. The shaded triangle is the consumer surpluse frombuying popcorn at \$1/carton. The colored region (ABEDC) is the increase in his consumer surplus if price falls from \$1/carton to \$0.50/carton.

Is \$1/carton the best price? Assume that, as shown on Figure 4-8, the *marginal cost* to the owner of producing popcorn (the additional cost for each additional carton produced) is \$0.50/carton. He can produce as many cartons as he likes, at a cost of \$0.50 (for popcorn, butter, wages, and so forth) for each additional carton. Suppose he lowers the price of popcorn from \$1 to \$0.50. He is now selling each customer 2 cartons instead of 1, so his revenue is still \$1/customer. His costs have risen by

\$0.50/customer, since he has to produce 2 cartons instead of 1. Consumer surplus, however, has risen by the colored area on Figure 4-8, which is \$0.75; he can raise the admission price by that amount without losing customers. His revenue from selling popcorn is unchanged, his costs have risen by \$0.50/ customer, and his revenue from admissions has risen by \$0.75/ customer; so his profits have gone up by \$0.25/customer.

The argument is a general one; it does not depend on the particular numbers I have used. As long as the price of popcorn is above its marginal cost of production, profit can be raised by lowering the price of popcorn to marginal cost (MC on Figure 4-8) and raising the price of admission by the resulting increase in consumer surplus. The reduction in price reduces the owner's revenue on the popcorn that he was selling already by its quantity times the reduction-rectangle ABDC. The cost of producing the additional popcorn demanded because of the lower price is just covered by what the consumers pay for it, since the price of a carton of popcorn is equal to the cost of producing it; on Figure 4-8, both the additional cost and the additional revenue from selling popcorn are rectangle DEHG. Consumer surplus goes up by the colored area in the figurerectangle ABDC plus triangle BDE. Since the owner can raise his admission price by the increase in consumer surplus, his revenue goes up by (ABDC + BDE) (increased admission) + (DEHG - ABDC) (change in revenue from selling popcorn). His cost goes up by DEHG, so his profit goes up by the area of triangle BDE.

The same argument can be put in words, without reference to the diagram: "So far as the popcorn already being sold is concerned, the price reduction is simply a transfer from the theater owner to the customer, so revenue from selling popcorn goes down by the same amount that consumer surplus goes up (ABDC). So far as the additional popcorn sold at the lower price is concerned, the customer pays the owner its production cost (DEHG) and is left with its consumer surplus (BDE). So if we lower the price of popcorn to its marginal cost, consumer surplus goes up by more than revenue from popcorn goes down. The theater owner can transfer the consumer surplus to his own pocket by raising the admission price to the theater; by doing so (and reducing popcorn to cost), he increases his profit by the consumer surplus on the additional popcorn (BDE)."

This shows that any price for popcorn above production cost lowers the profits of the theater owner, when the effect of the price of popcorn on what customers are willing to pay to come to the theater is taken into account.

We are now left with a puzzle. We have used economics to prove that a theater owner maximizes his profits by selling popcorn at cost. Economics also tells us that theater owners should want to maximize their profits and know how to do so. That implies that they will sell popcorn at cost. Yet they apparently do not. Something is wrong somewhere; there must be a mistake either in the logic of the argument, in its assumptions, or in our observation of what theaters actually do. We will return to that puzzle, and two possible solutions, in Chapter 10.

- This lecture will introduce you to the supply side of economics. We'll look at the types of firm and the concepts of cost and revenue.
- Till the last class, we've been watching ourselves in the picture! You have been the center of attraction, hogging the limelight. You've seen how you can get the best out of the limited pocket money you extract from your mom or may be in some cases, the income that you earn out of the part-time job. You've also seen how to make the right choice between various alternatives and pick the one that's just made for you. This is what we call the utility theory in Economics, where you study the dynamics of economics from the point of view of consumer; which means you are looking at demand. Isn't it? Because consumer is the King. You create a demand for a particular commodity or service in the market.

But, wait a minute! Who fulfils your demand? Uhhh! No prices for guessing. C'mon! Where do you guys rush to when you run out of your stock of cola or your favourite brand of shampoo, sim card or anything or every thing on this earth that you cannot live without? You go either to a kirana store, internet café, departmental store, shopping mall or a book store for that matter. At this moment we need not go into the details of the size, functioning and financing of a firm. What is more important is that a firm basically fulfils your demand. It provides you goods and services.

Types of firms

Proprietorship:

- Full Control by Owner
- Little Legal Complication
- Reduced Tax Liability
- Unlimited Liability
- Limited Access to Capital Funding

Partnership

- Greater Access to Capital
- Reduced Tax Liability
- Unlimited Liability
- Legal Complication (Partnership Agreement)
- Need for Consensus among Partners
- **Corporation:** a firm that has a legal status as a fictional individual owned by stockholder(s), & run by its elected board of directors
 - Limited Liability
 - Increased Access to Capital
 - Infinite lifetime
 - Double Taxation
 - Hired Managers

Firm Financing

- Common Stock: Ownership rights to the firm & its profits (Voting Rights)
- **Bonds**: Firm borrowing by issuing promissory notes (Firm is committed to paying this until maturity)
 - Price of a bond is inversely related to the interest rate
 - r falls, the price of the bond rises
 - r rises, the price of the bond falls

Bondholders face risks from inflation Bondholder has a greater claim to the firm's assets in the case of bankruptcy

Retained Earnings (Plowback)

- The portion of profits the firm retains for investment back into the firms operations (Most Important source of investment for the firm)
- Borrowing from banks (Short term financing and cash flow)

Stock Markets

Operation of the Firm

Production

- Production Function: Underlying technical relationship of the factors of production.
- How does the firm combine K, L, and Raw Materials to produce output Q?
- Productivity of Inputs
- Time
- Short Run: Period of time where some inputs cannot be varied
 - Capital in place
 - Structures
 - Inputs such as labor or raw material
- In the Long Run, all inputs are variable

Short Run Production

- Inputs
- Output = f(Labor, Capital, other inputs)
 - Q = f(L, K, other inputs)
 - Variable inputs: Labor, raw materials
- Fixed inputs: Capital (Plant & Equipment)

Input Productivity

- Marginal Product: (Change in Output)/(Change in Input)
- Average Product: Output/Input
- Total Product

Now we move on to our next topic. A firm provides you the goods and services you demand or require, fine. But why

should anybody do this favour to you? Are we really living in a world where people are so selfless, that they would give you anything without expecting anything in return. Not really! So what does the firm expect when it provides you a good or a service

A firm obviously expects to make more than what it has spend to provide you a particular good or service. So just like you look for the best combination that maximizes your satisfaction, a firm would look for best way to maximize..... what?????? The buzz word of every businessman under the sun who cannot survive without it.... Profit.

How does a firm, producer, entrepreneur or a businessman make profits? While some of you must have already tried your hand at managing a school or college journal, others would be aspiring to become a media entrepreneur. Now tell me, what do you need to start a small journal? You need money, machine, computers, journalists, reporters, sub-editors and much more. All this would require a minimum of say...... 40,000 to start off. Now when you have invested so much money, you obviously expect something in return, unless you plan to do some charity which doe. After all your aren't launching this paper for charity, are you? So in that case, you would want your income to be more than expenditure.

In other words:

P (Profits) = R (Revenue) - C (Cost)

Cost

Now all that you've spend on bring out your journal is called the cost. To be more accurate it is the cost of production. This could include the raw material, rent that you pay; in case it's a magazine or a newspaper and not just a college journal then you will also have to pay for the labour that you employ, electricity bill, phone bill, printing etc.

Revenue

Revenue is the income that you get from the sale of the product or service. So the total income you derive from the sale of your journal will be your revenue. There could be some confusion in the understanding of revenue and profits. Some people the entire amount that you get after the sale of the commodity or service is called profits. But you get profit only when the revenue is more than the cost of production.

• This lesson explains the theory of costs and enlists the different kinds of costs.

Theory of Costs

Average Cost

If you think we're now beginning to use some loafty economic terms, don't you worry. Let's go step by step.

When we say the average percentage of this class is 70 per cent, we mean, most of the students score atleast 70 per cent. And we arrive at average cost by dividing the total number of marks by the nuber of students.

That's exactly what we mean by average cost. It is the average cost of each unit of product. In order to maximise profits, the producer would always want to reduce his average cost.

Marginal Cost

Let's test your memory. Do you remember the law of diminishing marginal utility. There we had used this term called marginal utility. It is utility derived from the consumption of an additional unit of a commodity. Similarly marginal cost is the cost incurred to produce an additional unit of commodity.

Then we also fixed cost and variable cost.

Fixed cost is the cost incurred to employ fixed inputs like plant, machinery etc, where as variable cost is the cost incurred to employ variable inputs like salery, raw material etc.

Average Cost (AC)

The average cost is the total cost divided by the number of units produced.

It is important to understand that firms maximize profits by considering the marginal cost, not the average cost. The difference between the average cost and the sales price does determine the profits per unit once the profit maximizing quantity is determined, but the profit maximizing quantity generally does not maximize profits per unit.

Average Cost Definition

The average cost of a unit of product is made up of its fixed costs/#units produced, and the variable cost per unit. With digital products, where the variable costs are very small (and in some instances zero) the average cost of the product declines as more units are produced and sold. Thus the market leader for a product typically has the lowest average costs per unit. This allows the leader to have increased margins, and increased flexibility to lower price. This is one of the reasons why first-mover advantage can be so important.

Marginal Cost (MC)

The marginal cost of an additional unit of output is the cost of the additional inputs needed to produce that output. More formally, the marginal cost is the derivative of total production costs with respect to the level of output.

Costs of Production

The following concepts provide information on how costs change to produce *different levels of output*. (The previous section focused on how revenues and costs change when inputs change).

Definitions

Opportunity cost is equal to the value of other opportunities given up in order to produce any good.

Total Variable Cost (TVC) – total cost to employ variable inputs to produce a given level of output. Variable costs change as output levels change.

Total Fixed Cost (TFC)— total cost to employ fixed inputs. Fixed costs do not change as output levels change.

Total Cost (TC) – total cost of producing a given level of output including both variable and fixed costs. TC is calculated as:

TC = TFC + TVC

Average Variable Cost (AVC) – the variable costs *per unit* of output when producing a certain amount of output. AVC is calculated as:

Total Variable Cost / Output = TVC / Y

Average Fixed Cost (AFC) – total fixed costs per unit of output when producing a certain amount of output. AFC is calculated as:

Total Fixed Cost / Output = TFC / Y

Average Total Cost (ATC) – total costs per unit of output when producing a certain amount of output. ATC is calculated as:

Total Cost / Output = TC / Y = AVC + AFC

Marginal Cost (MC) – change in the cost to produce an additional unit of output. MC is calculated as:

Change in TC / Change in Output or Y

Or

Change in TVC / Change in Output or Y

The relationship between ATC, AVC, and MC is shown on the graph below (note that output is now on the horizontal axis) Note the general relationships between the cost curves



• In this lesson you will not get acquainted with the theory of supply but also learn to derive the supply curve.

Theory of Supply

If you remember the theory of demand, there was an inversely proportional relationship between price and demand. Price rises demand falls and price falls demand rises. In case of the theory of supply, it's exactly the opposite:

Your nearest department storewallah or would be happy to sell all his hoarded stock of onions when the price rises so that he can cash on the opportunity. But when the price falls he will immediately hoard the goods and stop the supply. He would rather wait and watch the situation.

• This lesson introduces you to market and the dynamics of competition.

Market & competition

What is market? Well, it is as simple as asking oneself: Where do I go to buy my pen, book, or chocolate or chips. Market is a place where sellers sell goods and services and consumers buy products that fulfill their requirements. In fact you can call it the meeting ground of buyers and sellers – A place where goods are bought and sold.

Competition

Why does competition arise in the first place? There is competition both among buyers and sellers.

Buyers want to strike the best deal and purchase a commodity or a service for the least price, whereas sellers look forward to selling most of their output so that they earn maximum profits.

• This lecture gives a complete picture of the types of competition.

Types of Competition

Based on the size and competition, markets can be divided into various types.

- Perfect Competition & the Market:
- The Firm Under Perfect Competition
- Industry Under Perfect Competition

Types of Markets

- Perfect Competition
- Monopoly
- Monopolistic Competition
- Oligopoly

Perfect Competition

- Numerous small firms & customers
- Product Homogeneity
- Easy Entry & Exit (Free)
- Perfect Information

The Firm under Perfect Competition

- Price Taker: It faces the price determined in the market.
- The firm faces a horizontal or perfectly elastic demand curve
- The Firm is a profit maximizer
 - MR=MC
- Since the firm faces a horizontal demand curve
 - P = MR = MC

The Firm in the Short Run

- Short Run Profit (Figure 9-2, p 214)
- Short Run Losses (Figure 9-3,, p. 216)

The Firms Shut Down Decision

- TR> TC> TVC Profit
- TC> TR> TVC Remain Open
- Suffer a loss (FC)
- TC>TVC>TR Shut Down
- Cannot recover Variable Cost
- AC>P=MC>AVC Remain open
- Suffer Loss
- AC>P=MC=AVC Shut Down Point
- P=MC>AC Profit

Firm's Supply Curve

• Short Run -

- As long as P=MC>AVC it pays to operate
- P<AVC Shutdown
- The Firm's Supply Curve is MC above the point where: MC=AVC

The Industry

• The Industry Supply Curve is the horizontal summation of each individual firm's supply curve.

Short Run Equilibrium

- Where Industry Supply Curve intersects the Market Demand Curve
- Firm's may be earning an economic profit, normal profits (zero economic profit), or a loss.

Long Run Dynamics

- If Firms are earning a profit
- This invites entry into the market
- Industry Supply Curve shifts out
- P falls, supply shifts out until we reach the point where firms earn zero economic profit.
- If Firms are losing money
- Firms Exit the Market
- Industry Supply shifts in
- P rises until firms earn zero economic profit

In both cases Long Run Equilibrium results in firms operating at:

- P=MC=AC
- Long-Run Industry Supply is the Industry's LR Cost Curve
- Perfect Competition is efficient because every firm produces at minimum average cost, thus outputs are produced at the lowest possible cost to society

Perfect Competition

Perfect competition is a very ideal market condition which does not exist in reality at all. The very first condition of perfect competition is that there should be equal number of buyers and sellers which never happens in reality. It is a theoretical concept that cannot be practiced.

A market structure in which:1. All firms sell an identical product.2. All firms are price takers.3. All firms have a relatively small market share. 4. Buyers know the nature of the product being sold and the prices charged by each firm.5. The industry is characterized by freedom of entry and exit.

Perfect competition is a theoretical type of market structure. It is primarily used as a benchmark in comparison with other market structures. The industry which best reflects perfect competition in real life is agriculture. This is sometimes referred to as pure competition. Why does competition arise in the first place? There is competition both among buyers and sellers.

Buyers want to strike the best deal and purchase a commodity or a service for the least price, whereas sellers look forward to selling most of their output so that they earn maximum profits.

Imperfect Competition (Monopoly)

Imagine the kirana store you go to buy your things was the only store in the entire locality. Not only would that limit your choice but also give an opportunity to the kiranawallah to do what he wants. He could stock the goods and sell a commodity five times costlier. He can easily compromise on quality since there is no other choice. So as the term suggests Mono = 1 ie it is the control of one seller over the market.

Monopoly

- Monopoly an industry in which there is only 1 supplier of a product for which there are no close substitutes
- Pure Monopoly additionally implies that it is virtually impossible for another firm to coexist in the industry.

Causes of Monopoly

- Legal Restrictions
- Patents
- Control of a Scarce Resource or input
- Deliberate Entry Barriers
- Large Sunk Costs
- Technical Superiority
- Economies of Scale
- Being First in an industry
- Geographic (Regional)

Profit Maximization & the Monopolist

- The monopolist faces the entire market demand curve.
- Monopolist faces a downward sloping MR curve
- The Monopolist is a price maker
- Sets price to maximize profit
 - MR = MC < P
 - Monopolist chooses the level of output where MR=MC
 - Price is established from the market demand curve (at profit maximizing level of output)
- As a result of profit maximizing behavior there is no supply curve in a monopoly market

Monopoly vs Perfect Competition

- Profit can Persist
- Output is restricted to maintain profit
- Price is higher than perfect competition (short run & long run)
- Monopoly leads to inefficient resource allocation:
 - MC = MR < P = MU so MC < MU
- Monopolist may have no reason to produce at minimum costs

Monopolistic Competition

Do you ever wonder why companies spend so much money trying to convince us that their laundry detergent will leave our clothes the cleanest or how a talc can do wonder in one's life? This describes the essence of monopolistic competition, an industry structure that combines aspects of perfect competition and monopoly.

Like perfect competition, firms produce goods that share many similar attributes with other goods of their class. The obvious goal of advertising is to give information about the advantages of a product, or to create the perception of differences when none really exist. It doesn't really matter if there are actual contrasts in products, as long as the consumer believes there is.

As we know from perfect competition, if products are identical (and known to be so) then the firm faces a horizontal demand curve and accepts the market price. Firms would prefer to face a downward sloping demand curve where they have some degree of control over the price they can charge for the good, since by charging a higher price, they may be able to increase profits. Contrasting a perfectly competitive firm to a monopolist facing a downward sloping demand curve shows that monopoly profits are higher.

Firms advertise to create some degree of brand loyalty among consumers who believe their product is superior, and may be willing to pay a bit more for that brand than another. By creating differences in goods, firms then have a downward sloping demand curve for their product, like a monopolist.

Remember that in the perfectly competitive industry, if a firm tries to raise price above the market price, demand falls to zero as consumers switch to perfect substitutes. However, in monopolistic competition where the firm faces a downward sloping demand curve, the firm can raise prices without losing all of its customers. The amount of sales it will lose depends on the elasticity of demand in the range of the demand curve where it is raising prices. In competitive industries entry is relatively easy and we see this with many popular consumer goods and brand competition.

Monopolistic competition is the closest to reality. Usually manufacturers try creating distinct brand images through advertising. The different brands of toothpastes vying for attention are the best examples of monopolistic competition.

Oligopoly

The easiest way for a firm to compete is with price - charge less than the other firms for a quality product and take significant chunks of their market share. But cutting prices often leads to lower profits. Advertising is a way for firms to avoid serious price competition - look at the auto industry. An even better way for a firm to avoid price competition is to cooperate or directly collude with your competitors.

Note how two gasoline stations located across the street from each other charge an identical price. It would be easy for one station to undercut its competitor by a few cents and grab an increased market share. But the station owner knows that if he cuts his prices, the station across the street will match the price cuts and they will both end off with lower revenues and only the consumer will gain. Why cause trouble? Direct collusion between businesses to restrict competition in the United States is illegal, but it certainly happens. One form of cooperation is through tacit collusion where firms have an understanding to avoid competition. We see this in the steel, auto, airline and other industries where the industry often exhibits **price leadership**. For example, when an airline announces a fare cut, their competitors immediately match the rate. From there, fares are allowed to move upward with little fanfare until the next slow period, when rate cuts are once again temporarily enacted. Price leadership implies that one firm in the industry sets prices and the other move in unison. If a gas station in a cluster changes its price per gallon, the others soon match the change in price.

How effective firms are in maintaining oligopolistic and anticompetitive behavior depends on the ease of entry for new firms into the industry. The auto industry has maintained good discipline due to the prohibitive cost of entry into the industry. In contrast, the airline industry has occasionally disintegrated into debilitating price wars as new firms can quickly establish a market share in certain routes.

A legal way to restrict competition and limit entry into an industry is to form a **cartel**. Examples of legal cartels include the medical and legal professions that restrict entry based on academic and certification requirements. To become recognized as a physician you must complete medical school and other required training.

• Just like consumer equilibrium, you will learn about the market equilibrium in this chapter.

Market Equilibrium

Consider the market for paneer. If your local shopkeeper thinks he will be able to sell paneer at Rs 25 per packet, he will keep 150 packets for sale in a given week. But he can never be sure of the level of demand. He takes **risk** and carefully monitors the level of his **stocks of unsold paneer**.

But it looks like he will only sell 50 packets of paneer (point \mathbf{K}) by the end of the week, and not the 150 packets he had expected. What does your shop keeper do? He lowers his price for paneer, in an attempt to sell more packets. If he does not lower his price, he risks making a loss on the unsold stock.

Equilibrium is the point where the demand and supply curve converge. Just like consumer equilibrium it is the point of ultimate satisfaction for the seller.

• In this lesson you will get an overview of postindependence scenario of India, especially with reference to the economic challenges facing the country.

ECONOMIC CHALLENGES FACING A NEWLY INDE-PENDENT INDIA (Scourges of poverty & unemployment)

OBJECTIVE: This lesson will discuss the basic issues and challenges facing the Indian Economy in post independence period.

India awakes to Freedom

To borrow a tired cliché: August 15, 1947 is a red-letter day in India's history. India's first Prime Minister Jawaharlal Nehru made lofty remarks about our tryst with destiny. But what really was the tryst all about? Was it only about liberating Indians from the oppressive clutches of the imperial British Empire? Was it only about Indians reclaiming their motherland, their ancient civilization that was lying moribund for centuries? Was it only about political freedom, a flag, a national anthem and the unfettered right to claim a rightful status as an independent nation?

It was all that, no doubt. But there was much more to India's tryst with destiny on August 15, 1947. In fact, Nehru had clearly pointed out the challenges confronting a newly independent India during his tryst with destiny speech. According to him, the twin challenges confronting the newly born India were poverty and unemployment. The vast majority of Indian masses were mired in poverty of the most inhuman kind. The Bengal famine of 1943, which had killed perhaps as many as 5 million Indians, was fresh in the memory of Indians. The two hundred years of colonial rule had left deep scars not just on the psyche of Indians, but also on the economic structure of the country. And the scars were so deep that healing them was going to be a monumental challenge.

India: From Fabulous Wealth to Poverty

A lot of you would probably be aware of the fact India was one of the richest nations of the world in 1611 when the British first set foot on Indian soil. Of course, poverty was endemic no doubt. Landless peasants and tribals virtually lived on the edge of survival. Yet, the poverty in Europe was worse. Of course, the rich in India in those days could boast of standards of living which most people in Europe could not even dream of. More importantly, the industrial sector of India was highly advanced compared to the technology available in the 16th and 17th centuries. Indian textiles, handicrafts and spices dominated the global markets of that era.

Yet, even as the Mughal Empire attracted envious glances from everyone because of its grandeur, pomp and wealth; Europe was moving ahead in technology, fire arms and the art of warfare. A decisive edge in military technology enabled the Britishers to take political and military control of vast swathes of India. The first period of rule by the East India Company was marked by plunder of Indian wealth. If you recollect, this plunder had been preceded by numerous invasions in earlier centuries when invaders ranging from Mohammed Ghazni in the 11th century to Nadir Shah in the 18th century had resulted in a huge and unprecedented loss of wealth.

Interestingly, if you look at how easy it was for foreign invaders to loot Indians; and for dictatorial powers to loot the same Indians in the name of taxes, you will understand the Indian obsession with gold. Large assets were not easy to hide. Gold was. So Indians got into the habit of investing in gold and secreting them in nooks and corners. It was easier to take the gold and run when yet another invasion swept across the country. While gold is a useless asset in the sense that it gives no returns to a saver, the Indian psyche has been so deeply scarred that our magnificent obsession with gold continues even in the 21st century. Did you know that India is the largest importer and consumer of gold in the world; followed by China, of course!

Understanding Economic Growth & Development

The earlier class has given you a bird's eye view of India's economic position on the threshold of independence. In fact, rather than call it position, we can call it India's dire economic straits. The previous class also touched upon some fundamental reasons why India was transformed from being a major economic power of the world during the 17th century, controlling 35 % of the world trade, to a hopelessly poor country by 1947, controlling about 3 % of the world trade.

The challenge before Nehru and his team when India emerged as an independent nation was simple: how to trigger a high rate of economic growth on a sustained basis so that India catches up with the economically advanced western countries; and that the standard of living of Indians improves steadily over time. The logic was:

- A high and sustained rate of **GDP growth** would result in a high and sustained rate of growth in **per capita incomes,** resulting in improved living standards for Indian citizens
- A high and sustained rate of growth in GDP would be possible only if there was **massive industrialization** and significant improvements in **productivity in agriculture.**
- This was possible only if there was a sustained rise in the **savings and investment rates** in the country.

For those who have studied—and more importantly understood, not mugged—a little bit of economics during their plus two years, the terms marked in bold above may not be sounding Greek mythology. But I am sure a large number of you students must also be scratching their heads in despair. If you do not have a formal training in, and even for many who have studied it, economics can be an intimidating subject. Many students run away from economics as if their very lives are in danger. That's quite sad because it can be one of the most fascinating, and even exhilarating, subjects to ponder, discuss, debate and argue over. And it should be that way, for economics is really the bedrock of the existence of individuals, families, communities and societies.

My advice to those who are tying up their shoelace is: relax; economics is not all that intimidating. In this, and subsequent lectures, you will realize that the esoteric terms and jargon which you seem to confront every now and then while making a valiant effort to study economics is really common sense if someone takes the trouble to explain the jargon in layman's terms. I had the great fortune of having a smashingly wonderful teacher who explained micro economic and macro economic theory to us; and made it so fascinating that I have been hooked ever since.

Anyway, let's get back to the jargon related to the growth and development related challenges confronting Nehru and his team as they prepared to **transform a newly independent India from a resource rich yet poverty stricken country to a nation whose economic might could rival that of the rich western nations like the United States and United Kingdom.**

The first concept we need to get a hang of is income and growth in income, along with per capita income. Forget about jargon like GDP et al for the moment. **Just think of your family as a nation.** Odds are, both your mother and father (lets hypothetically call them AB and Hema Malini (HM). Lets say you are two offspring: AB Jr. and Amisha Patel (AP). So your family constitutes of AB, HM, AB Jr. and AP.

Do you ever have any problems in answering the question: what is your family income? Odds are, you know how much your parents earn; you know how much AB Jr. and AP earn by working part time in McDonalds or Pizza Hut.

In your family's case: the GDP of your family is the combined income of all the family members. The same logic can be extended to the whole country. The combined income of all citizens of a country can be roughly called the GDP of the country. Economists prefer to define GDP as the combined value of all goods and services produced in the country. But you guys need not worry about the finer nuances. At the moment, be happy to know that GDP of a country is roughly the combined aggregate income earned by all citizens.

Not very difficult, isn't it? Equally simple to understand is the concept of **per capita income**. Take the case of your hypothetical family. Lets say AB, HM, AB Jr. and AP together earn Rs 1,00,000 or Rs 1 Lakh a month. The per capita monthly income of your family is Rs 1 lakh divided by 4, i.e. Rs 25,000 or Rs twenty five thousand. In layman's terms, **per capita income** of a country is average income of a citizen. Economists prefer to calculate per capita income in annual terms. So, in the case of AB's family, economists would say that the per capita income is Rs 25,000 multiplied by 12 (12 months in a year) i.e. Rs 3 lakh or Rs 3,00,000. Exactly the same way we calculate the per capita income of a country's population is 1 billion. Quite simply, the next time someone asks you what is the per capita income of India, you say \$ 550 divided by 1 billion, i.e. \$ 550.

Not all that difficult to comprehend, isn't it? But there are some finer nuances you need to grasp here before you can proclaim that you have finally got hold of an esoteric thing called economics. **The magic, and the tragedy of economics is that** everything is measured in terms of money, or cash if you prefer. No cash, and no economics. Which means that when economists calculate GDP and per capita income, they take into account only those things which have a directly attributable monetary value, or if a monetary (cash or cheque) transaction has taken place. Which is why many philosophers have rightly pointed out that concepts like GDP and per capita income do reflect the financial well being of a nation and its citizens, but not the over all well being.

We go back to the familiar AB family to illustrate the power of cash in economics. Just think about the yummy and delicious meals cooked by your mom (and your dad if he is an evolved metro sexual man!!). Think about it again. Despite microwaves and food processors, your mom does have to slog it out to turn in a great meal for AB, HM, AB Jr. But then, does your mom charge you or your dad any money for cooking that great meal? No, isn't it? Then as far as economics is concerned, all that effort, and your enjoyment have no value. Your per capita income will not increase if your mom cooks a great meal. But if you pay maidservant a monthly salary to cook your meals, her family's per capita income will definitely increase! And because the income of the maidservant's family will increase, so will India's GDP!

If you are meditating quietly in your house to ease off the ugly pressures of contemporary urban life, your personal well-being may improve. But that will not make any difference to GDP or per capita income. However, if you pay Rs 750 for the foundation course of The Art of Living, your personal well-being may not improve; but India's GDP will definitely increase by Rs 750!

The key here is: only cash and cheque transactions have an impact on the value of national income, GDP and per capita income.

This single-minded focus on money and the monetary value of goods, services and work and led to many controversies. Philosophers, economists and critics have pointed out the fact that while cash is king, money is not everything!! They insist that just measuring per capita income of a country is not a sufficient indicator of the quality of life of its citizens. According to this school of thought, there are many more factors that influence the quality of life of a country's citizens. Take Saudi Arabia, for example. The country boasts of one of the highest per capita incomes in the world. But then, as critics point out, literacy, access to health care, human rights, political freedom are things which the average Saudi Citizen misses out on. There are many countries with per capita income lower than Saudi Arabia. But by the rules of this school of thought, countries which offer better education, better healthcare and more freedom to their citizens should be ranked well above Saudi Arabia even though the desert kingdom is rolling in cash.

To a large extent, this point has been taken care of by contemporary economists. The United Nations Development Program (UNDP) now brings out an annual list that ranks countries by what is called the Physical Quality of Life (PQLI) index or the Human Development Index (HDI). The HDI index measures not just the per capita income, but also things like infant mortality, literacy, number of doctors per thousand population and many other social indicators that show the quality of life of a nations' citizens.

Though cash is still king in economics, the HDI is now universally accepted as a better measure of the well-being of a country and its citizens than just per capita income. If you look at it from the point of view of AB and his family, this too ends up making a lot of sense. Lets say AB and his family earn Rs 1 lakh per month. Wouldn't their quality of life be better if they are staying in an unpolluted area as compared to a slum? Wouldn't their quality of life be better if AB Jr. and AP are studying in St Stephen's College instead of some college in a moffusil town? Wouldn't their quality of life be better if AB and family bonded especially well and spent quality time with each other—exchanging anecdotes over informal dinners instead of being cocooned in their won shells? Doesn't your quality of life improve when you make more friends and spend quality time with siblings, parents and cousins?

The simple point for us to understand is: money is vitally important, perhaps the most important ingredient for improving the quality of life. But, it is not everything. Remember a famous song by Beatles: Money can't buy me love !!!

If you are an Indian, you will not be a happy one because whether it is per capita income or the quality of life index, our country is way, way below in the bottom heap of nations. Pakistan and India keep exchanging positions between rank 125 and rank 130 when it comes to quality of life.

That's precisely what we will be discussing in subsequent

chapters: why is that India could not—and has still not—fulfilled Nehru's dreams of eradicating poverty and unemployment.

But before we do that, we must wade through some other jargon. Remember the first part of this lecture? I think you have forgotten. To remind you, we still nee to get a hang of concepts like rapid industrialization, drastic increase in agriculture productivity, a sustained increase in the savings and the investment rate of a nation.

Sounds intimidating? Don't be. As I keep repeating, these are simple concepts once they are explained in layman's language. Till next class

India got her freedom in 1947, after 200 years of colonial rule. British rule destroyed the internal economic fabric of the country. The massive economic drain, socio-economic oppression, commercialization of agriculture, introduction of zamindari system, utter neglect of traditional industries, handicrafts, changes in land relations all impacted severely upon Indian economic structure.

The national government of the country inherited a critical land relation, a low productivity, very limited rate of capital formation, a low level equilibrium trap, vicious circle of poverty, a massive unemployment — chronic, seasonal structural.

It was a major challenge of the government for reorganization of the economy. As agriculture was the main source of livelihood so it was a major responsibility on the part of the government was to reorganize land relation, environment and semi-feudal characteristics of agriculture. The zamindars and intermediaries did not take any active interest in developing agriculture. They were only interested for cornering the surplus, which were collected forcefully. The reorganization of land relation was to arouse permanent and direct interest of tillers for development of agriculture.

Agriculture surplus would pay for industrial products. So industry will have to be strengthened for developing the country to remove poverty and unemployment. Industrialization will also increase the rate of increase in GNP. That is why there would be more stress on industrialization to make Indian economy a productive one and to remove poverty and unemployment.

The poverty India had inherited during 1947 was precarious. More than 50% of the population was below the poverty line. It was immediate responsibility of our government to provide jobs to our millions. Government created various institutions. They built up the Planning Commission to co-ordinate the effort of planning and economic development. The Planning Commission coordinated the issues, strategy of growth and development. The government of India changed the status of R.B.I through RBI Act 1948. The situation in the entire economic exercise was to give more stress on social development as well as policies which would include raising the level of industrial standards, literacy, average life expectancy and extending the periphery of social health. While addressing these issues, a lot of institutions would have to be built up and a lot of employment opportunities would be created. However through developing such institutions a large number of employment opportunities was created in both organized and unorganized sector. India needed to offer gainful employment to 5 million people in the organized sector.

Another challenge for Indian economy was making Indian economy a productive one. A major challenge was to ensure family welfare programmes which would ensure reduction of and control of population growth.

The challenges were vast. The first responsibility was to make the people aware about the menace but unfortunately such wider campaign could not be possible and no significant step could be adopted for control of population. Control of population would also be a great contribution to reduce the course of unemployment.

It is a matter of great regret that during the British rule agricultural output suffered a major setback and low productivity. Total output in agriculture increased by only 10% during 52 years period of 1893-94 to 1945-46. The index of food grains came down from 100 to 93 during this period. The per capita availability of food grains also came down to 587 lbs to 399 lbs i.e. by 32%. A stagnant agriculture, with inequitable ownership of land and massive expropriation of subjects which resulted in abject poverty and recurrent famine.

The challenges before the national government would be to make the economy out of the scourge of backwardness, low productivity. The poverty and unemployment were outcomes

ECONOMICS FOR MEDIA

of these features. Keeping in view the situation the real challenges were

- 1 To ensure fair distribution of National Income.
- 2 To increase the living condition of people.
- 3 The improve quality of life.
- 4 Changes in the institutional setups, technology
- 5 Reorganization of economic institutions
- 6 End of feudalism in the production relations.

• In this lesson you are introduced to the genesis of planning, the rationale behind the five year plans and its objectives.

So far, there is a lot of distance that we have covered in understanding what economics and Indian economy are all about. We have figured out why consumers behave the way they behave and how they maximize their utility or satisfaction; we have seen how firms or companies behave the way they behave and how they try to maximize their profits; and of course, we have also figured how the consumer and the firm (the agents of demand and supply) meet in the marketplace and interact with each other to reach what is described in economics jargon as the market equilibrium; not to forget that we have also figured out various ways in which markets behave and the types of competition that one can encounter in the market place.

Coming to Indian economy, we have already figured out the basic concepts of growth, development, the kind of challenges faced by India during independence and the various ways and means by which an economy can take the high road to rapid economic growth. By rapid economic growth I mean how savings and investments can trigger a rapid growth rate of GDP and per ca[pita income. The net result: a more prosperous society where citizens of a country earn more and spend more.

Now comes the time to finally understand why Nehru opted for the kind of policies that he did. To be able to better understand the world around us as communication professionals, we need to really understand why Nehru took India along the path India took. The path of socialism, the path of public sector and the path of crazy discretionary controls which eventually bred smuggling, black marketing, hoarding and of course, India's chief curse—that of endemic corruption.

Try and imagine India when it became a free country in 1947. As discussed in earlier lectures, Nehru and his team confronted the twin challenges of poverty and unemployment. There was consensus on the fact that the only way India could eliminate, or at least drastically reduce poverty and unemployment was to ensure that the rate of growth of GDP (you should be familiar with all this now) was very high. The result of that would be a higher rate of growth of per capita income. And a sustained increase in the per capita income of the country would mean that Indians were becoming more prosperous. There was also consensus on the issue of how important savings, investments and productivity were to ensure that the GDP of India does grow at a faster rate on a sustained basis.

It all appears very simple and clear on surface. But things were not so simple. For instance policy makers in India had to answer some basic questions: who will do the savings for the economy who will do the investments for the economy; and who and how will productivity of investments be increased in a sustained manner so that GDP growth rates are increased. How was the world positioned after the Second World War that ended in 1945?

No doubt, the United States of America (U.S.A or the US)

Genesis of Planning in India

Planning is process in which economic decision are made how much to be produced, for whom to be produced by the conscious decision of a determinate authority on the basis of survey of the economic system as a whole. The philosophy and principle of planning depends upon economic necessities and resource endowment of a country.

Planning is necessary for rational allocation of resources to attain certain well-defined objectives with limited resources and burning needs of the economy within a limited time frame. The planning is to be done by the central authority and its direction is bindings on everybody. If it is a democratic planning, there is a scope of taking decision after a mutual discussion among the panchayats and then the steps are taken for implementation. The implementation process is subject to principles and philosophy of planning.

The planning is more or less a process allocation. The first planning system started in Soviet Russia where centralized planning system was much successful. India got her inspiration from Russian planning exercise. The ideas of Soviet Revolution inspired the freedom struggle of India and leaders like Pundit Nehru, Netaji Subhas Bose were highly motivated by the Soviet Unions experiment with planning. In 1939, when Subhas Chandra was Congress President he established a National Planning Committee under the chairmanship of Pundit Nehru.

Meanwhile M.N Roy a noted freedom fighter prepared "people plan". M.Visheshwariya the famous engineer from Karnataka also prepared a scheme of planning but with limited variables. The real exercise started after India became free and Pt Nehru as a chairman of Planning Commission and Dr. P.C. Mahalonobis as deputy chairman started the exercise of planning in India. The first model was done on the basis of Harrod and Domar growth model as well as Feldman model and much stress was given on the capital output ratio as technique of achieving the planning investment target with various c/o ratio for various sectors of the economy. The first year plan was a more or less a model plan trying to build social overhead capital. The formal and rigorous exercise or planning was done for second five-year plan, which began in 1956.

India Awakes to Freedom

To borrow a tired cliché: August 15, 1947 is a red-letter day in India's history. India's first Prime Minister Jawaharlal Nehru made lofty remarks about our tryst with destiny. But what really was the tryst all about? Was it only about liberating Indians from the oppressive clutches of the imperial British Empire? Was it only about Indians reclaiming their motherland, their ancient civilization that was lying moribund for centuries? Was it only about political freedom, a flag, a national anthem and the unfettered right to claim a rightful status as an independent nation?

It was all that, no doubt. But there was much more to India's tryst with destiny on August 15, 1947. In fact, Nehru had clearly pointed out the challenges confronting a newly independent India during his tryst with destiny speech. According to him, the twin challenges confronting the newly born India were poverty and unemployment. The vast majority of Indian masses were mired in poverty of the most inhuman kind. The Bengal famine of 1943, which had killed perhaps as many as 5 million Indians, was fresh in the memory of Indians. The two hundred years of colonial rule had left deep scars not just on the psyche of Indians, but also on the economic structure of the country. And the scars were so deep that healing them was going to be a monumental challenge.

India: From Fabulous Wealth to Poverty

A lot of you would probably be aware of the fact India was one of the richest nations of the world in 1611 when the British first set foot on Indian soil. Of course, poverty was endemic no doubt. Landless peasants and tribals virtually lived on the edge of survival. Yet, the poverty in Europe was worse. Of course, the rich in India in those days could boast of standards of living which most people in Europe could not even dream of. More importantly, the industrial sector of India was highly advanced compared to the technology available in the 16th and 17th centuries. Indian textiles, handicrafts and spices dominated the global markets of that era.

Yet, even as the Mughal Empire attracted envious glances from everyone because of its grandeur, pomp and wealth; Europe was moving ahead in technology, fire arms and the art of warfare. A decisive edge in military technology enabled the Britishers to take political and military control of vast swathes of India. The first period of rule by the East India Company was marked by plunder of Indian wealth. If you recollect, this plunder had been preceded by numerous invasions in earlier centuries when invaders ranging from Mohammed Ghazni in the 11th century to Nadir Shah in the 18th century had resulted in a huge and unprecedented loss of wealth.

Interestingly, if you look at how easy it was for foreign invaders to loot Indians; and for dictatorial powers to loot the same Indians in the name of taxes, you will understand the Indian obsession with gold. Large assets were not easy to hide. Gold was. So Indians got into the habit of investing in gold and secreting them in nooks and corners. It was easier to take the gold and run when yet another invasion swept across the country. While gold is a useless asset in the sense that it gives no returns to a saver, the Indian psyche has been so deeply scarred that our magnificent obsession with gold continues even in the 21st century. Did you know that India is the largest importer and consumer of gold in the world; followed by China, of course!

Five-year Plans and Socialistic Policies

This lesson provides a Comprehensive review of Indian Planning in the light of development theory over the last three and a halfdecades. It presents an analysis of what led India to opt for development planning in the first instance, of the difficulties encountered, and the relevance in contemporary India. It has been explained by variety of factors like Indira Gandhi's hard socialism, reforms of 80's & many more

Rationale Behind Five Year Plans

During the first half of the twentieth century, there was little economic growth in India. When this country got independence in 1947, not only was its economy in a stagnant condition, it was also confronted with a number of difficult problems, which called for an urgent solution. The per capita income of India was extremely low and there was an ever-present menace of rapidly growing population due to ill developed resources the standard of living was very low and the vast majority of the people live in the state of appalling poverty. India suffered from (a) insufficiency of production, (b) instability of economic life, and (c) inequality of distribution and a host of other economic ills. Obviously for solving these problems the country could not rely on the market mechanism alone. Further it was doubtful that the economy of this country could even break the low-level equilibrium trap to end the long spell of stagnation. Keeping in view these difficulties, planning as an instrument of economic development had to be adopted to remove all economic ills

Economic Planning for India?

One of the major objective of planning in India is to increase the rate of economic development, implying that increasing the rate of capital formation by raising the levels of income, saving and investment. However, increasing the rate of capital formation in India is beset with a number of difficulties. People are poverty ridden. Their capacity to save is extremely low due to low levels of income and high propensity to consume. Therefore, the rate of investment is low which leads to capital deficiency and low productivity. Low productivity means low income and the vicious circle continues. Thus, to break this vicious economic circle, planning is inevitable for India.

The market mechanism works imperfectly in developing nations due to the ignorance and unfamiliarity with it. Therefore, to improve and strengthen market mechanism planning is very vital. In India, a large portion of the economy is nonmonitored; the products, factors of production, money and capital markets are not organized properly. Thus the prevailing price mechanism fails to bring about adjustments between aggregate demand and supply of goods and services. Thus, to improve the economy, market imperfections have to be removed; available resources have to be mobilized and utilized efficiently; and structural rigidities have to be overcome. These can be attained only through planning.

In India, capital is scarce; and unemployment and disguised unemployment is prevalent. Thus, where capital being scarce and labour being abundant, providing useful employment opportunities to an increasing labour force is a difficult exercise. Only a centralized planning model can solve this macro problem of India.

Further, in a country like India where agricultural dependence is very high, one cannot ignore this segment in the process of economic development. Therefore, an economic development model has to consider a balanced approach to link both agriculture and industry and lead for a paralleled growth. Not to mention, both agriculture and industry cannot develop with out adequate infrastructural facilities, which only the state can provide and this is possible only through a well carved out planning strategy. The government's role in providing infrastructure is unavoidable due to the fact that the role of private sector in infrastructural development of India is very minimal since these infrastructure projects are considered as unprofitable by the private sector.

Further, India is a clear case of income disparity. Thus, it is the duty of the state to reduce the prevailing income inequalities. This is possible only through planning.

Planning in our country has an important role to play –to provide a vision for the future, to identify areas of development and fostering appropriate policy measures for promoting the various goals, to stipulate resource mobilization and to create social infrastructure for human development. Of course, planning and market mechanism has to be complimentary to each other. Market mechanism will serve, as an "efficiency promoting device" while planning will be the guiding force, keeping the long-term social goals in the perspective.

Objectives of Indian Planning

The Planning Commission was set up following the Directive principles:

- To make an assessment of the material, capital and human resources of the country, including technical personnel, and investigate the possibilities of augmenting such of these resources as are found to be deficient in relation to the nation's requirement.
- To formulate a plan for the most effective and balanced use of the country's resources.
- Having determined the priorities, to define the stages in which the plan should be carried out, and propose the allocation of resources for the completion of each stage.
- To indicate the factors which are tending to retard economic development, and determine the conditions, which, in view of the current social and political situation, should be established for the successful execution of the Plan.
- To determine the nature of the machinery which will be necessary for securing the successful implementation of each stage of Plan in all its aspects.
- To appraise from time to time the progress achieved in the execution of each stage of the Plan and recommend the adjustments of policy and measures that such appraisals may show to be necessary.
- To make such interim or auxiliary recommendations as appear to it to be appropriate either for facilitating the discharge of the duties assigned to it or on a consideration of the prevailing economic conditions, current policies, measures and development programs; or on an examination of such specific problems as may be referred to it for advice by Central or State Governments.

The long-term general objectives of Indian Planning are as follows :

- Increasing National Income
- Reducing inequalities in the distribution of income and wealth
- Elimination of poverty
- · Providing additional employment; and
- Alleviating bottlenecks in the areas of : agricultural production, manufacturing capacity for producer's goods and balance of payments.

Economic growth, as the primary objective has remained in focus in all Five Year Plans. Approximately, economic growth has been targeted at a rate of five per cent per annum. High priority to economic growth in Indian Plans looks very much justified in view of long period of stagnation during the British rule



• This lecture puts forth the industrial policy resolution of 1956 and its critical appraisal.

Industrial Policy Resolution of 1956

The objective of a socialist pattern and mixed economy was given expression in terms of industrial development through the "Industrial Policy Resolution, 1956". The 1956 Resolution laid down the following objectives for the industrial policy:

- to accelerate the pace of industrialization in the country especially the development of heavy industries;
- to expand the public sector;
- to strengthen the infrastructure or the economic overheads;
- to develop the basic &capital goods industries;
- wider diffusion of ownership and management in private industry;
- to expand cottage, village &small scale industries;
- to secure a balanced regional industrial development and
- to build up large and growing cooperative sector.

New classification of industries: The Resolution laid down three categories which bear a close resemblance to the earlier classification, but were more sharply defined &were broader in coverage as to the role of state. These categories were:

- Schedule A: those which were to be an exclusive responsibility of the state
- Schedule B: those which were to be progressively state owned and in which the state would generally set up new enterprises, but in which private enterprise would be expected only to supplement the effort of the state; and
- Schedule C: all the remaining industries and their future development would, in general be left to the initiative and enterprise of the private sector.

Arms & Ammunition Ot Atomic Energy Heavy castings and forgings	her Mining Industries uminium & other non- rous metals not	Industries not included in Schedule A & B
Heavy castings and Alu forgings fer	uminium & other non- rous metals not	
Of iron & steel inc Heavy machinery ma required for iron & all all steel production, Ch For mining, for ant manufacturers, etc. fer Heavy electrical rut industries, coo Coal, Mineral oils, Ro Mining, tra Iron ore & other important minerals like copper, lead & zinc. Aircraft, Air-transport, Aircaaft, Air-transport, telegraph Shipbuilding, Telephone& Other wireless equipments Generation &	luded in Schedule A, tchine tools, Ferro- oys &tool –steels, emical Industries, tibiotics &other sential drugs, tilizers, synthetic ober, carbonization of al, chemical pulp. and Transport &Sea nsport	

Critical Appraisal of the Industrial Policy of 1956

Although the 1956 Industrial policy was more explicit and clear as compared to 1948 policy it did not evoke a favourable response from the private sector. The private industrialists accepted the importance of public sector and the logic of the mixed economy, but were apprehensive about the relatively greater role of the public sector. However a serious analysis of the criticism of 1956 Industrial Policy as put forward by private capitalists exposes the weakness of this criticism. It is impossible to think of industrial development in underdeveloped countries without a strong &vibrant public sector. The basic soundness of the policy remained unquestioned. It has provided an "overall sense of direction, flexibility & thrust" to the process of industrial development.

However the implementation part was wrought with defects. Because of the loopholes and exceptions in the legislation, the basic concept of socialism and underlying goals were glossed over. Licenses were issued to private sector units in areas exclusively reserved for the State. For several years after its adoption, the Resolution was not even fully implemented. Planning & industrial administration tended to be slow reflecting the reluctance of the implementing authorities to carry out the Resolution in true spirit and ideals.

Industrial Policy Resolution of 1956

The 1948 policy determined the nature and pattern of industrial development in the country for full eight years. Dome significant changes had taken place during this year. The country had

completed one five year plan ie 1951-56. Industries (Development and regulation Act) was passed in 1951and gave the government the necessary expertise to control and regulate the private sector. The ruling party had declared 'Socialist patter of society' as the goal for the country. So a new declaration of industrial policy had to be passed.

Objectives

- 1. To accelerate the rate of growth and speed up industrialisation
- 2. To develop heavy industries and machine making industries
- 3. To expand public sector
- 4. To reduce disparities in income and wealth
- 5. To prevent monopolies and the concentration of wealth and income in the hands of a small number of individuals

Features

Division of Industrial Sector

As against four categories in the 1948 resolution, the 1956 resolution had divided the industries into three categories.

- 1. Monopoly of the state: Seventeen industries were included in this category and were listed in schedule A. The industries were grouped into defense, heavy industries, minerals, transport and communication, and power. O these arms and ammunition, atomic energy, railways and air transport were to be the government monopolies. In the remaining 13 industries, all new units were to established by the state. Existing units in private sector were allowed to subsist.
- 2. Mixed sector of public and private enterprise. In this section 12 industries were listed in schedule B. There were minerals, road transport sea transport, machine tools, ferro-alloys aluminum and tool steels, basic and intermediate products, chemical industries such as manufacture of drugs, plastic, synthetic rubber, antibiotics etc. Private sector would be denied opportunity to set up units.
- **3. Industries left for private sector:** All industries not listed in schedule A or B were included in this category. Their development would depend on the initiative and enterprise of the private sector. However state could also start its own units but it would play the role of providing facilities to the private sector to develop itself.

Mutual Dependence of Public and Private Sector

The two sectors are not be exclusive and totally independent of one another. There needs to be not just mutual co-existence but also mutual cooperation between the two. The government could establish units in any of the industries and allow, private sector to enter any field reserved for the public sector except the four industries: arms and ammuniation, railways, atomic energy and air transport.

Assistance and Control of Private Sector

According to this resolution, the government can assist expansion and development of private sector through participation in its risk capital and also provide various fiscal benefits. For this the private sector must also fit into the framework of the economic and social policy of the state.

Importance of Small-scale and Cottage Industries

The resolution gave importance to small scale industries which could create large scale employment opportunities, ensure equitable distribution of wealth and help in effective mobilization of human and physical capital.

Reduction of Regional Inequalities

It was advocated that transport facilities, power and other facilities should be provided to backward regions. Stress on balanced development of agriculture and industry was also laid.

Critical Appraisal

Though the industrial policy of 1956 was more explicit and clear, it was not welcome by all and sundry. The private sectors were apprehensive about the 'relatively greater role' of the public sector. Also there were many loopholes and in the implementation. The concept of socialism was unduly glossed over and licenses were issued to private sector units in areas exclusively reserved for the state sector.



• This lesson gives an outline of the second five year plan.

Second five year plan (1956-61)

This plan had the following objectives:

- 1. Increase in national income so as to raise the level of living in the country.
- 2. Rapid industrialization with special emphasis on basic and heavy industries.
- 3. A large expansion of employment opportunities.
- 4. Reduction of inequalities in income and wealth and more even distribution of economic power.

The second plan gave top most priority to transport and communication on which 28 per cent of the total outlay was spent. Agriculture, social services, community development and power also received priority on which 16 per cent of the total resources were allocated.

Achievements

Although the plan was very ambitious, its achievements were not very satisfactory.

The national income increased by 20 per cent as against 25 per cent. While the total food production increased to 76 million tones, a number of hydro-electric and thermal power projects, steel plants, heavy engineering, chemical industries, machine tool industries, cement and fertilizers and various small scale and cottage industries were also set up.

• This lesson not only outlines the third five year plan but also portrays the disillusionment with socialism

Third Five Year Plan (1961-66)

The third five plan of India accorded the greatest importance to the achievement of a balanced regional development. It aimed at a balanced approach by developing agriculture and rapid industrialization through the promotion and development of heavy industries. The following were its objectives:

- 1. To secure an increase in national income by over 5 per cent.
- 2. To increase agriculture production and achieve selfsufficiency.
- 3. To expand basic industries like steel chemical, fuel, power and establish machine-building capacity.
- 4. Optimum utilization of manpower resources and a sustainable expansion of employment opportunities.
- 5. To reduce the disparities of income and wealth and more even distribution of power.

Achievements

This plan had to face a number of difficult situations which arose due to financial crisis, adverse weather effect, Chinese aggression and Indo-Pak war. The annual growth rate was just 4 per cent and national income increased by 12 per cent. The capacity of some important industries like machine tools, machine building, cement, paper and pulp, sugar, cotton textiles. Coal mining for instance, was expanded substantially.

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• This lecture will recall Nehru's love affair with socialism and its early consequences.

Socialism in the Context of India

Socialism is a means to achieve classless society. It is achieved by transferring private property to state ownership. Socialist programmes entail redistribution of assets from rich to poor. Socialism concept became vital after its success in Soviet Union of late 20s of last century.

Indian leaders were highly moved by the success of socialism in Russia. India, after independence, took the democratic socialism, as a goal under which there should be adequate delegation of power on the basis of democratic principles. The goal of our economic planning is growth with social justice as a part of socialistic programme. Indian govt. nationalized many industries from private sector. India also launched a series of investment in the public sector, which was in the commanding heights of the economy. India launched abolition of intermediaries and other land reform programmes (but with limited success.) Socialistic pattern of society is our goal-----We have framed our rules as MRTP, FERA. There was a massive drive for nationalization as well as opening of PSUs in various sectors of the economy. Pandit Nehru, Mrs. Gandhi went in for PSUs to make India a Socialist Republic. Mrs. Indira Gandhi nationalized Banks, Insurance, Coal and many other strategic industries. She abolished Privy Purse and took many socialistic measures to uplift the economy. Pt. Nehru also made series of measures to strengthen the public sector, particularly Steel Plants, multipurpose river valley projects and mining.

Under mixed economy there is also a ground for development of private sector, which means nurturing the process of democracy. This simultaneous existence of Public as well as Private sector has become helpful for fostering democratic socialism.

Nationalization of Industries

The nationalization of certain private enterprises has led to the expansion of the public sector. In1953, private airways companies were taken over by the Government of India to form Air India & India Air-Lines Corporation. In 1955,Imperial bank of India was nationalized to form State Bank of India. In 1956, the life insurance companies were nationalized to form Life Insurance Corporation of India to protect the interest of the insured from the short sighted and rapacious private exploiters. The general insurance business was nationalized to form General Insurance Corporation of India. In 1969,14 major commercial banks were taken over by the government. In 1972, 214 coking coalmines and 12 coke oven plants were nationalized, and 711 non-coking coalmines were nationalized in 1973. In 1980, 6 banks were nationalized. The sick units in many industries have been nationalized to revitalize them. In a number of cases, the Government has been forced to take over a private sector industry or industrial units either in the interest of workers or to prevent excessive exploitation of consumers.

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• The lesson outlines the hard core socialism and nationalisation of banks.

Nationalisation of Commercial Banks

In the pre-independence period, the banking sector in India was not at all organized. Lending and borrowing was through unorganized sources like landlords in villages or pawns who charged unreasonably high rates of interests. After independence, a serious effort has been made to develop an organized banking and a financial system in the country. The country developed different types of banking institutions like commercial banks, co-operative banks, regional rural banks etc. All these institutions are supervised by the Reserve Bank of India which id the Central Bank of the country.

Commercial banking actually began during the Seventeenth century when the British established agency houses in the country. Before that indigenous banks in the form og Seths and Mahajans etc were in the field. But it began in the form of a system when the Presidency banks were established in 1913 - 18. The Imperial Bank of India was set up in 1920 with the merger of three Presidency banks. In 1955 the Imperial Bank was nationalised and renamed as Sate Bank of India. But the banking business in India was seriously affected by Depressions and also the partition of the country.

In 1949, the Banking Regulation Act, 1949, was passed and as per this act, Reserve Bank was awarded the exclusive regulatory power to control the commercial banks. In 1950-51, there were nearly 430 commercial banks in the, but the number of banks declined later due to the amalgamation of small banks with the bigger ones. In 1969, 14 major commercial banks were nationalized. During pre-nationalisation period, commercial banks in India were not very much interested in providing credit to priority sectors. Commercial banks completely neglected the agricultural sector and small industrial sector since they considered the agricultural cultural credit as the most unprofitable from the commercial point of view. These banks were owned and controlled by a very few number of people. Not only were they concentrating wealth and economic power in very few hands but were also being misused by directors for promoting only those industries in which they were interested. These banks could not implement the positive social and economic objectives of the five year plans.

Considering this situation, the government of India passed an act known as Banking Laws (Amendment) Act, 1968, to confer the powers to Reserve Bank for promoting social and economic planning. This was known as social control of banks. Under social control banks were asked particularly, to meet the needs of the farmers, small industries, and other neglected sectors. Thus on July 19, 1969, the Government of India nationalized top 14 scheduled commercial banks by promulgating an ordinance. Since then these banks have been working as independent units and the government is determining their credit policy. Again on April 15, 1980 the government of India nationalized six more commercial banks and with this total number of such banks has increased to 20.

Performance

Branch Expansion

In order to rectify imbalances in the banking system, nationalized banks set and objective to initiate a branch expansion programmes particularly in unbanked areas.

Assistance to Priority Sector

Providing credit to priority sectors like agriculture, small industry and exports another important objective of nationalization of banks. Public sector started extending liberal credit facilities to the priority sectors.

Deposit Mobilization

Since nationalization deposit mobilization has been of the order of 16 to 17 per cent in every year.

Involvement in Development Effort

Public sector commercial banks have shifted their emphasis from profitability to development effort in economically underdeveloped areas. 'Lead Bank Scheme' was introduced under which banks different districts of the country were allotted to these nationalized banks for making adequate credit for production and employment.

• This lecture will give you a fair idea of the MRTP & FERA acts.

Monopolies and Restrictive Trade Practices Act (MRTP)

The preamble to the Act described it as "An Act to provide that the operation of the economic system does not result in the concentration of economic power to the common detriment for the control of monopolies, for the prohibition of monopolistic & restrictive trade practices and matters connected therewith or incidental thereto".

The principal objectives sought to be achieved through the MRTP Act are as follows:

- i. Prevention of concentration of economic power to the common detriment, control of monopolies, and
- ii. Prohibition of monopolistic and restrictive and unfair trade practices.

The MRTP Act became effective in June 1970. With the emphasis placed on productivity in the Sixth Plan, major amendments to the MRTP Act were carried out in 1982 and 1984 in order to remove impediments to industrial growth and expansion. This process of change was given a new momentum in 1985 by an increase of threshold limit of assets.

With the growing complexity of industrial structure and the need for achieving economies of scale for ensuring high productivity and competitive advantage in the international market, the interference of the Government through the MRTP Act in investment decisions of large companies has become deleterious in its effects on Indian industrial growth. The preentry scrutiny of investment decisions by so called MRTP companies will no longer be required. Instead, emphasis will be on controlling and regulating monopolistic, restrictive and unfair trade practices rather than making it necessary for the monopoly house to obtain prior approval of Central Government for expansion, establishment of new undertakings, merger, amalgamation and takeover and appointment of certain directors. The thrust of policy will be more on controlling unfair or restrictive business practices. The MRTP Act will be restructured by eliminating the legal requirement for prior governmental approval for expansion of present undertakings and establishment of new undertakings. The provisions relating to merger, amalgamation, and takeover will also be repealed. Similarly, the provisions regarding restrictions on acquisition of and transfer of shares will be appropriately incorporated in the Companies Act.

Simultaneously, provisions of the MRTP Act will be strengthened in order to enable the MRTP Commission to take appropriate action in respect of the monopolistic, restrictive and unfair trade practices. The newly empowered MRTP Commission will be encouraged to require investigation suo motto or on complaints received from individual consumers or classes of consumers.

Decisions of Government

In view of the considerations outlined above Government have decided to take a series of measures to unshackle the Indian industrial economy from the cobwebs of unnecessary bureaucratic control. These measures complement the other series of measures being taken by Government in the areas of trade policy, exchange rate management, fiscal policy, financial sector reform and overall macro economic management.

- i. The MRTP Act will be amended to remove the threshold limits of assets in respect of MRTP companies and dominant undertakings. This eliminates the requirement of prior approval of Central Government for establishment of new undertakings, expansion of undertakings, merger, amalgamation and takeover and appointment of Directors under certain circumstances.
- Emphasis will be placed on controlling and regulating monopolistic, restrictive and unfair trade practices.
 Simultaneously, the newly empowered MRTP Commission will be authorised to initiative investigations <u>suo moto</u> or on complaints received from individual consumers or classes of consumers in regard to monopolistic, restrictive and unfair trade practices.

Necessary comprehensive amendments will be made in the MRTP Act in this regard and for enabling the MRTP Commission to exercise punitive and compensatory powers

Foreign Exchange Regulation Act (FERA)

"An Act to consolidate and amend the law regulating certain payments, dealings in foreign exchange and securities, transactions indirectly affecting foreign exchange and the import and export of currency, for the conservation of the foreign exchange resources of the country and the proper utilization thereof in the interests of the economic development of the country"

According to these guidelines, the principal rule was that all branches of foreign companies operating in India should convert themselves into Indian companies with at least 60 % local equity participation. Furthermore, all subsidiaries of foreign companies should bring down the foreign equity share to 40% or less. The 1976 guidelines provided for three levels of foreign equity: 74%, 51% and 40%. Companies were allowed to retain foreign equity holdings above 40% and upto 74%, on condition that they were engaged in

(i)core industries (ii) predominantly export oriented production (iii) Activities requiring sophisticated technology or specialized skills or (iv) tea plantation activities

New Concessions for FERA Companies.

The FERA Act was comprehensively amended in January1993, removing most of the regulations restricting the activities of

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the companies with foreign equity & liberalizing further the rules governing foreign exchange transactions. The RBI regulations relating to business travels overseas were further relaxed. The reform of the exchange rate system with emphasis on market determination of exchange rate and progressive reduction in import and exchange control constitute important components of the reform programme.

• This lesson puts forth the menace of corruption, black money, smuggling: the license permit raj.

The License Permit Raj and Corruption

Most of the socialist policies and discretionary controls exercised over economic players in the country were in the name of helping the poor and the downtrodden. The abiding logic of the era, which crooked politicians and bent bureaucrats exploited to the hilt was: if you give any space or freedom to the bania or the industrialist, he will end up exploiting the common man. Hence, it was imperative for the state to impose all sorts of restrictions on the private sector and on entrepreneurship.

You have the 1956 industrial policy that reserved the commanding heights of the Indian economy for the public sector. So, you had Tata Iron and Steel Company (TISCO), one of the finest and proudest and oldest companies of India that could compete with the best steel companies in the world put in a death embracing straightjacket. Since steel was one of the industries reserved for the public sector, TISCO and JRD Tata's hands were literally tied behind their backs. It is a tribute to JRD's managerial and entrepreneurial skills that TISCO survived the rough treatment meted out to it from 1956 to 1991 and yet emerged as one of the most competitive steel companies in the world.

Even more damaging and dangerous than the reservation of the commanding heights of the Indian economy for the public sector was the policy resolution which required that all private sector companies would need a license before they could start any business. It was quite phantasgormic, the way planners and politicians and bureaucrats appropriated the rights to decide what was good and what was bad for the Indian citizen. The surprising thing is: millions of Indians were hoodwinked by the policies which, in the longer run, only feathered the nest of bureaucrats, politicians and crooked industrialists. The common Indian citizen continued to suffer.

Here is what happened with Nehruvian and Indira Gandhian socialism. Since no businessman could start a business without first obtaining a license, business families which had better access to the powers that be became more successful. You had to travel to Delhi, and get after your liaison guy to set up a meeting of sorts with touts who had access to the ministers and the secretaries who would grant the licenses. It needs no imagination to figure out what happened here: deals were stuck whereby the businessman would deliver a bagful of money and the powers that be would deliver the license.

The peculiar thing was: in India of those days, since competition—both domestic and global—was actively discouraged, obtaining a license was as good as a license to print money. Any industrialists—who would not have survived global competition managed to make fortunes after obtaining licenses. Because once you got a license to start a factory to make any product, it would be years before the powers that would grant another license for the same product. The reason: mandarins sitting in darkened corridors of Planning Commission would decree that India and Indians would need only X amount of that product, and no more.

In reality, the demand for most products in India was growing rapidly because the creation of government and public sector jobs by the millions had created a huge base of middle class consumers who wanted some goodies for the good things of life. But because of these restrictions o licenses, India was an economy plagued by shortages I almost every product category.

I remember the year 1975 when my father wanted to buy a Bajaj scooter. So severe was the shortage of Bajaj scooter that under normal circumstances, my father would need to pay the price of Rs 5,000 in advance to Bajaj Auto and wait for five years for the delivery of the scooter. Yes, five years was the waiting period for a stupid scooter which was in any case of shoddy quality. But the Indian consumer had no choice and had to suffer this ignominy in the name of helping the common man.

The next option open to my father was to buy the scooter in the black market. There was an army of individuals who booked Bajaj scooters and then sold the allotment letters in the black market. The black market price of Bajaj scooter was Rs 12,000 compared to the official price of Rs 5,000.

The Bajaj scooter example is a clear case of how socialist policies encouraged black marketing. They encouraged smuggling also. You might remember some Bollywood movies of 1970s where the villains were gold smugglers. The powers that be had decreed that Indians don't need gold because India is a poor country and why waste precious dollars importing gold. I reality, Indians love gold and simply took the market underground with gold smuggling emerging as one of the most powerful industries of India.

My father had a third option when he wanted to buy that Bajaj scooter. He could approach a minister who had discretionary quotas. If you got the signature of the minister and the seal of his ministry recommending an allotment for you, you would be allotted a scooter on a priority basis. Luckily for my father, one of his students in college had gone on to become a minister and like magic, we were allotted a scooter within a week while the less privileged had to wait for five to six years for their dream scooter. (Remember, in those days, cars for the average Indian were beyond even dreams).

How my father obtained the scooter beautifully explains all that was wrong with the socialistic policies and the discretionary powers and controls exercised by bureaucrats and politicians. If you had access to the high and mighty, life would be easier for you. But you normally had access to the high and mighty only if you were wealthy and belonged to the privileged class. A crooked government official or businessman could easily afford to pay the black market price of Rs 12,000 for the Bajaj Scooter. Or, he could get a priority allotment by bribing the minister's staff. When it came to the honest middle class Indian citizen, there was no choice but to wait and suffer.

There was yet another reason why India was wracked by black money, smuggling, hawala and such. Indira Gandhi raised the marginal rates of income tax to as high as 97 %. So, if your annual income was Rs 1,20,000; it meant that 97% or Rs 19,400 out of your Rs 20,000 (in excess of Rs 1 Lakh) would go to the tax payer. Obviously, no sane man would like to pay 97% of his earnings to the government. So you had an entire industry devoted to tax evasion and generation of black money.

There was yet another law called FERA which you have discussed already. Lets say Rahul Bajaj wanted to go to Italy to discuss a tie up with Piaggio. He would be allowed to take only \$ 500 a day for his expense in Rome. The hotel bill alone would come to close to \$ 700 a day. So where does Bajaj find the balance of the money? He goes to Hawala operators. Indians working in the middle east knew that if they send their savings to family members back home through legal banking channels, the government would loot more than 90% of their hard earned money as taxes. The result, they relied on Hawala operators to send money home.

Jut a few examples of how socialism created shortages and you will clearly get the picture:

- The wait list for a scooter was 5 years
- The wait list for a maruti car was more than 4 years
- The wait list for an LPG connection was 7 years
- The wait list for a telephone connection was 10 years
- If you wanted to buy 1000 bags of cement for house construction, the government official would allot you only 100 bags, unless...

The list can be endless. It is not as if the waiting periods were frustrating. Even the quality of products and services was bad.

Ask you parents about their horrible experiences in public sector banks where unionized employees ensured that it took you more than one hour to withdraw your own money. That you could not make an STD call because that did not exist.

Truly, can you imagine an India like that?!

• You will get an idea of the oil stocks of 1973 and consequences on the Indian economy.

Oil Shocks of 1970's

After the Arab Israel war in November 1970 OPEC countries raised the prices of oil from 4 dollar per barrel to 12 dollar in December. This had significant impact on the world economy.

Indian economy also became a sufferer since India's major import item is oil. The oil shock had much tremendous impact. Apart from giving a current account deficit there was continuous pressure on BOP position as a result of this. Indian economy had to make an arrangement to continuously pay for increased cost of production due to fuel price hike. This has given rise to cost push inflation simultaneously with a stagnation in the economy during the mid seventies.

The first and second oil crises(1973 & 1979), showed that an external stock could be disastrous for the Indian economy as India's performance in the external sector was dismal during the plan period. It was understood that unless India could make progress in the area of export the country could not achieve stability

 This lesson briefly outlines Green Revolution and its impact on Indian economy.

Green Revolution

The need for more productivity influenced Indian economy in early &mid 60's. The agrarian system was supposed to undergo a through change by adapting a new technology. It was a turn in Indian agricultural profile towards mechanization and large-scale farming. It was expected that the use of capital-intensive methods in agriculture would bring a thorough change in productivity. Initially the new technology was tried in 1960-61 as a pilot project in seven districts and was called "Intensive Agricultural District Programme". Later the high yielding varieties program was also added and the strategy was extended to cover the entire country. This strategy has been called as seedfertilizer-water-technology or simply the Green Revolution.

It was package combining of - high yielding variety seeds, chemical fertilizers, pesticides, and machineries like tractors, irrigation. Actually there was a concept of optimum doze i.e. a perfect combination of some inputs for successful cultivation. Further the HYV seeds had short harvesting period, so they were quick maturing and hence they opened the scope for multiple cropping. Since much of the agricultural processes in the new technology are linked with industry (through supply of chemical fertilizers, pesticides, machines, etc.), it has become necessary to do farm management along modern lines. Being increasingly science linked and industry linked, the new technology has made agriculture less dependent on nature than before. The new technology has brought about a sharp rise in the yield of land in respect of food grams. This gain is of key importance because in view of the scarcity of land, there is practically no scope for extensive cultivation in the country. The gain in the vield was very large in the initial years after the coming of Green Revolution, because the increase took place on the then existing very low level of yield of land. So much hope was there for the new technology later however there were no significant changes other than wheat in the output in post Green Revolution period. So Srinivasan has coined the term "Wheat Revolution" for this particular revolution. It was found that the new technology was successful only in some places in India - mainly in two states Punjab and Haryana. Critics also say that this policy generated huge income disparities between successful states and unsuccessful states. Punjab and Haryana became surplus state and exported wheat to other states. As the programme was initiated in limited areas hence the results were also limited. Only 33% of land was irrigated. The use of tractors was necessary for this new technology. Obviously it reduces employment and requires a good amount of investment which is possible for a big farm. On the other hand use of tractor is worth while in case of big plots and in general big land plots were not very much common due to chronic fragmentation of holdings. So this huge investment prone

method was not fit for a country full of marginal farmers, share croppers and agricultural labourers. The new technology is only worthwhile in terms of private benefits e.g. if the farmer receives yields which are not only larger than traditional varieties but are substantially so, to make up for the additional variable costs of cultivation. This in turn requires, a mere intensive useof the fixed factor e.g. land. One very important consequence of Green Revolution is that in areas, which have come under its sway, the traditional agricultural inputs and practices have given way to new and science-based inputs and practices. Instead of the farm seeds, the farmers in these areas are using HYV seeds, which have been developed, in the science laboratories. So is the case of another key input, namely fertilizers. As a result of this new agricultural strategy food grains output increased substantially from 81 million tones in the Third Plan (annual av) to 118.1 million tones in Fifth Plan and further to 155 million tones in the Seventh Plan. However, we must remember that the contribution of wheat in raising the total food grains production is very large. The effect of the Green Revolution has been both qualitative in so far as it has modernized agriculture in India, and quantitative, as it has resulted in sharp increase in the productivity of land, and production of good grains.

• In this lecture we shall review the five year plans

Review of Five Year Plans

Individuals groups, the Congress Party as well as the Govt, advocated planning in India before independence. A number of committees had been set up and proposals were made for post war reconstruction and development it was however, after independence that the Govt. of India setup the Planning Commission in March, 1950 to prepare a plan for the most effective and balanced utilization of the country's resources. India embarked on the path of planned economic development on Apr. 1,951. Since then she has gone through nine five year Plans and is in the midst of the Tenth Plan. Both performance and policy are in some sense best judged in terms of the objectives of development policy, the more so in an economy in which objectives have been consciously set in successive national plans. Failures of the plans thus depend upon how far the objectives set in each "Five Year plans" are achieved.

A brief of overall objectives of the Plans is attempted below:-

First Plan (1951-56)

- i. to correct disequilibrium in the economy caused by Second World War and partition
- ii. to solve the food crisis and to ease the raw material position.
- iii. to build up economic infrastructure extensively
- iv. to enlarge the scope of employment.

Second Plan (1956-61)

The objectives were formulated to conform to the goal of the Indian Parliament to form a socialist pattern of society.

- i. a sizable increase in national income so as to raise the level of standards of living of a country
- ii. rapid industrialization with special emphasis on basic and heavy industy
- iii. Large expansion of employment opportunities.

Third Plan (1961-66)

Five – fold objectives

- i. to secure an increase in NI of over 5% per annum
- achieve self-sufficiency in food grains and increase agricultural production to meet industry requirements and exports
- iii. to expand basic industries
- iv. full utilization of man-power resources
- v. to bring about a reduction in disparities in income and wealth and a mere even distribution of economic power.

Fourth Plan (1969-74)

i. acceleration of the tempo of development in conditions of stability and reduce uncertainties

- ii. attaining a 5.5% annual growth of NI
- iii. to achieve self reliance
- iv. achieving social justice with equality
- v. correct regional in balance.

Fifth Plan (1980-85)

Repeated the old objectives. Its basic thrust were on

- i. removal of poverty and
- ii. attainment of self reliance

Sixth Plan (1980-85)

- i. removal of poverty and unemployment
- ii. reduction of inequalities
- iii. significant step-up in the economic Growth rate by promoting efficiency in use of resources
- iv. achievement of economic and technological self-reliance
- speedy development of indigenous sources of energy with proper emphasis on conservation and efficiency in energy use
- vi. reduction of regional unbalance
- vii. control population growth
- viii. promotion, protection and improvement of ecological and environment asset.

Seventh Plan (1985-90)

The Seventh Plan seeks to emphasis policies and programmes, which will accelerate the growth in food grain production, increase employment opportunities and raise productivity. Within this framework, the movement towards social justice has to be faster and there must be sharper focus on employment and poverty alleviation.

Eighth Plan (1992-97)

- i. Generation of adequate employment opportunities to achieve near full employment by the turn of the century
- ii. Universalisation of elementary education and complete eradication of illiteracy.
- iii. Provision of safe drinking water and primary health care facilities for entire population
- iv. Growth and diversification of agriculture
- v. Strengthen infrastructure to support growth process on a sustainable basis.

Ninth Plan (1997-2002)

- i. Priority to agriculture
- ii. accelerating economic growth
- iii. containing population growth
- iv. empowerment of women, strengthening of Panchayati Raj Coperatives and self help group.

Tenth Plan (2002-07)

Like all other previous five year plans, the Tenth five year plan also has certain goals but its major emphasis are on globalization, business environment, India's Foreign Trade, agriculture and Environment.

The planning process in India has been criticized for defects in its form and policy frame and implementation failures.

- Employment generation objective: each plan has ended with an increased backlog of unemployment –problem remained acute in both rural &urban sector
- Performance is dismal in the area of removal of poverty: initial "trickle down" approach & the subsequent antipoverty programme have made marginal impact on the plight of poor.
- Failure to reduce inequality
- Fiscal and monetary failure: country faced critical situation both at domestic & external front.
- Domestic: persistent &increasing fiscal deficit resulting in mounting debt burden, inflation &critical BOP position
- External: country resorting to excessive foreign loans
- Absence of financial strategy: absence of coherent strategy of resource mobilization—forces to resort to deficit financing which is inflationary in nature
- Implementation failure

• This lecture portrays the structure of Indian economy and the factors leading to the changes in this structure.

Structural Changes in Indian Economy

This chapter portrays the various factors for the steady shift of employment & investment from the essential "primary " sector into "secondary" and to a still greater extent into "tertiary" sector. This chapter will enable the students to analyze the changing structure of Indian Economy

Classification of Various Sectors in the Indian Economy

- **i. Primary sector:** Agriculture and allied activities, such as, forestry and logging, fishing ,mining and quarrying.
- **ii. Secondary sector:** Registered manufacturing and unregistered manufacturing, such as, gas, electricity and water supply.
- **iii. Tertiary sector:** Banking and insurance, transport, communication and storage, real estate, ownership of dwellings and business services, trade, hotels and restaurants, public administration and defence.

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•	In this lesson we shall see how Indira Gandhi begins to
	liberalise and Rajiv Gandhi arrives with his 21st century
	dream.

• This lecture portrays the first efforts at the economic reforms during 1980's.

Soon after taking over as Prime Minister in 1985, Mr. Rajiv Gandhi outlined the new trends in economic policy of the government. The basic thrust of the new economic policy was a greater role for the private sector. To provide larger scope to the private sector, a number of changes in policy were introduced with regard to industrial licensing, export-import policy, technology up gradation, fiscal policy, removal of controls & restrictions, rationalizing & simplifying the system of fiscal and administrative regulation.

The Government initiated a number of measures in this regard:

- a) Cement was decontrolled and a number of units were sanctioned additional licensed capacities in the private sector.
- b) The ceiling asset limit of big business houses was raised from Rs.20crores to Rs.100 crores.
- c) A scheme of "broad branding" of licenses were introduced.
- d) 94 drugs were delicensed and 27 industries were virtually placed outside MRTP Act.
- e) New Textile Policy (1985) virtually abolished the distinction between the mills, power loom & handloom sectors as well as between natural and synthetic fiber for licensing.
- f) The electronics industry was freed from the MRTP Act restrictions. FERA companies' entry welcomed.
- g) Export –Import Policy (1985) was announced whose basic aims were (i) to facilitate production through quicker access to imports,(ii)strengthen export production base(iii)stabilize Exim policy &(iv)facilitate technological up gradation.

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• This lecture introduces you to the crisis that Indian economy was facing in the year 1991.

• You will get an overview of the economic reforms since 1991.

Metamorphic changes in the world economy have generated a new international order. It is this basic philosophy, which is behind India's liberalized economic policy proposed and implemented in 1991. The foreign investors who wishes to undertake business in India, will find tremendous opportunities under the present industrial policy, which opens up the whole economy. The far reaching changes include the dismantling of cumbersome regulations and controls, abolition of industrial licensing for almost all projects, scrapping of threshold asset limit of monopoly companies, relaxation of the FERA to encourage greater flow foreign direct investment and toning down the all-pervasive role of the public sector and allowing private sector entry in a number of areas so far reserved exclusively for the public sector. The thrust of the move is towards "**privatization**"

Need for reforms: The economic philosophy of democratic socialization, commanding height of public sector importing substitution type of growth model did not yield desirable rate. There was constant deficit in foreign trade and budgetary exercises of the economy. There needed a reform i.e. changing of economic policy to increase efficiency.

Fiscal Policy: Reduction of public sector deficit from 12.4 to 4%. A change in policy to increase tax and non-tax revenue.

Monetary Policy: Monetary policy to reduce inflation and deregulated investor friendly interest rate structure.

Price Policy: More freedom to public sector, dismantling of administered prices in oil sector, rationalized structure of railway fare and freights, rationalization of electricity charges, reduction of cross subsidies.

Social Policy: The economic reforms process was committed to reduce poverty and as a result more facilities for primary education, rural drinking water was to be provided, assistance to small and marginal farmers, welfare of weaker section of the society, strengthening of primary health services and a solid social structure.

Industrial policy: Reduction of reservation list of public sector removal of licensing and quota system, repeal of MRTP and FERA. More foreign investment, automatic approval of FDI up to 51%, there would be disinvestments of PSU's and the excess labour force to be reduced to VRS.

• You will be introduced to the business of stock exchange in India.

The stock exchange is the market where stocks, shares and other securities are bought and sold. It is the market where the owners may dispose of their securities as and when they like. In a modern capitalist economy, almost all commodities, even the smallest, are produced on a large scale; and large-scale production implies large amounts of capital. The joint stock company or the corporate form of organisation is ideally suited to secure large amounts of capital form all those who have surplus funds and who are willing to take risks in investing in companies. It issues stocks and bonds are enables those with surplus funds to invest them profitably in either of them, according to their convenience and temperament. An investor who puts his savings in a company by buying its securities cannot get the amount back from the company directly. The only way the capital invested in stocks and shares of a joint stock company may be realized by its owner is through the sale of those stocks and shares to others. The stock market or exchange is a place where stocks and shares and other long-term commitments or investments are bought and sold. For the existence of the capitalist system of economy and for the smooth functioning of the corporate form of organisation, the stock exchange is, therefore, an essential institution.

History of Stock Exchanges in India

The first organised stock exchange in India was started in Bombay when the Native Share Stock Brokers' Associationknown as the Bombay Stock Exchange - was formed by the brokers in Bombay. In 1894, Ahmedabad Stock Exchange was started to facilitate dealings in the shares of textile mills there. The Calcutta Stock Exchange was started in 1908 to provide a market for shares of plantations and jute mills. The Second World War saw great speculative activity in the country and the number of stock exchanges rose from 7 in 1939 to 21 in 1945. Besides these organised exchanges, there were a number of unorganised and unrecognized exchanges known as kerb markets which functioned under a set of usages and conventions and did not have any set of rules which could be enforced in courts of law. Under the Securities Contract (Regulation) Act of 1956, the Government of India has so far recognized 23 stock exchanges. Bombay is the premier exchange in the country and nearly 70 per cent of all transactions in the country are done in that exchange.

• In this lesson we shall scrutinize privatisation & the arguments against privatization and disinvestments.

Arguments Against Privatisation and Disinvestment

- Outright privatization will be self-defeating. May convert PSU into a sick unit. Due to termination of contract of an entrepreneur earlier than prescribed time period will reduce his interest towards the development of PSU's and will make it a sick unit.
- ii) Ignorance of social and economic change.(As they are mainly profit motive)
- iii) Lead to retrenchment of workers (As PSU's are and has demoralized the public sector employee, overstaffing)
- iv) Staff will have to adjust to new culture.
- v) Monopoly in public sector will move to private sector till competition comes in.
- vi) Inefficient allocation of resources (Misuse of resources to earn higher profit which often lead to exhaustion of resources)
- vii) Irrational decision-making. Selling of NAVRATNAS (profit making PSU) e.g. VSNL.
- viii) Under valuation of assets of PSU's/Underselling of shares, as a result of hasty decision, which leads to reselling of the same PSU by the New Private owner at higher price.
- ix) Disinvestment a prolonged strategy with lack or absence of firm policies or commitments to meet target in a time frame e.g. the government decision to disinvest in Maruti Udyog came at a time when the share in the Indian Car market dropped below 50%.

 This lesson introduces you to the banking system in India and the various irregularities and scams that had mushroomed in the year 1992.

The Banking System and the Securities Scam of 1992

There was an upward swing in the stock market, from 1988-89 spearheaded by excellent performance by market leaders, industry-friendly policies by successive governments, such as liberalization of licensing producers, liberal fiscal measures, liberal and positive export-import policy, greater scope for the private sector etc. The upward trend displayed by the market in the previous three years was given a big boost by Dr. Manmohan Singh's 1991-92 budget with a series of marketfriendly policies.

According to the Finance Ministry of the Government of India, this unprecedented stock exchange boom was a reflection of the tremendous welcome accorded to the 1992-93 budget by the industrial and business community. Actually, however, it was a manipulated stock exchange boom. Unscrupulous brokers in the stock exchange, colluding with some bank officials, violated established rules and guidelines and siphoned off bank funds for speculative transactions in the stock market. These irregularities and frauds are popularly called "securities scam". On the one hand, it led to one of the worst manipulated booms in the Indian stock markets which later crashed resulting in huge losses to many; and on the other, it revealed serious weaknesses of internal control and supervision on banks, which led to huge losses to banks. RBI set up the Janakiraman Committee, which identified several types of irregularities in securities transactions, which were used to siphon off funds out of the banking system:

- (i) Purchases were made by banks and their subsidiaries of securities and other instruments where the counter-party was ostensibly another bank but when in reality the proceeds were directly or indirectly credited to the accounts of brokers.
- (ii) Ready-forward (sale and purchase) transactions were entered into either on their own or on clients' accounts by banks with brokers who used these funds for speculative activity.
- (iii) Banks directly financed brokers in the stock exchanges by discounting bills, not supported by genuine transactions.
- (iv) Banks and other institution showed large payments as call money to other banks. However, in the books of the receiving banks, there was no record of call money acceptances but instead, the amounts were credited to the accounts of individual brokers. On the due date, these alleged call loans were repaid by payment out of the brokers' accounts in the name of other banks.

- (v) Banks and other institutions rediscounted bills of exchange held by the other banks and institutions but the proceeds and repayments were routed through brokers' accounts.
- (vi) Sums received as inter-corporate deposits and under portfolio management schemes (PMS) by merchant banking subsidiaries of public sector and other banks were passed on to brokers through ready-forward deals.

There were other types of frauds too. The Janakiraman Committee estimated that the extent of unreconciled amount would be around Rs.4, 000 crores. Public sector banks, private sector banks and foreign banks committed these irregularities



• You will analyse the corporate governance and the criticism against foreign investment.

Problems of Foreign Capital

It is said that foreign capital helps to remove capital gap, promote investment and helps in technology transfer.

But the **dangers** are many. Foreign capital cannot remove unemployment because investment in hi-tech sectors creates very limited jobs. It also results flight of capital in the form of dividend, royalty outgo. It increases regional disparities. Very limited research and development activities are undertaken in the host country. The foreign investors are guided only by profit motive. Foreign investors are interested for their share of cake, trim manpower and enhance profit even without any ethics. Absence of investment in strategic sectors by the foreign companies create imbalance in the investment structure.

Foreign capital fails to promote local skills, local talents, and managerial acumen. Foreign capital increases capital debt and destabilizes the economy.

"Corporate Governance" How Indian Corporates are Up To?

Much water has flown through to Thames, ever since the Committee under the chairmanship of Sir Ardian Cadbury submitted its report on Corporate Governance in 1992 at the London Stock Exchange, Corporate, academicians and management experts have talked a lot about this. India did not fall behind. The recently submitted recommendations of Naresh Chandra Committee on Corporate Audit and Governance it just the latest example of India's concern over this aspect. The Naresh Chandra Committee was formed by Government of India, the Ministry of Finance in view of recent scams in the stock market and other undesirable activities of the various Corporate, which are detrimental to the interests of stakeholders.

Naresh Chandra Committee is not the only venture in this regard. Before Naresh Chandra Committee's recommendations, there were also recommendations of CII task force, Kumar Mangalam Birla Committees Report under S.E.B.I. (Kumar Manyalam Birla himself under S.E.B.I) scrutiny for his alleged breaching charge in the Grasim and L & T episode). The recommendations and emphasis of these committees are more less identical, overlapping such as duties of Boards, accountability of various functionaries, role of Directors and Nominee Directors etc., norms of disclosure, transparency, reporting and responsibility of auditors, shareholders.

By Corporate Governance, we mean the system by which the companies are controlled. It also takes care of shareholders' interest at large. In spite of so much debates, discussions as well as seminars yet corporate in large number in the world over have failed to observe what is called good governance in India as well as abroad. The Audit Firm A.F. Forsson report on Tata Finance pointed out major irregularities. The TATA group wanted to utilize a large point of V.S.N.L.'s reserve (accumulated before disbursement) for investing in Tata Teleservices Ltd., a loss making company. Credit Rating agencies like ICRA has also downgraded some instruments, which they declared, previously as highly secured. CRISIL downgraded BPL's as nonconvertible debentures issue by fully 12 stages form A to D category at one stroke. These actions of credit rating agencies have obviously sent wrong signals to the investors.

Critics have also found fault with the action of government and breach of norms of corporate governance in the government action. In the disinvestments issue of H.P.C.L. and B.P.C.L., it has been decided that Indian Oil will not be allowed to participate, for the reasons best known to them. Participation of I.O.L. would increase vertical and horizontal integration in view of its enriched experience and it would also prevent creation of private monopoly as many observe pointed out. In case of privatization of ITDC Hotels, government action was not transparent. There were proper valuations of assets. Investors are denied of much vital information by the companies what an Indian company has to furnish in the case of taking a loan under ADR/GDR issue. The mutual funds in many cases also are not transparent in NPA determination. Thus, investors are getting a raw deal in the hands of corporate. These are examples of breaching norms of corporate governance. Numerous such illustrations may be cited. Whatever is published in the press are as a tip of the iceberg only. We have to nurture the ethos of good governance and corporates should pay adequate attention to morality and accountability while they discharge functions.

Naresh Chandra Committee's major recommendations are as follows:

- (a) At least 50 percent of the seats in the board of major companies (with a paid up capital of Rs.10 crores and above) should be independent.
- (b) Annual accounts have to be certified by CEOs and CFOs.
- (d) Auditors must forward all accounts to S.E.B.I., stock exchanges and Registration of companies.
- (e) Government should set up a fraud office to look for bigger crimes.
- (f) Companies Act must be amended to provide necessary safeguard in the case of fraud. These steps include attachment of bank accounts, property wherever possible.
- (h) Audit firms should be debarred from providing non-audit services.

The recommendations are comprehensive and heroic. It is a matter to be seen, whether such wide scale changes in corporate practices will be possible. If the charges can be brought, there will be aright milieu of corporate culture characterized with ECONOMICS FOR MEDIA

accountability and responsibility. Phenomena like World Com, Enron, Ketan Parikh Scam, UTI Scam, and Harshad Mehta Scam will also come down. The stakeholders and shareholders will be the ultimate winners at this juncture. It remains to be seen how far regulatory authorities like SEBI, RBI, TRAI as well as government become proactive in ensuring corporate governance and whether corporates respond to this "Governance" mantra to form the basis of a sound Corporate Culture.

• The final lecture will give you an overview of some of the contemporary issues like globalisation, GATT, WHO; and their implications on the Indian economy.

Globalization

Globalization, in brief, is a process of increasing economic integration and growing economic interdependence between countries in the world economy. It is relative softening up of economic and trade barriers across the countries so as to facilitate a free interflow of capital, technology, people, goods and services. Eventually, globalization would mean being able to manufacture in the most cost-effective way anywhere in the world. It means being able to procure raw materials and drawing management resources from the cheapest source anywhere in the world.

Globalization intends to integrate the Indian economy with the world economy. Globalization is considered to be an important element in the reforms package. It has four parameters:-

- (i) Reduction of trade barriers to permit free-flow of goods and services across national frontiers.
- (ii) Creation of an environment in which free flow of capital can take place.
- (iii) Creation of an environment permitting free flow of technology among nation states.
- (iv) Creation of an environment in which free movement of labour can take place in different countries of the world.

The advocates of globalization, especially from the developed countries, limit the definition of globalization to only three components viz., unhindered trade flows, capital flows and technology flows. They insist that developing countries accept their definition of globalization and conduct the debate on globalization within the boundaries set by them. But several economists and social thinkers in developing countries believe that this definition is incomplete. If the ultimate aim of the globalization movement is to integrate the world into one global village, then the fourth component of unrestricted movement of labour cannot be left out. But whether the debate about globalization is carried out at the World Trade Organisation (WTO) or at any other international forum, there is a deliberate effort to black out 'labour flows' as an essential component of globalization.

Effect of Globalization of Indian Economy

The process of globalization initiated in 1991 and far-reaching changes in industrial and other policies have led to considerable changes. The following achievements have been claimed specially on the external front:

(i) Our foreign currency reserves, which had fallen to barely one billion dollars in June 91, rose substantially to about 20 billion dollars in March 1995. Since then, they have been maintained at around this level only.

- (ii) Exporters are responding well to sweeping reforms in exchange rate and trade policies. This would be clear from the fact that as against a fall in the dollar value of exports by 1.5 per cent in 1991-92, export grew in the range of 18-21 per cent per annum during 1993-96. Since 1996-97, however, the export growth has been decelerating. In 1997-98, exports increased only by 2.1 per cent over the previous year.
- (iii) Exports now finance over 90 per cent of imports, compared to only 60 per cent in the latter half of the eighties.
- (iv) The current account deficit was over 3 per cent of GDP in 1990-91. It has fallen to about 1.4 per cent in 1998-99.
- (v) At the time of crisis, our external debt was raising at the rate of 8 billion a year. After that its growth has been arrested. From 1997 to 1998, it grew only by about \$ 1 billion.
- (vi) Contrary to what many feared, the exchange rate for the ru0pee has remained almost steady despite the introduction of full convertibility of rupee.
- (vii) International confidence in India has been restored. This is indicated by swelling foreign direct and portfolio investment.

GATT, WTO and INDIA

GATT is an international body having its Headquarters at Geneva and was founded in 1947 by 23 member countries including India. The body now comprises on 117 member countries of which around two-thirds are developing nations.

The international body has been holding negotiations ever since it was set up and the eighth round of negotiations was held at Uruguay in 1993 wherein the Dunkel Draft came into being.

During the course of Uruguay Round of negotiations, some member nations desired to add a few topics related to agricultural products, textiles and clothing under the purview of the accord. A few items like Intellectual Property Rights faced widespread disagreement among the member nations.

It is in this background, that the then Director General of GAT^{*}T, Dr. Arthur Dunkel introduced a package of proposals as a compromise formula, which was later, called as the Dunkel Draft. The Draft was signed by all the member nations on December 15, 1993 and is now part of the new GAT^{*}T accord approved at Marrakesh.

According to the approved GATT accord, a Preparatory Committee would be set up, which in turn would set up the World Trade Organisation (WTO), to become operational in early 1995. The WTO will act as a permanent watchdog on the International Trade and will enjoy the status similar to that of UNIDO, wherein each member nation will have single voting right.

Areas of relevance in the Indian Context

The GATT accord has its impact on three major areas in the Indian context. The major impact would be on the agricultural sector, textile and pharmaceutical industries. The sectoral impact is dealt in the subsequent sections.

Agricultural Sector: The Dunkel proposal, as accepted by the member countries has its impact on four different areas of agricultural namely,

- Reduction of domestic support in the form of subsidies
- Minimum level of import content in total consumption
- Possibility of disbanding of Public Distribution System
- Extension of Intellectual Property Protection on agriculture and introduction of seed
- Patenting.

Reduction of Farm Subsidies: According to the proposal, in the developing countries, the value subsidy commitment should not be more than 10% of the value of gross agricultural output.

In India, the Govt. offers minimum support price to 20 agricultural products and the subsidy provided in each case is leas than 10%. The ratio currently stands at 5.2% only.

Further, according to the proposal, this 10% norm excludes subsidies to the low income and resource poor farmers and those farmers having less than 2.5 hectares are defined as low income and resource poor farmers in the draft proposal.

In India, the low income farmers (as defined in the draft) account for around 40% of the total farmers. Hence, this provision may not result in a significant change in Government's policy in the foreseeable future.

Provision of minimum Access to Imports: The import content in the total consumption, according to the draft, would have to be at least 3% in the first year of enforcement of Uruguay agreement. This limit would go up to 5% by the end of sixth year. However, according to the draft, countries having Balance of Payments (BOP) problems are exempted from the commitment. India, being classified as the country having the BOP problem, is exempted from this clause. Hence this area too is unlikely to have a major impact on the agricultural policy of the Government.

Disbanding Public Distribution System (PDS): The GATT accord necessitates the member countries to procure the agricultural products at market price to sell them at market price. The Government, however, maintains that the PDS is meant to help the poor consumer and not the farmer. The question of undue influence on the PDS system therefore does not arise.

Seed Patenting: The agreement on Trade Related Intellectual Property Rights (TRIPs) argues that as far as the plant varieties are concerned (which include seeds), they must be protected either by a patent or by an effective sui generis system or by combination of both.

Another arc falls under WTO, which concerns India, is Pharmaceutical Industry TRTPs agreement. This requires India to pay royalties for using patents of drugs. Though many drugs (90%) are out of Patent now, but India will face difficulty after 2005, when New Patent Regime will start. India has to strengthen its R & D in pharmacy

Notes

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