A BACKGROUND NOTE ON THE APPROACH PAPER TO THE ELEVENTH FIVE YEAR PLAN

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1. The Kerala State Planning Board has serious reservations both on the approach of the Approach paper of the Planning Commission and on a number of specific points. The basic emphasis of the document is on an acceleration of the growth rate, which, both directly and indirectly (by generating greater revenue for appropriate State expenditure), is supposed to reduce poverty and unemployment. This presumption is untenable. It is not the magnitude of the growth rate, but the nature of it, and hence the regime within which it occurs, that is crucial for poverty and unemployment.

2. The decade of the nineties has witnessed an acceleration of the growth rate. And yet at the end of the decade, in 1999-2000, 74.5 percent of the rural population was poor, precisely in the sense that the rural poor are officially defined, viz. with a calorie intake of less than 2400 per person per day. (This figure is arrived at without making any adjustments to the "contaminated" NSS data; adjustments would raise it further). In 1973-74 the corresponding figure was 56.4 percent. Rural poverty, in the strict sense defined by the central government itself, appears to have increased, or at the very least not declined, despite the significant acceleration in growth rate. (The decline shown by the Planning Commission is methodologically faulty: it updates a "poverty line" by using the Consumer Price Index for Agricultural Labourers which only partially covers the consumption basket of the labourers). If growth acceleration has left rural poverty untouched at best, then more of the same would hardly make any difference to poverty. On the contrary, it would only accentuate inequalities even further.

3. The magnitude of poverty is linked essentially to unemployment. If growth remains "jobless" then no amount of acceleration in it would ever reduce poverty. The Planning Commission's presumption is that the growth of labour demand will increase with the growth of GDP, especially if GDP growth is based significantly upon the manufacturing sector. But there is no evidence for this. The elasticity of employment with respect to output does not appear to remain constant, either for the economy as a whole or for the manufacturing sector; on the contrary *it declines as growth rate increases*. And the decline is so sharp that a 12 percent growth rate in manufacturing, where it has occurred on a sustained basis, has been accompanied by an employment elasticity of 0.08, implying a mere 1 percent growth in employment. It follows then that the emphasis on the magnitude of growth is misplaced. The Approach Paper talks about the lot of the "average Indian" improving faster through growth acceleration; but this "average Indian" is a piece of fiction. The Planning Commission's statement is analogous to saying that a person whose head is in the freezer and feet over fire is "on average" comfortable.

4. Of course the Approach Paper visualizes an increase in the rate of agricultural growth to 4 percent, which is supposed to have a significant impact on rural unemployment and poverty. But there is a serious conceptual lacuna here. The problem with the Indian economy of late should be seen not just as the stagnation of *agriculture*, but above all as the stagnation of *peasant agriculture*. The relevant category in other words is not *sectoral* but *social.* And this makes a world of difference to our understanding of the remedies. If the problem was merely one of increasing *agricultural* growth, then corporate agriculture and contract farming, as endorsed by the Approach Paper, should make eminent sense. But if the problem is one of protecting and promoting *peasant agriculture*, then encouraging corporate players to enter the field and promoting contract farming, could have a further adverse impact on the peasantry, pushing it further towards destitution, causing even larger numbers of suicides, causing even greater rural unemployment and destroying the rural economy even further. The category of analysis in short is fundamental and the Approach Paper uses *sectoral* categories which are misleading.

5. What we have had in India is a phenomenon of undermining of *petty production*, of peasants, of craftsmen, and of the unorganized sector generally, under the impact of the policies of "liberalization", which have opened them up to competition from the world market, exposed them to price fluctuations of the world economy, entailed a drying up of institutional credit for them, and brought about a withdrawal of government support for them. We in Kerala have been witnesses to this crisis of petty production, which has resulted in a large number of suicides in Wyanad, and threatens to reduce small fishermen and plantation workers to destitution (especially with the spate of Free Trade Agreements which the Union Commerce Ministry has embarked upon).

6. It is a symptom of the Approach Paper's obliviousness to this issue, arising from its exclusive use of *sectoral* as distinct from *social* categories, that it actually advocates a further *de-reservation* of items hitherto reserved for the small-scale sector, which would only compound the crisis of petty production. Likewise leaving peasants to the mercy of multinational corporations which would directly interact with them as purchasers of their products, as sellers of inputs to them, and as contracting parties (within a regime of contract farming) will only aggravate their dire conditions, given the massive mismatch in their respective bargaining strengths. This would only worsen the crisis of the petty production sector, and, in the context of the incapacity of the expanding organized sector to absorb more workers which was noted above, accentuate rural unemployment and poverty.

7. If obsession with the quantitative magnitude of growth constitutes one major lacuna of the Approach Paper, then its inability to pinpoint the nature of the crisis afflicting large segments of the economy, to recognize that the crisis is

not simply one affecting particular *sectors*, but one that affects petty production generally, constitutes its other lacuna (inter-related with the first). To overcome this crisis, support of the State is essential; pushing petty producers into direct deals with MNCs or with the corporate sector in general, will only aggravate the crisis. And the Approach Paper's endorsement of MNCs' entry into agricultural retailing at the expense of local traders, through an overcoming of the latter's "vested interest" (as if the MNCs are devoid of any "vested interest"), will only generalize the crisis of *petty production* into a *crisis of petty production and petty trade*. It will additionally throw large numbers of petty traders out of business and work. In our view therefore *the State must interpose itself between the MNCs and the corporate players on the one hand and the petty producers on the other*: this is the only way of neutralizing the consequences of the mismatch in their respective bargaining strengths.

8. This requires a strengthening of the extension services provided by the State so that the peasants are not deceived in the matter of purchase of seeds and other inputs. It requires a strengthening and widening of the price-support system erected after the mid-sixties instead of a dismantling of it. It requires a strict enforcement of priority sector lending norms instead of their dilution through a widening of the definition of the priority sector as has been occurring of late. And it requires that if contract farming is to be undertaken then the contract cannot be between petty producers and the corporates alone; the State must insert itself as a party to the contract to ensure that the interests of the petty producers are properly defended.

9. The Approach Paper's lack of comprehension of the nature of the agrarian crisis manifests itself in its attributing the "problems facing agriculture" to the provision of subsidized power, to the under-pricing of canal water and to the "preset system of fertilizer subsidy". In each case, it argues, the provision of subsidy has resulted in over-use and wasteful use of the relevant input and contributed to agricultural stagnation. The Green Revolution strategy itself required intensive use of fertilizers and water. Water required power. Many have criticized the Green Revolution strategy on the grounds of its intrinsic unsustainability arising from such intensive use. But the Planning Commission's argument emphasizes not this strategy as such, but only the price-"distortions", as if "getting prices right" would have rid us "costlessly" of the problem of intensive input use. No evidence is given in the paper for the implicit perception that it was not the intensive use of inputs *per se* under the Green Revolution strategy, but only the "over-use" arising from "price distortions" that makes agricultural performance unsustainable. What is more, the document shows lack of awareness of the consequences of removing these subsidies, which would entail not "optimal" use of these inputs, but a further squeeze on the peasantry, through rising input costs in the context of falling or subdued commodity prices.

10. Of course even if higher growth does not in itself reduce poverty and unemployment, it provides the State, as the Approach Paper notes, with the wherewithal to do so. The Approach paper's emphasis on the need for State intervention to reduce poverty, through the provision *inter alia* of education and health services, is welcome. But the paper's attitude towards such expenditure is ambiguous: it simultaneously asks for an increase in user charges and a cut in subsidies, though not necessarily for a small, deserving, targeted population. Targeting however scarcely ever works. It is well-known that the officially recorded BPL population is far less than the actually poor, so that a large chunk of the poor are left out of the ambit of targeting. Besides, once the logic of targeting is accepted, the tendency typically is to keep reducing the size of the targeted population. All over the world, targeting within the Public Distribution System has been the prelude to a gradual winding up of the system itself. Thus, while the Approach Paper talks in one breath of the need for State intervention for reducing poverty, in the very next breath it makes suggestions that enfeeble any such intervention. An attempt to curtail food subsidy, through a rise in issue prices or a restriction of the scope of the PDS for instance, will undermine food security of the people, and hence nullify the impact of the provision of health facilities which the Approach Paper recommends as an anti-poverty measure. Indeed even the view that the withdrawal of subsidies, which are not directly meant for the poor, would not hurt them, is not necessarily correct, since the withdrawal of such subsidies often entails changes, such as rise in prices or cuts in output, which *do* have an impact on the poor.

11. Thus the basic growth obsession of the Approach Paper is misplaced. Higher growth neither has a direct impact on poverty and unemployment, nor necessarily provides the wherewithal for enlarged anti-poverty intervention by the State. On the contrary, the strategy visualized for achieving such higher growth, entails an even greater squeeze on petty production and an even greater tendency to let the poor fend for themselves through cuts in subsidies. The time has come when the planning exercise in the country, instead of getting bogged down in growth rate targets, should start instead from the "other end": *by having targets only with regard to employment, poverty reduction and social sector achievements, and working out ways to achieve them.*

12. If the Approach Paper's obsession with growth rate lacks pertinence, several parts of the strategy it advocates for achieving it are unacceptable. It advocates the opening up of the mineral sector to private capital, including MNCs. Since minerals are scarce natural resources, their rate of extraction, the prices charged for them, the conditions under which they are extracted, the uses to which the proceeds from their extraction are put, are matters that should be socially determined. It is for this reason that in India and in the rest of the third world, freedom from colonial rule was accompanied by nationalization of the mineral sector which till then had been monopolized by

metropolitan capital. The Approach Paper, without giving any valid reason for it, wants this entire approach to be given up. It is not as if there are any technological reasons for inducting private capital into mining, or any change in the nature of capital which has made the earlier decision to keep mines within the public sector untenable. The Approach Paper's suggestion is purely gratuitous, with at best a reference to some financial argument, which, as argued below, is theoretically untenable. We can not accept the privatization of the minerals sector. The induction of private capital (especially MNCs) not only jeopardizes crucial national interests, but poses a serious threat to the lives and conditions of the workers employed in mines. (Experience from within the third world shows clearly that privately-owned mines have been the sites for more frequent mineral accidents than publicly-owned ones).

13. The Approach Paper advocates "Public-Private Participation" as the strategy of development, not just in infrastructure but in almost every sector, including social sectors like education. Nowhere however is there any justification provided for PPP. The fact that private players would like to concentrate on the more lucrative sectors; the fact that the overhead sectors where they do come in would entail increases in user charges, to the detriment of the poor; the fact that in the absence of such increases in user charges, the State has to provide subsidies, which, given its self-imposed financial constraints (and in the absence of possibilities of cross-subsidization owing to its withdrawal in favour of PPP), would effectively mean the exclusion of large segments of the population from such overheads altogether; and the fact that even when such subsidies (in the form say of guaranteed rates of return) are provided, they are liable to seriously misused as in the case of the Dabhol plant of ENRON; are all well-known. There is however a deeper point. A change from public sector to PPP affects the basic structure of the economy. It cannot occur without a national debate and the emergence of a national consensus. For this there have to be valid and basic arguments. The financial argument on the basis of which PPP is justified is not of a basic over-riding nature: a sovereign State can never be considered to be intrinsically devoid of investible resources. *Besides, it is entirely spurious, based on a conceptual confusion between savings and finance.*

14. An act of investment does not require a prior act of *saving*; it generates, leaving aside capital inflows, an amount of savings equal to itself. An act of investment however requires *finance* for carrying it out which is not the same as *saving* (the excess of income over consumption). Hence government investment is never constrained by government savings, just as capitalists' investment in no capitalist economy is ever constrained by capitalists' own savings. To argue for PPP on the grounds that *the government does not have enough resources* therefore makes no theoretical sense. If the government could not raise *finance* then the matter would be different; but this obviously is not the case. The case for PPP may be argued on other grounds, e.g. the supposedly better management of private units or the supposedly greater

efficiency of privately-run units; but these grounds have to be established. The Approach Paper does not do so, but advances instead a spurious financial argument. This spuriousness is evident not only from the theoretical argument just given above, but also from the fact that even when public enterprises have had financial resources they have nonetheless been encouraged to take the PPP route (e.g. the freight-corridor project of the railways).

15. The Approach Paper, in a circumlocutory manner, advocates labour market flexibility as a means of expanding employment in the organized manufacturing sector. This position can be advanced, and has been, on the basis of two possible arguments: one, labour market flexibility, by allowing a reduction in the real wage rate, will generate larger employment through a shift to more labour-intensive techniques; two, labour market flexibility, by improving "investors' confidence", will generate larger investment and hence greater labour demand. This position, no matter which theoretical route we take, is based on a false argument. The "choice of techniques" argument not only presumes the existence of a mythical "aggregate production function", but also ignores the demand side altogether. Any cut in real wage rate results immediately in a reduction in the level of consumer demand. Since the level of investment can only change, if at all, over time, this means a fall in aggregate demand, and hence in employment. Hence the first argument is false because a fall in the real wage rate, instead of increasing employment, actually reduces it. And when this happens, the lower demand in the economy makes businessmen reduce their investment plans, so that the second argument too becomes false. Large numbers of empirical studies, conducted at the ILO, have also shown that the introduction of flexibility into the labour market has no positive effects whatsoever either on investment decisions or on the employment profile. The Approach Paper's reviving the demand for labour market flexibility is theoretically indefensible, and completely unacceptable.

16. A second gratuitous demand of this *genre* which the Approach Paper makes, though again in a circumlocutory manner, is for capital account convertibility. Such convertibility, by making it possible for domestic citizens, not just foreigners, to take out or bring in funds freely, gives rise to great volatility. It also keeps the economy deflated, through government expenditure cuts, as a means of retaining "investor confidence". India could escape the East Asian crisis of 1998 because she did not have capital account convertibility at the time. (The same is true of China). While the gains from capital account convertibility are completely dubious (it is likely to draw in speculative funds rather than productive investment from abroad), the costs to be paid for such convertibility are enormous, in terms of both instability and deflationary cuts in expenditure, which give rise to stagnation, unemployment, and cuts in social wage. While even influential sections among those who stand for liberalization have come out against the introduction of capital account

convertibility, it is surprising to find the Approach Paper pleading for it. Capital Account convertibility should be avoided under all circumstances.

17. Many of these suggestions, whether on capital account convertibility or on PPP, derive from the basic need for infrastructural development emphasized in the Approach Paper. Infrastructure however is not a homogeneous term. Different kinds of infrastructure require different amounts of investment, and which kind of infrastructure is in short supply depends upon the distribution of the gains of the development process. Along a growth trajectory favouring an increase in income and wealth inequality, modern infrastructure, such as airports, flyovers and express ways, would be in short supply. Along an alternative growth trajectory which emphasizes rural development with a greater degree of income and wealth equality, the shortage will be predominantly of rural infrastructure. The amounts of investment required in the two cases will be vastly different. It follows then that the so-called infrastructural investment need that the Approach Paper talks about is itself a product of the specific trajectory of development, with accentuating inequalities, that we have been having; it is not some independently given, objective requirement. By the same token however these needs will never be satisfied. With the perpetuation of inequalizing growth, the need for infrastructural investment will keep mounting. In short, infrastructure of the sort that sustains and is demanded by the inequalizing trajectory of development that we have had in the recent period, constitutes an area of perennial excess demand, a bottomless sink sucking in investment that never succeeds in overcoming this excess demand. The only way of getting out of this bottomless sink is to opt out of this particular growth trajectory itself. But the Approach Paper, as already mentioned, remains stuck in this trajectory.

18. The Approach Paper talks of encouraging "partnerships" between Civil Society Organizations and PRIs, and also of associating Civil Society Organizations in the evaluation of Plan programmes. While a number of Civil Society Organizations have done admirable work in helping PRIs and in raising the level of consciousness of the people regarding Plan programmes and their rights, one cannot ignore the fact that Civil Society Organizations are of various kinds. Many are funded by foreign governments and agencies and carry over into their work the concerns, the outlook and the predilections of their donor agencies. Many are simply the external arms of foreign governments and agencies. There is need for monitoring the role of these CSOs themselves. To confer on them indiscriminately a monitoring role over the work of the elected bodies of the State in implementing Plan programmes, constitutes a restriction of democracy. This is especially so since these organizations are not themselves in any way accountable to the people. Likewise while PRIs should be free to take the help of CSOs if they so wish, to *make them do so* constitutes an abridgement of their freedom.

19. The Approach Paper's suggestion for amending the FRBM Act is welcome. It makes the point that the focus on revenue deficit should be abandoned, since a number of items of expenditure which contribute to human capital formation are listed as revenue expenditure. Normally, the opposite point is made, namely that it is the revenue deficit rather than the fiscal deficit which should be restricted: while a government must not "consume" beyond its income, its borrowing for capital formation should not be frowned upon. While this latter argument is persuasive, the Approach paper is right in suggesting that in the Indian system where revenue expenditure does not reflect pure "consumption" *even the revenue deficit should not be arbitrarily curtailed.* It follows then that the FRBM Act should be taken off the statute book *in toto*, since it makes no sense to put a ceiling either on the fiscal deficit or on the revenue deficit.

20. In any case, there is *no theoretical justification whatsoever* for putting a ceiling on the fiscal deficit. The idea that a rise in the fiscal deficit causes a rise in interest rates (if it is not monetized) or inflation (if it is monetized), is both theoretically erroneous, and empirically unfounded. Its theory is wrong because in a demand-constrained system where idle capacity, surplus foodgrain stocks and substantial foreign exchange reserves exist, there is no danger of inflation through a rise in the fiscal deficit; and monetary policy can be used to ensure that the interest rate rules at whatever level is considered appropriate. Empirical studies have also shown that there is no connection whatsoever between fiscal deficits and (real) interest rates. This obsession with curbing the size of the fiscal deficit *irrespective of the situation* is a throwback to the "principle of sound finance" which characterized the policy of the colonial government, with devastating consequences for the Indian economy. It is a relic of pre-Keynesian economic theory, which is promoted by finance capital for its sectional interests but which has no rationale as macroeconomic policy. We favour the discontinuation of the FRBM Act. This does not mean encouraging fiscal irresponsibility; but fiscal responsibility cannot be enforced through meaningless formulae.

21. The fact that such formulae, and the false theory underlying them, have been thrust on the state governments via the Twelfth Finance Commission, is symptomatic of a deeper malaise, namely a severe curtailment of the rights, powers and authority of the state governments in recent years. The issue is not one of the Centre versus the states; it goes much deeper, to the strength and autonomy of the Indian nation-State, of which both the Central and state governments are constituent units. The centralization of financial powers in recent years has been accompanied by greater permissiveness with regard to agencies like the World Bank and the ADB exercising control over "governance" at the state level. We have a simultaneous combination of processes of centralization and decentralization which are undermining the strength of the Indian nation-State by giving a larger say to external agencies in the running of our economy and polity. This centralization-decentralization dynamic can be arrested only if a proper balance is introduced between the

powers of the Centre and the states, a balance that is optimal for the strength of the nation-State as a whole. Instead of moving towards such a balance, we have been moving further and further away from it in recent years. The process of this movement is worth exploring.

22. In the decade of the nineties, while the ratio of the Central government's tax revenue to GDP had declined, that of the states taken together had not. And yet at the end of the decade most state governments faced a fiscal crisis. The reason lay partly in the reduced scale of transfers from the Centre to the states, but to a large extent in the exorbitantly high interest rates charged by the Centre on the loans (including Plan assistance) it gave to the states. The average interest rate on these loans was in most cases higher than the rate of growth of the net state domestic product, a sure recipe for a fiscal crisis. This is the period when state government debts escalated, which reduced them to the status of mendicants. Successive Finance Commissions in the recent period whittled down the autonomy of the state governments even further. The Eleventh Finance Commission took the extraordinary step of making the transfer of resources, which were Constitutionally due to the states, dependent upon their fulfilling certain "conditionalities" to the satisfaction of the Centre, such as for instance the restructuring of the State Electricity Boards. The Twelfth Finance Commission while providing debt relief, made such provision conditional upon state governments enacting Fiscal Responsibility legislation. Curiously, however, neither of these Finance Commissions took the Centre to task for any act of fiscal omission or commission on its part. Finance Commissions in other words have acted more like School monitors appointed by the Principal (the Central government) to discipline recalcitrant school children (the states) according to the former's notions of discipline.

23. Kerala has been a particular victim of the arbitrariness of successive Finance Commissions. The per capita transfers to Kerala according to Finance Commission awards have been lower than the average for all states throughout the nineties and subsequently. But the last two Finance Commissions have been particularly harsh on the state. For the period 2000-05, covering the award of the Eleventh Finance Commission, the state is estimated to have got Rs.3664 cr. less than it would have got if the criteria of the Tenth Finance Commission had been applied. And during 2005-10, the loss to the state by the same measure is estimated at Rs. 6088 crores. In short the loss to the state under the awards of the last two Finance Commissions, measured by the Tenth Finance Commission's criteria, amounts on average to around Rs.1000 crores per annum. The arbitrariness of these awards is manifest from the fact that the Eleventh Finance Commission even penalized the state for its performance on decentralization, despite the fact that the state's pioneering role in decentralizing plan funds, prior to the coming into being of that Commission, had been widely appreciated, and is now being sought to be extended to the country as a whole: the criteria applied by the

Commission were obviously so arbitrary and narrow that they failed to capture this achievement.

24. The introduction of a uniform VAT regime, which took away the discretion of state governments to alter tax rates in the main sphere where they raise their revenue, the sales tax, was yet another blow to the autonomy of the states. Today, since the VAT rates are given to them and since their borrowing limits are determined by the Centre, there is very little elbow room available to states for garnering resources. And the availability of even these resources depends on their "behaving properly" to the satisfaction of the Centre.

25. But it is not just in the matter of finances that the power and authority of the states have got eroded. A whole range of international treaties have been signed which have an extremely important bearing on the livelihoods of the people living in particular states without any consultations whatsoever with the concerned state governments. Likewise, tariff policy which affects the people of particular states has been pursued without any consultations with the state governments. The same is true of food policy. The list can go on. Kerala has been a particular victim of this too. And even now, though the spate of Free Trade Agreements being signed by the Union Commerce Ministry will have a serious impact on the agricultural sector of Kerala, no body has thought it fit to consult the state government in the matter. Since Kerala is a food importing state, Central food policy has a crucial bearing on the welfare of the people of the state which has an enviable system of public distribution; and yet, important decisions regarding the procurement and public distribution regime for food are taken by the Central government without any consultations whatsoever with the state government. The states in short have merely become the recipients of the consequences of Central decisions without having any say in matters that affect them crucially. This is completely contrary to the spirit of our federal system; but the Approach Paper makes no mention of this fact which certainly has an important bearing on the planning process.

26. Planning is concerned not just with a set of growth rate, resource mobilization, and expenditure targets; it also encompasses the erection of an appropriate economic regime within which plans can be decided and implemented. The Planning Commission's holding these regional consultations is a welcome development: it constitutes a recognition of the fact that the country can advance only though the inculcation of a spirit of co-operative federalism. But more than just spirit is needed here. There must be appropriate institutional structures. To advance discussion in this area, we make the following initial proposals. (i) All international treaties, such as the WTO agreement, which the Union government signs, must be ratified both by the parliament, and, where they impinge heavily on state fortunes, by the National Development Council. (Even in the U.S., Congressional approval is needed before an agreement signed by the Administration becomes effective). (ii) Policies in a number of

vital spheres such as food pricing, procurement and distribution, and tariff policies having overwhelming consequences for particular states, should be brought before the National Development Council which should have the final decisive say in the matter. (iii) Appointments to Constitutional bodies like the Finance Commission which have the task of adjudicating between the Centre and the states, should be made by the President on the recommendations of the Inter-state Council, and not of the central government alone. (iv) There should be appropriate legislation to ensure that the nominal interest rate charged by the Centre on loans to the states should not exceed a figure that falls short by a stipulated margin the average nominal GDP growth rate over a specified past. (v) The state governments, vying with one another to attract private, including foreign, capital to their respective states, are making ever larger concessions to such capital, which is detrimental in the long-run. Their bargaining strength is greatly reduced as they undercut each other. The NDC must work out guidelines within which the states seek to attract private investment, and these must be strictly enforced. (vi) Different states have already deviated from the regime of uniform VAT rates. This *de facto* state of affairs must be made *de jure* with the prescription only of a set of minimum VAT rates and the extension of freedom to states to exceed this minimum. A movement along this route can put our federal polity on a sounder footing and strengthen our nation-State which is essential for our freedom in this “globalized” world.

(This background note has been prepared on behalf of the Kerala State Planning Board by Prabhat Patnaik, Vice-Chairman of the Board).