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SRISHTI MISHRA
ECFC23L1020
TEST 3
5/08/2023

Appearing for Mains !

Completed in 3 hrs.

SPACE FOR COMMENTS :-

Page

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Q1a) An individual earning all income (Y) in money terms and having opportunity cost 'r' as well as brokerage cost 'b' has the following money demand function:

$$c = \sqrt{\frac{2bY}{r}}$$

Baumol's inventory model approach to money demand.

According to Baumol's theorem:

(i) individual can hold money in 2 ways:
1. Money terms (real)
2. Bonds

(ii) The Opportunity cost of holding money is the interest foregone on holding it as bonds.

As shown by equation;

(i) mony dd (c) has direct relation with income (Y) because more income raises the ways in which transactions can be done. So transactional dd rises.

NEXT IAS

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(ii) direct relation with brokerage cost (b) since higher brokerage will reduce frequency of extracting money, so more will be held by the people.

(iii) indirect relation with interest. Higher interest (r) on bonds will incentivize people to save in that form as it raises opportunity cost of holding money.

Criticisms of the model

(1) other assets (like equity, debentures) not considered → taken up in Tobin's theory.

(2) Savings concept not elucidated.

Thus Baumol's model was an early model that was built upon by following economists like Tobin & Friedman QTM.

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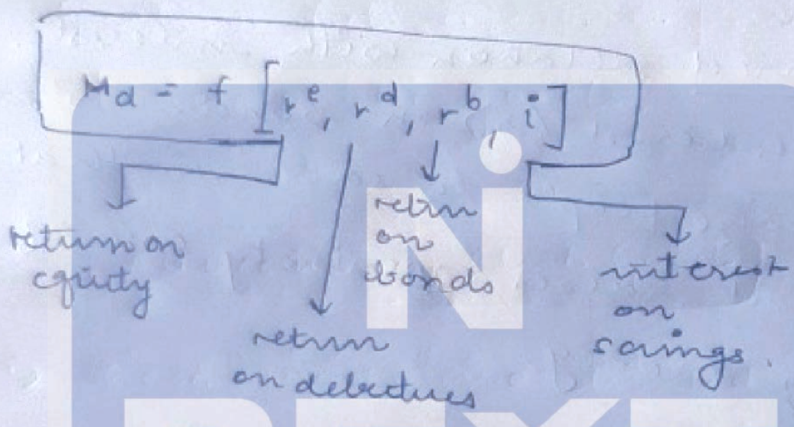
(b) Tobin's Portfolio Balance model was an improvement on Baumol's model :



According to Tobin's model :

(i) Md is dependent on returns on various assets like equity, debenture, bonds, etc.

(ii) This is called the portfolio approach as it takes a portfolio of assets into account.

(iii) Rise in returns on any of these assets will reduce demand for money as people will keep money in these assets.

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(iv) Tobin assumed homogenous macroeconomic behaviour for this model.

(v) An extension of this was Tobin's (q) theory that defines returns in international terms.

CRITICISMS

(i) macroeconomic behaviour homogeneity was questioned. But Tobin answered that assuming all individuals are rational, behaviour can be extrapolated to macro level.

(ii) No policy suggestion.

Tobin's theory was an improvement over earlier theories but still didn't provide policy support.

NEXT IAS

(c) Club goods are those that can be exludable but are non-rivalrous. they lie in the middle of the spectrum between pure private goods and pure public goods.

Allocation of club goods

(i) these goods are limited in scope and therefore need to be allocated efficiently.

(ii) use of entry-barriers eg: membership to a pool house, only those with member-card can enter. others are exluded.

(iii) Since these goods are semi-private they are funded by individuals and aim is to avoid free-ridership.

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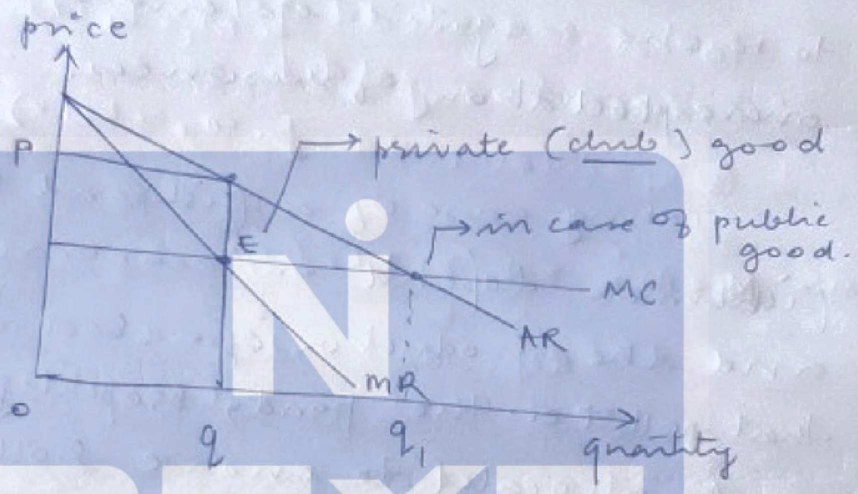
(iv) Price is set equal to where MC = MR to ensure maximum profit is earned.



Thus, instead of producing at MC=AR quantity of q_1, it is restricted to q where MC=MR and there is no misuse.

~~non~~ Excludable nature allows club goods to remain profitable through entry barrier allocation system.

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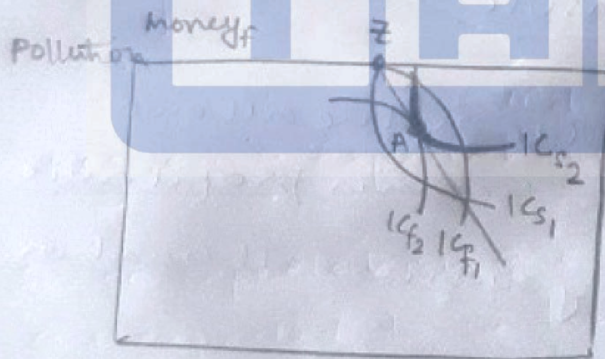
d) Coase Theorem is a property-allocation theorem that aims to resolve negative externalities and overexploitation of resources.

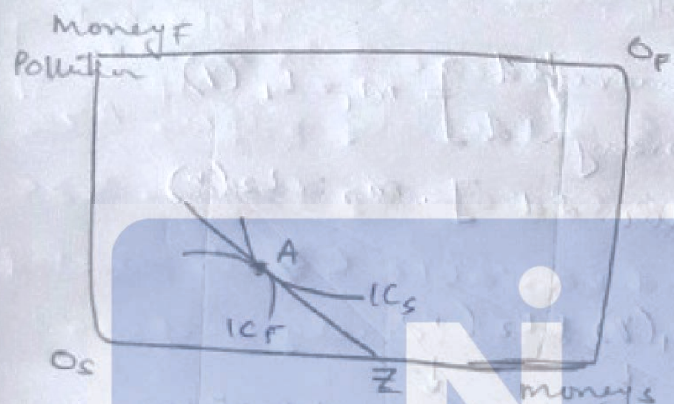
Taking case of a fishpond which fishermen depend on economically and the introduction of a steel firm that pollutes the pond, property rights can be allocated to ensure both parties are at equilibrium.

Case 1 All rights to steel firm



As shown, all rights begin with steel firm at Z where money is allocated equally to both the firm and the fishermen. Now, fishermen can pay to reduce pollution to reach (A) where ICs of both are tangent to each other representing pareto optimality.

Similarly : CASE 2 where all property rights belong to fishermen.



In this case, at Z, all property rights belong to the fishermen. Steel firm can pay fishermen to allow them to pollute such that new equilibrium is reached at A where IC_S is tangent to IC_F and both are at Pareto Optimality.

Thus, Coase theorem defines property rights to allow market to reach Pareto Optimality and control over utilization of common resources.

c) Keynesian Demand for Money is based on 3 forms of money dd:

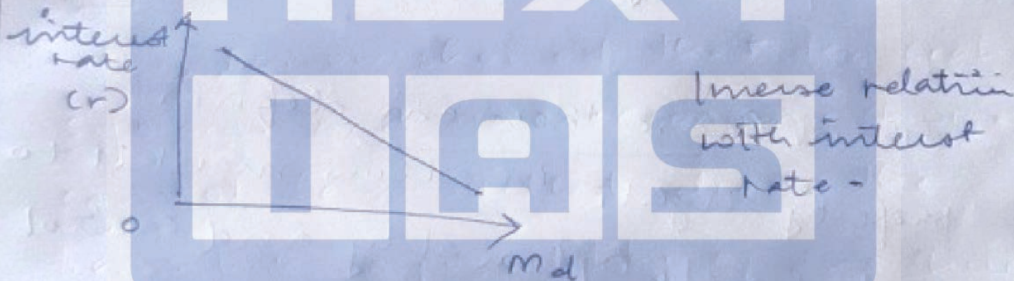
① Transactions dd } $M_1 = L_1(Y)$
② Precautionary dd }
③ Speculative dd] $M_2 = L_2(r)$

$M = M_1 + M_2 = L_1(Y) + L_2(r)$

$L_1(Y)$ ↓ dependent on income

$L_2(r)$ ↓ depend on interest rate.

Speculative dd for money



Regressive Expectations model:

Since expectations are regressive, interests are expected to be low. As a result, speculative dd for money is high & fluctuating. This leads to high uncertainty in bonds market and pushes interests to fall further.

"What you expect is what will happen".

Q3a)

The Impossibility Theorem by Arrow which sought to showcase the difficulty of predicting outcomes in a democracy was critiqued by Amartya Sen & Buchanan. The latter critiqued the nature of ascribing individual choices to society at large.

ARROW's Impossibility Theorem

1. Assumptions :

(i) transitivity of choices

eg: if A>B and B>C then A>C

(ii) Completeness of the bundles

eg: A ~~~A~~. is fully defined.

(iii) Reflexivity of the bundles

eg: A ~ A

(iv) Individual choices ~~and~~ can be extended to the overall population.

(2) According to the model, people are given 3 choice situations having 2 bundles each:

[Rank order Preference & Irrelevant variable Approach]

(i) Between A & B, society prefers A>B

(ii) Between B & C, society prefers B>C

(iii) Now, third variable C is presented alongside A and society prefers C>A

⇒ This violates rule of transitivity since A>B & B>C means A>C.

Thus, Arrow showed that democratic systems and macroeconomic choice cannot be modelled due to the transitive impossibility of the choices.

This was critiqued by many economists:

(i) Buchanan:

Individual choices cannot be attributed to the economy as a whole.

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eg: one person may prefer A > B, B > C ⇒ and also A > C.

whereas another may prefer C > A.

Since choice is subjective, it cannot be given a macroeconomic constant.

(ii) Amartya Sen criticized the methodology ~~of~~ or approach of the model, particularly speaking on democratic nature of government and goods allocation.

thus, Arrow's Theorem was somewhat flawed and therefore followed by the Capabilities Approach to public expenditure and distribution

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3 b) Theories of Public Expenditure evolved through the Pigou-marshall theory, Wagner's Hypothesis, Peacock-Wiseman as well as Adam Smith's Canons of Taxation.

Public Expenditure refers to the spending that government undertakes for purpose of socio-economic upliftment in the country. It is a function of:

(i) welfare state
(ii) social requirements
(iii) economic stability
(iv) developing nature of economy
(v) Revenue collected

Theories of Public Expenditure

① Initial theory was given by marshall-Pigou that stated:

ambitz
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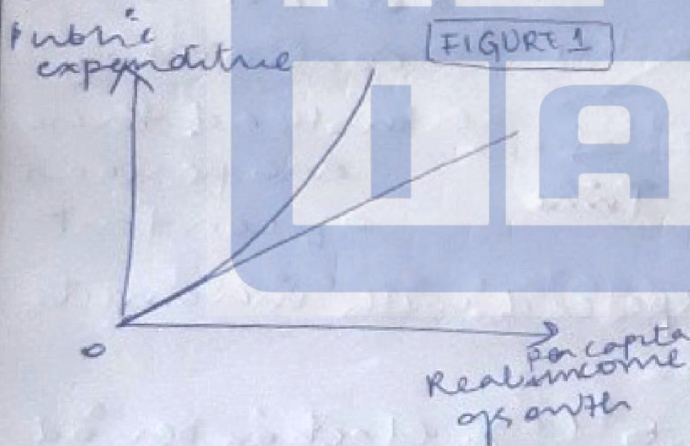
"expenditure should be distributed in such a way that every last unit of money spent on each sector yields equal real returns"

In a way, this theory was an extention of the equi-marginal utility function of consumer equilibrium theory $\left[\frac{MU_x}{P_x} = \frac{MU_y}{P_y} = MU_m \right]$.

② This theory was followed by wagner's hypothesis.



According to this theory, growth in the economy (GDP) leads to increase in public expenditure due to:

(i) rising role of state
(ii) increase in local governance (decentralization of expenditure leads to more expenses).
(iii) administration increases → further raises public expenditure

There is thus an exponential increase in public expenditure as shown in figure 1.

② As opposed to Wagner's Continuous growth, Peacock-Wiseman provided a model of Discontinuous increments of public expenditure.

According to this model, expenditure does not increase continuously. Instead there are periods of constant expenditure interspersed with increments due to:

(i) political events (eg: election period sees rise in programmes with higher spending).

(ii) Budget sessions (eg: Finance Commission, devolution of funds.

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④ adam smith's Canons of Taxation provide a roadmap for effective tax rules.

(i) Equality / Equity
(ii) Certainty
(iii) Economy
(iv) Convenience

This is supplemented by Laffer Curve theory that shows effectiveness of taxation on total tax revenue.

overall, public expenditure models have evolved to reflect the changing role of government in a mixed economy with aims being:

◎ allocative efficiency &
◎ distributional justice

along with fiscal prudence and consolidation.

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Q3(c)

Taxation is an economic policy wielded by the government that can influence quantity consumed/produced of a product and contribute to government's total revenue figures.

Taxation is often used as a method of influencing social choice by internalizing negative externalities and allowing for distributional justice through effective reallocation of tax revenue.

① case of negative externality of production.

Taking a situation where a firm is producing paint which is releasing harmful toxins in the environment, it can be shown that it has negative impact on 3rd party, i.e. local residents.

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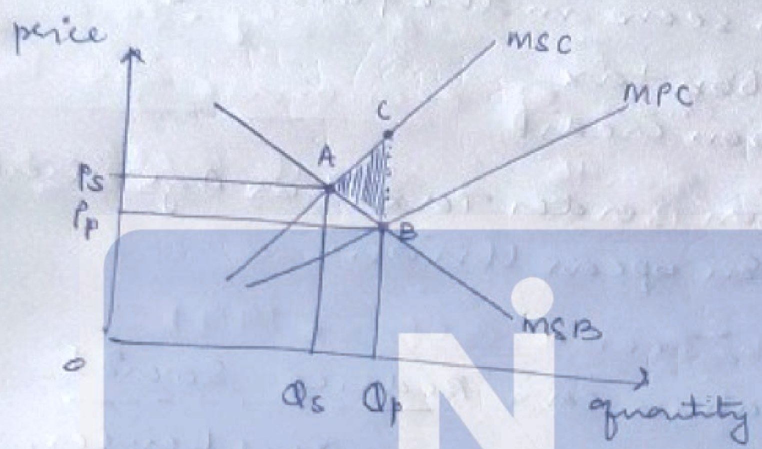
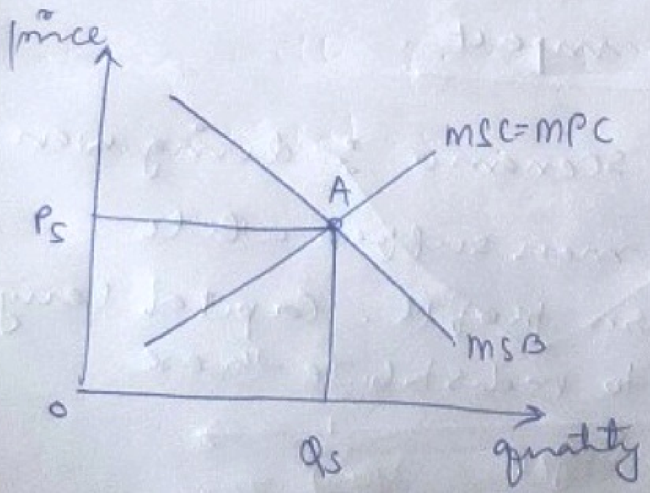
Before Taxation



Since marginal private costs (MPC) is lower than marginal social cost (MSC) of pollution, the quantity produced (Qp) is greater than socially optimum quantity (Qs) where MSC = MSB. This creates deadweight loss of ΔABC.

After Taxation



Taxing the firm can shift its MPC curve upwards to intersect MSC such that ΔABC is internalized as quantity falls to socially optimum level Qs.

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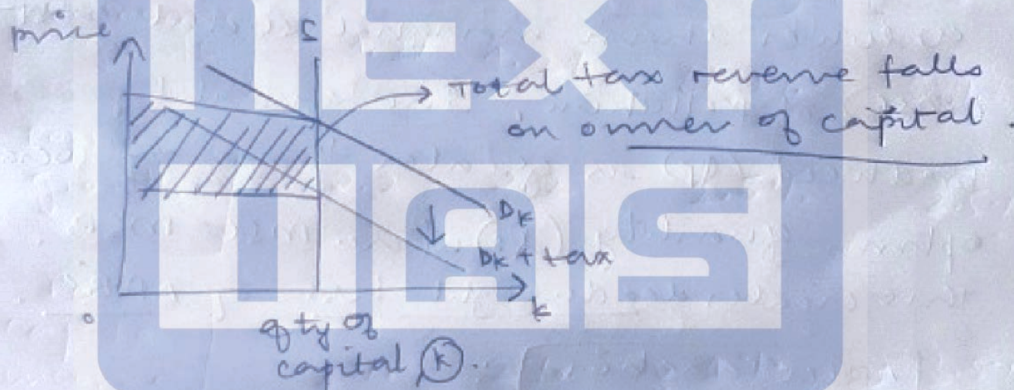
Thus, tax can ensure social costs are considered.

This is seen in the form of:
- carbon tax
- carbon credit

eg: Carbon Border Taxation Agreement, European Union.

② Taxation can Reduce Social Inequities, eg: Capital levies.



Equalization impact:

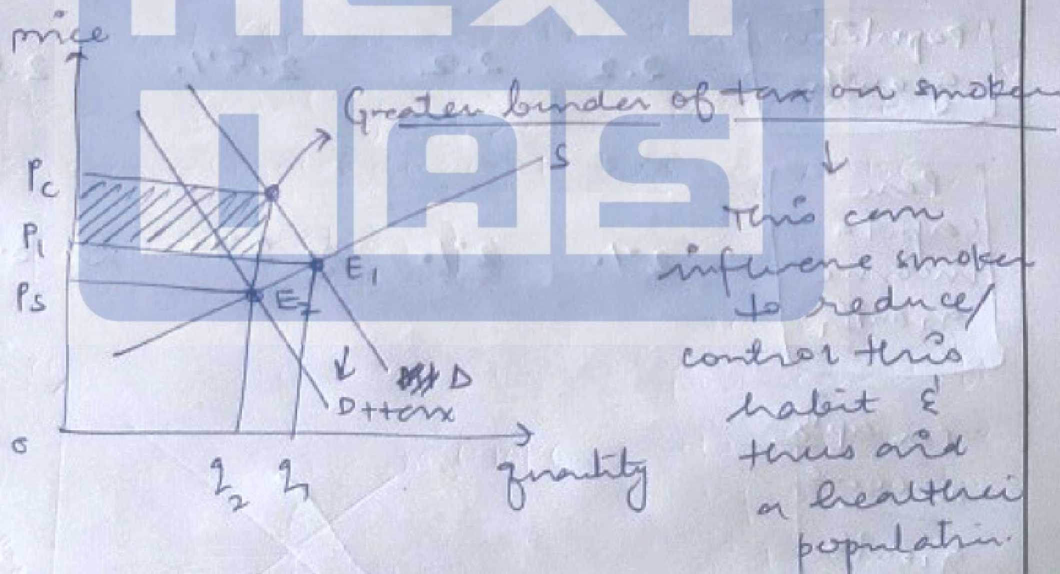
(i) post-war Scenario: during war, soldiers, lay men suffer while capitalists earn profits. Capital levy can be used to redistribute these unfair earnings.

(ii) liquidation of assets allows government to prioritize spending such that welfare goals can be targetted

eg: Disinvestment of Air India. Returns can now be spent on government schemes.

(3) Change social behaviour by taxing consumers.

eg: Smokers



This can influence smoker to reduce/ control this habit & thus aid a healthier population.

Thus, tax acts as a method of equalizing welfare, reducing adverse externalities & encouraging good behavior while also aiding government revenue growth.

Q5a) Before the LPG policy of 1991, Indian poverty rates were high along with very high inequality. Poverty was a function of economic growth, population growth & social welfare.

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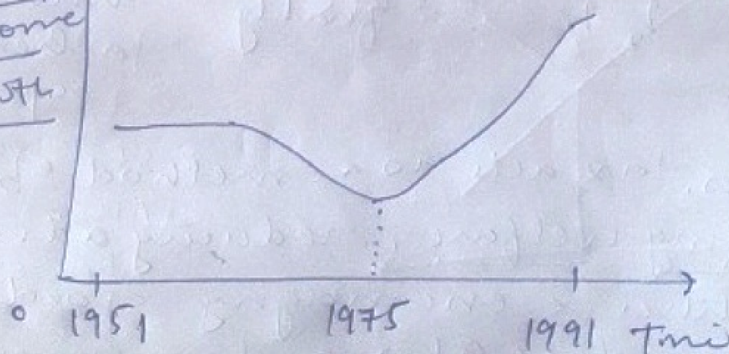
Poverty Trend Before 1991

(i)

	1st, 2nd		3rd, 4th	5th, 6th
Economic growth	4.2%	4.2%	3%, 4%	5.8%, 6.2%
Population growth	2.2	2.2	2.5%	2.5%
Per capita income growth	2%	2%	≈ 1%	≈ 3.5%



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अभ्यर्थियों को इस हाशिए में नहीं लिखना चाहिए
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according to Per capita income trends:

(i) Structural retrogression during 1970s led to ~~fall~~ rise in poverty

(ii) structural shocks, oil crisis of 1973, subsequent famines and skewed defense expenditure led to a weak social welfare scenario.
↳ dependence on PL480 (food insecurity), overdependence on agriculture added to poverty burden.

However, per capita income is inadequate measure of poverty.

(i) Indira Gandhi's emergency period saw a rise in poverty due to forced schemes eg: rehabilitation/ vasectomy / tubectomy, etc.

(ii) 20 Point Programme & socialist nature increased welfare role.

(iii) Green Revolution & Rise in labour productivity (Prof. Nagraj) led to lower poverty.

Thus, before 1991, poverty was not a targetted goal but overtime, saw greater focus.

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c) Crony-socialism refers to the nexus between the socialist state and the constituents of economy within, particularly the PSUs and the few licensed private players.

Crony socialism in Pre 1991 India

① License Raj promoted very few private players in consumer industry.

② PSUs were the Commanding heights of the economy [Industrial Policy Resolution 1956] such that they became the strongholds of the government.

③ Excessive political interference led to apathy in output production & inefficiencies in the industry.

④ Socialist planning led to skewed development:
eg: excessive focus on capital industry, agriculture was ignored.

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Stigmatized capitalism

① As a result of the skewed policy, some industries were able to excel while other sectors perished.

eg: 1980 3rd IPR allowed opening up of some sectors → these grew in 1991.

② High tariffs/quotas in 1970s (≈400%) led to imbalanced, unstable capital growth.

③ Globalization led to flooding of domestic markets which crushed sunrise industries that had been heavily protected earlier.

Thus, crony-socialism led to adverse effects on capitalist growth in India post liberalization

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d) India's foreign Trade Policy Before 1991 was based heavily on the concept of import substitution.

FTP, Before 1991 – Before 1980 :-

① Inward looking policy of production.

② Production was heavily skewed to be self-sufficient.

③ Import substitution: tariff rates were at an average of 400%
[highest tariff was 1000%].

④ Excessive quotas/limits on quantity of imports.

⑤ Exports were initially low as production & consumption was almost closed-economy based.

This led to the structural retrogression of 1970s.

FTP after 1980s (And before 1991)

- Some liberalization to correct the Hindu Rate of Growth (≈3%)

- Reduced tariffs from 400% to 150% average under 3rd Industrial Policy Resolution 1980s.

- Allowed imports of capital for industrial growth. [eg: intermediate goods].

- Export promotion scheme [ECGS] led to increase in automobile parts exports

Hence, although overall FTP was import-substituting and inward looking, some liberalization had taken place in 1980s which led to growth rate of 5.8% & 6.2% in the years before the 1991 BOP crisis.

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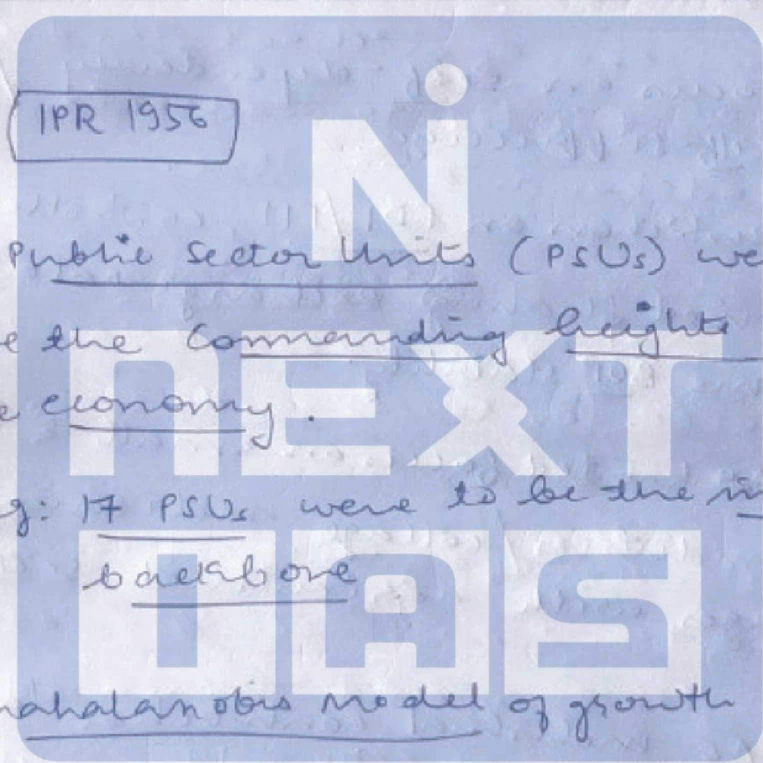
e) Industrial Policy Resolution of 1956 was coupled with Mahalanobis model to provide a roadmap for the 2nd 5 year Plan.



IPR 1956

(i) Public Sector Units (PSUs) were to be the commanding heights of the economy.

eg: 17 PSUs were to be the industrial backbone

(ii) Mahalanobis Model of growth

- strong capital goods industry.
- create capital in bulk to set foundation for industrial growth in India.

(iii) License permit system for other industries eg: consumer goods industries were to be given to private sector.

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(iv) Very limited scope of private players in large industrial units.

(v) Policy of import-substitution with high quota/tariff barriers.

(vi) Focus on self-dependency / self-sufficiency.

(vii) Restriction on FDI/FII, controlled (fixed-floating) exchange rate to ensure BOP stability.

(viii) limited focus on small & medium industries/cottage industries/ linkages with agricultural sector.

As industrial contribution to GDP was at a meagre 17% at independence, IPR 1956 aimed to boost industrial growth to raise India's GDP and allow for eventual trickle-down of gains to the vast population.

Q6a)

Agricultural condition at the eve of independence were pitiable as it contributed 53% to total GDP with a labour participation rate of 73%.

Agricultural Public Investment at Independence :-

(i) British drain of wealth of approx. ₹ 2.5cr led to an impoverished peasantry.

(ii) Commercialization of agriculture (growth of cash crops at 85% under British) created deficit in subsistence food grain production (fall by 7%).

(iii) Permanent/Ryotwari and mahalwari settlements created exploitative middle-men with no incentive to invest in capital/land.

⇒ more than 90% of India's population used wooden tools for ploughing at independence.

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Public Investment After Independence

Initial Years

① Land reforms in the form of abolition of zamindari, tenants rights, illegalization of evictions, land ceiling all contributed to reduced exploitation in agriculture.

② Resolving land fragmentation and policy implementation at state level allowed for space for development in agriculture.

③ Extension of agricultural loans at low interest, replaced middlemen moneylenders and increased formalization of economy.

Green Revolution

① 1980s saw a rise in both public & private investment.

eg: Government built canals for better irrigation.

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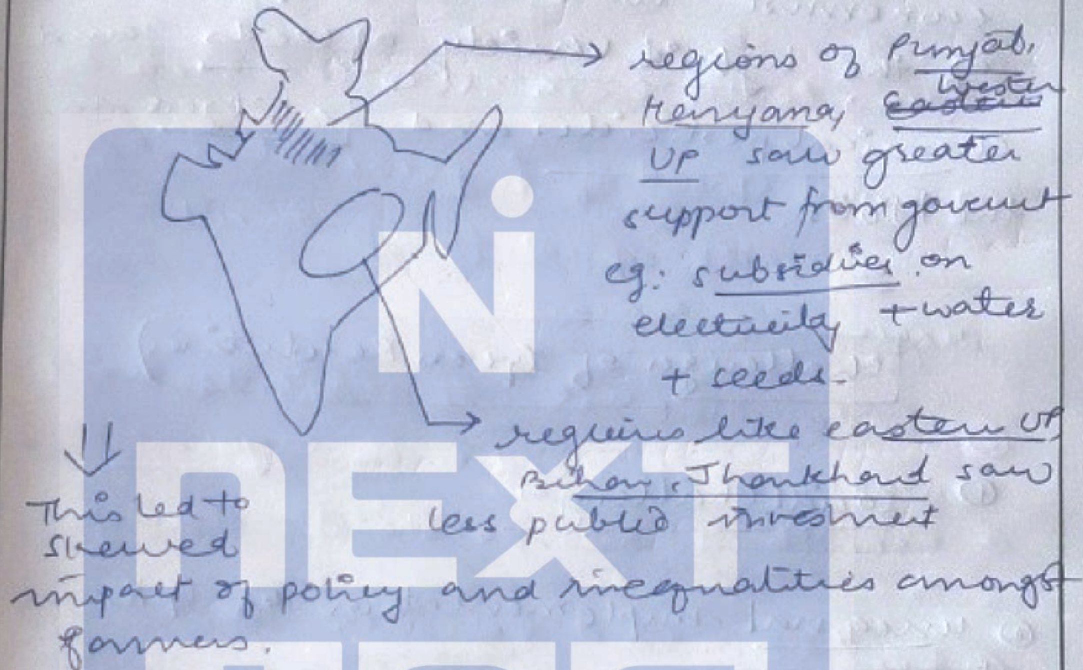
② However, public investment was slightly skewed in favour of states with better agricultural organization.



impact of policy and inequalities amongst farmers.

③ Rise in private investment and cooperativization allowed govnmt to take the back seat in investment procedure.

Thus, pre-1991 saw a good mix of public & private investment which turned India from a dependent importer (PL480 scheme of USA) to an exporter of surplus grains.

Q6b)

Green Revolution was introduced in India by M.S. Swaminathan, an agricultural economist with technological invention of the hybrid variety of seeds and chemical pesticides and fertilizer in the 1980s.

Challenges of Green Revolution

① Social Challenges

◎ unequal implementation of G.R.

◎ this caused backwardness in ignored areas whereas farmers of UP, Punjab got higher returns.

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- landless peasants became even more marginalized
- Expansion of lands led to conflict with tribal regions (forested units).

② Environmental Challenges

- Deforestation saw an increase due to expansion of farmed lands.
- Excessive water usage → droughts, groundwater exploitation, wastage, etc.
- Unsustainable use of chemicals (pesticides/fertilizers) reduced soil health and contributed to
  - biomagnification
  - bioaccumulation
  - eutrophication.

③ Economic/Governmental Challenges

- Implementational issues
  eg: logistics of canal/transport/procurement/storage/distribution.

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- Technological issues : coordination of project implementation at ground-level.

How Could These Issues Have Been Avoided?

① Equal spread of implementation of GR with equal focus on all regions of India.

② Sustainable use of pesticides and water balanced with organic growth to ensure stable development.

③ Long term and holistic planing.

However, factors like need for food security, India's distressed rural population & inadequate research on environmental sustainability somewhat justify the difficulties faced. In spite of these difficulties, it is important to realize the gains of GR and work to create an EverGreen Revolution now onwards.

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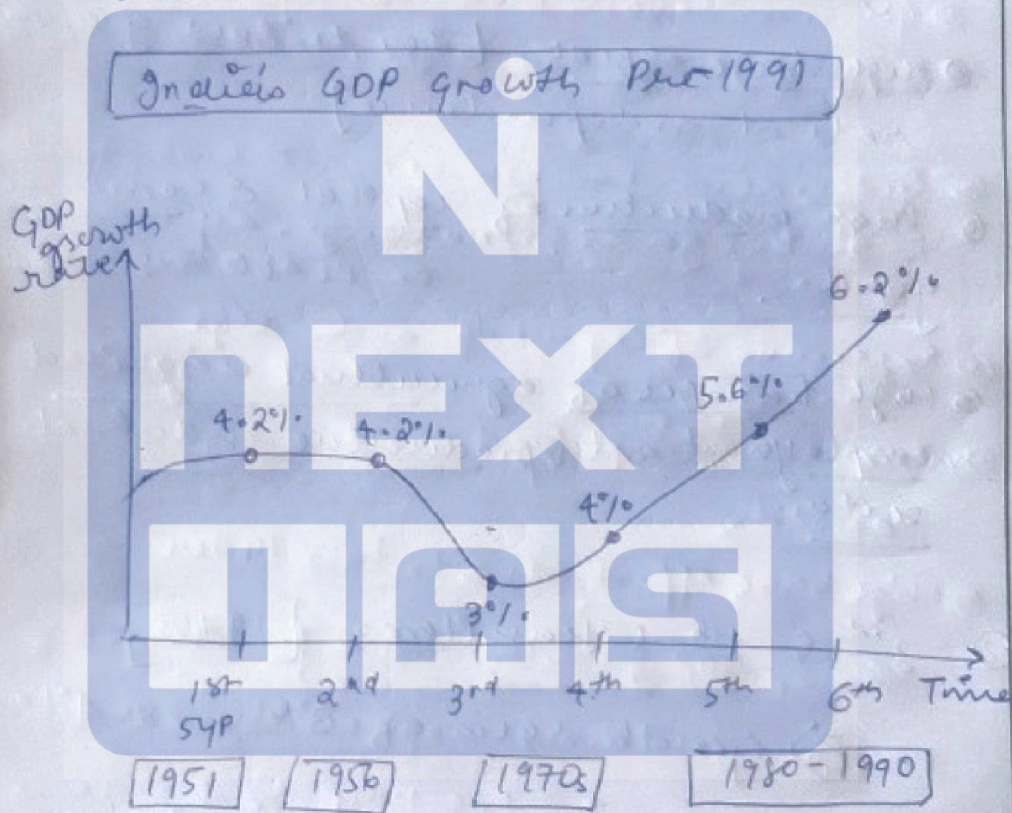
Q6(c)

Between 1950s and 1991, India witnessed many ups and downs in its growth trajectory which were both a reason for and cause of India's policy resolutions.



Trends & Explanation :-

① 1st & 2nd 5 year Plans [1951 - 1961]

⇨ Growth rate of 4.2%.

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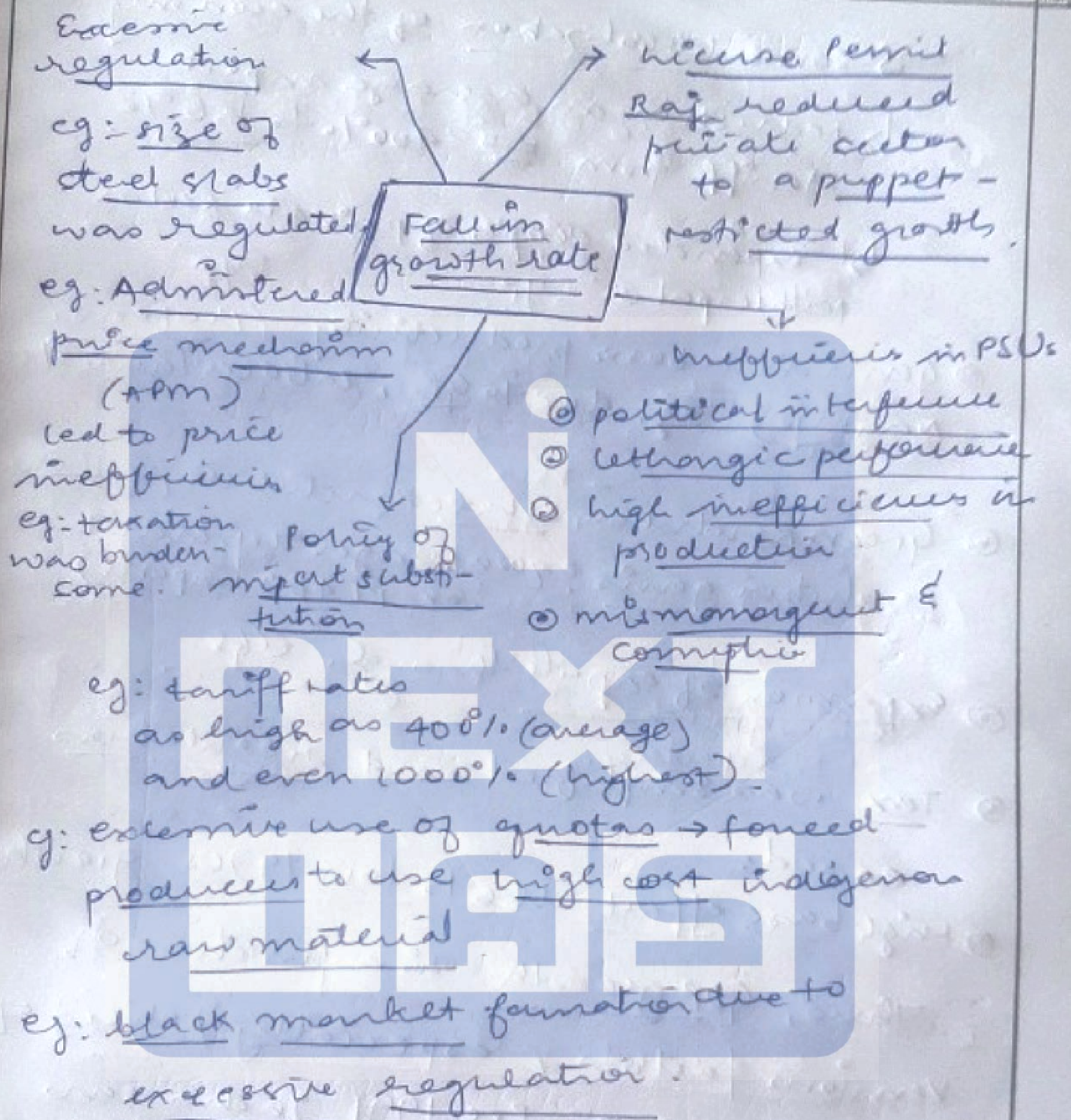
- Industrial Policy Resolution of 1956 focused on industrial growth based on PSU-centric capital development.
- High public investment in capital growth [Mahalanobis Model]
- High base effect [due to low growth rate at independence].
- High production of capital & consumer goods.
- High transfer of agricultural disguised unemployment into productive industrial sector.

② 3rd & 4th 5 Year Plans [1970s]

⇒ Growth rates of 3% and 4%

- Structural retrogression due to losses in sectors like industrial growth, financial sector, administrative inefficiencies, etc.
- External problems like 1973 oil crisis, 1962, 1965, 1971 wars (Pak, China).



③ 5th + 6th 5 Year Plans [1980s to 1991]

① Growth rate of 5.8% and 6.2%.

② 3rd Industrial policy resolution of 1980 created beneficial changes:

↳ some liberalization of the economy
↳ reduction in average import tariff from 400% to 150%.
↳ Expanded scope of private sector participation

- Gains in labour productivity (Professor Nagraj) eg: due to GR, labour laws, etc.
- Green Revolution, White Revolution, Yellow Revolution gains. (no longer dependent on PL480 imports)
- expansion of exports through ECGS.
- Tax was simplified and regulations eased.
- High base effect due to low 1970s growth.

Thus, GDP growth is a function of various factors, especially policies of the government. Pre 1991 India saw initial years of Hindu rate of growth + retrogression which was followed by resolved temporarily until the 1991 BoP crisis.

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Q79)

Industrialization in pre-1991 was characterized by heavy focus on PSUs and command-and-control economy.

Industrial Growth, Pre 1991, Features :-

① PSUs were the commanding heights of the economy.

eg: 17 PSUs for basic industrial goods

② Import Substitution policies

- high tariffs (approx. ~ 400% average)
- high quotas on imports
- restricted free trade created a closed economy.

③ License Raj system that allowed limited, controlled and directed private sector involvement in selected sectors.

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④ Trend in growth of Industry :-

1st, 2nd 5YP	3rd, 4th 5YP	5th, 6th 5YP
High growth due to	Structural retrogression	Semi-liberalization.
- high public investment (big push)	- PSUs inefficiency	- 1980s, 3rd IPR
- high base effect due to low growth at Independence.	- excessive regulation	- reduced regulation eg:- tariffs.
	- black marketing	- opening up of industry to world economy.

[was this trend responsible for diversified industrialization?]

(YES) → increase in industrial goods from 17 industries in 1956 to >800 in 1991.

→ Regional stability and expansion due to focus of government to reach backward regions of India to ensure inclusive development.

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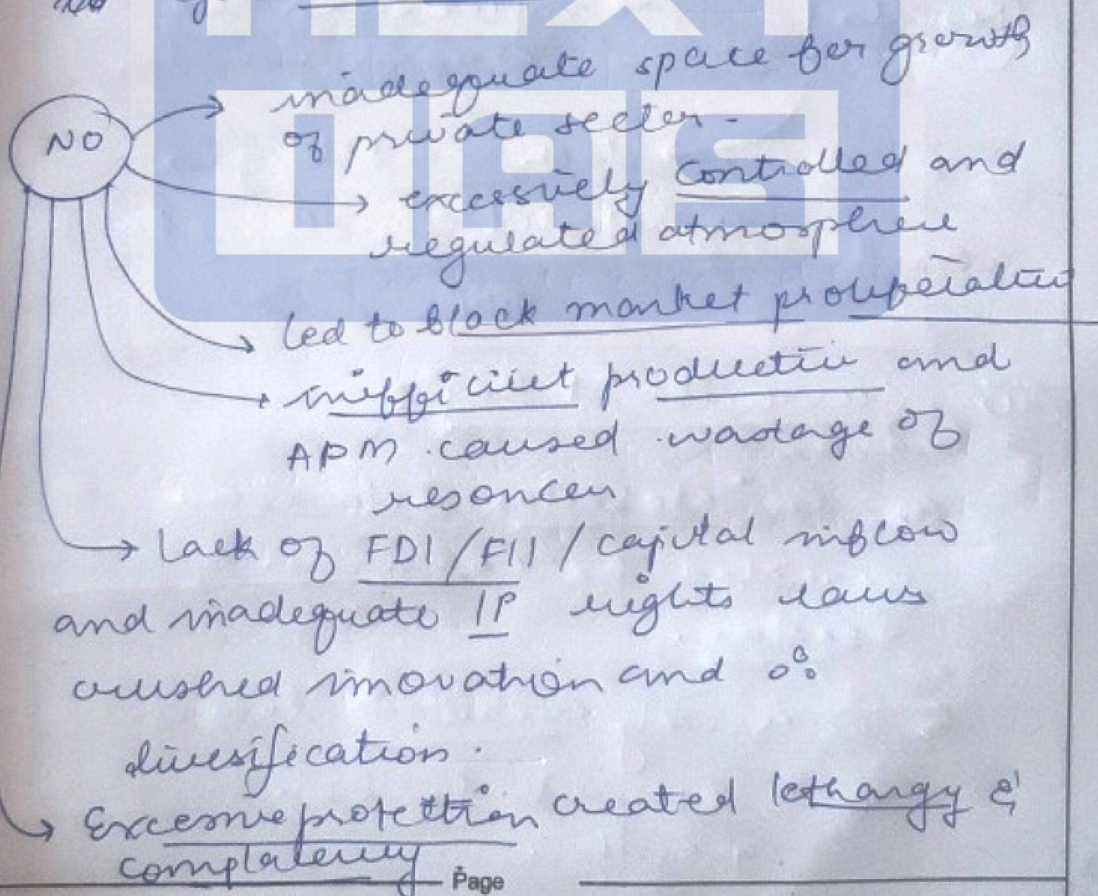
→ growth of banking services in all regions with extension of branches in both rural and urban areas.

→ Growth and sustenance of cottage industries (SMEs) due to adequate protection by government.

→ sunrise industries were protected due to import-substitution policy allowing for growth + expansion.

→ agri-industry linkages established. eg: raw material and manufacturing.



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Thus, Indian government's industrial policies played a role in diversification of industry in the regional sense but not so in the industry-growth sense. It was the 1991 liberalization that saw India make leaps in industrial diversification.

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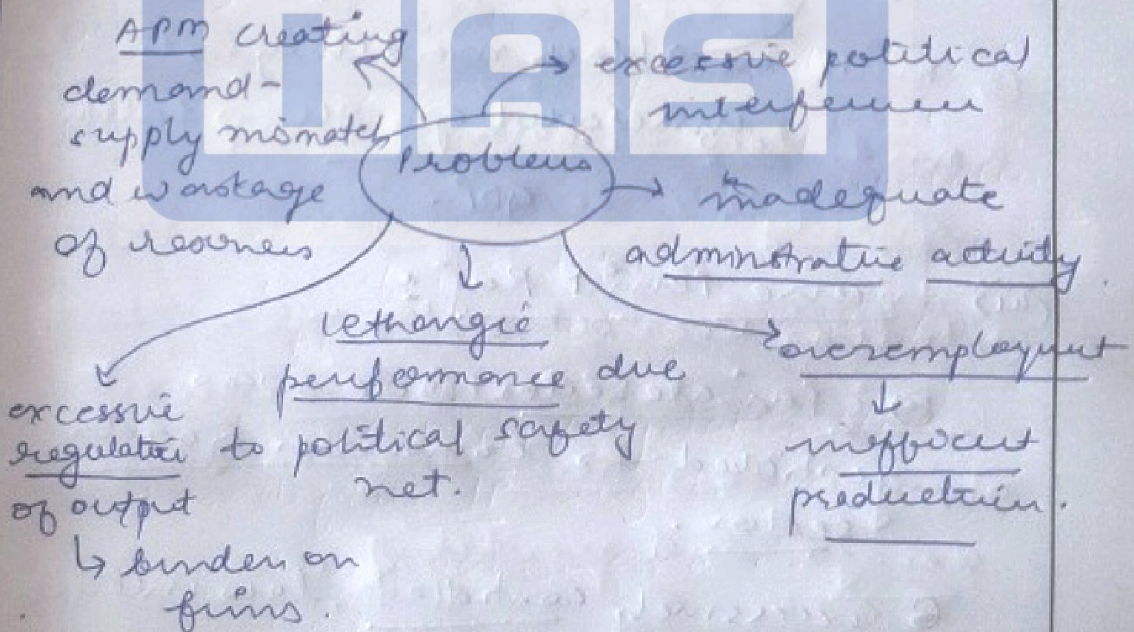
(Q7)

During the 3rd & 4th ~~Indial~~ 5 Year Plan, India's growth rate was at its lowest of 3% and 4% respectively. This was due to the structural Retrogression faced during 1970s.

Structural Retrogression due to industrial policy

(i) Inefficient PSUs management



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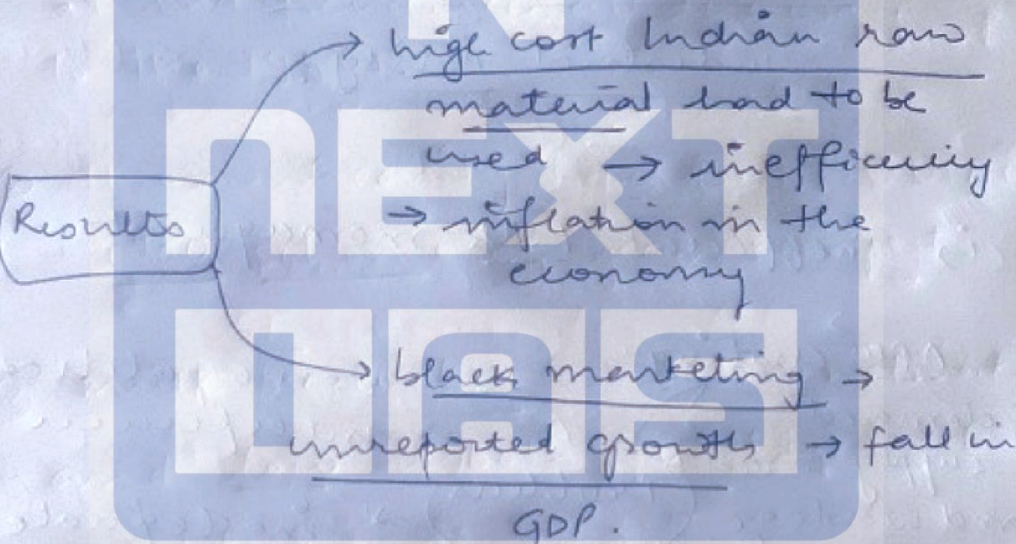
(ii) Excessive import-substituting policy decisions.

- rate of average tariff was ≈ 400%
- highest tariff rate: 1000%.
- quotas created greater restrictions on cheap imports.



(iii) Licence Permit Raj:

- Private sector role was restricted to consumer goods sector.
- excessively controlled, low incentive of investments further dampered growth.

(iv) External policy

- Fixed exchange rate
- Restrictions on FDI/FII dampened investment & technology transfer - hurt industrial growth

(v) Inadequate laws/policies:

- taxation was excessive & broad
- Administered Price Mechanism created regulation of markets
- inadequate labour laws.

As a result of these industrial policies, structural retrogression was experienced in the 1970s which was then corrected by the 3rd IPR in 1980.

NEXT IAS

Q2c)

The White Revolution saw its beginings in a small village named Anand, in Gujarat.

The story of India's White Revolution

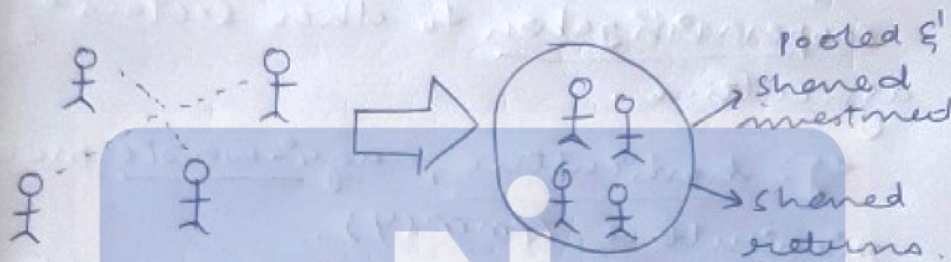
① India was a food insecure nation at independence all the way up to the 1980s.

② It was heavily dependent on USA's PL480 scheme of grains import.

③ milk production was un-networked and low in both quantity and quality.

④ India's livestock sector was lacking public (and private) investment along with infrastructure for transport/storage and marketing.

- White Revolution introduced cooperativization of milk production :-



According to this model, individual milk producers get together & pool their resources. The (collective) produce is then sold in bulk which earns higher returns as opposed to individual sellers. Returns are then redistributed on share basis.

- This method led to the following impacts:-
  1. Increase in milk production.
  2. Dairy exports by India → BOP returns.
  3. Increased returns to farmers through livestock rearing → ∴ financial empowerment
  4. Collectivized agriculture. eg: AMUL

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[what more can be done?]

(i) Expansion of the method of cooperativisation to other sectors of agriculture.

eg: horticulture, agri-waste processing, pisciculture (PMMSY).

(ii) Enhanced cold chain storage infrastructure through public investment

(iii) enhanced linkages between agri and industry for GDP growth.

eg: PMFME for food processing and SF scheme for fabric.

(iv) linking SHGs with Cooperative-agriculture to target women empowerment [ministry of child & women Dev. & min. of Cooperation].

(v) linking export schemes to expand market along with technological intervention like ONDC, e-commerce.

White Revolution model can be extended to all sectors of India's economy for higher returns & sustainable growth.