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THEORETICAL PERSPECTIVE ON THE ROLE OF REQUIREMENTS AND STAGES OF ECONOMIC DEVELOPMENT IN DETERMINING ECONOMIC POLICY SELECTION

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Abstract

Criteria behind selection of economic policy may include improvement in real per capita income, its distribution, employment generation and provision of necessary infrastructure through investment of required resources. Effectiveness of such policy is dependent upon detailed economic survey and presence of required structure. Size of that may bear correlation to number and nature of economic policy which in turn is guided by prevailing economic situation and stage of economic development. Given investment constraint and time budget, associated expenditure and lag structure may have significance to pull an economy parsimoniously from low per capita income of lower level equilibrium. From this perspective, this paper attempts to analyse performance of various policies adopted from 1970 onwards, with special reference to Indian economy, gradually moving forward with developing traits.

This paper put emphasis on consideration of economic nature before economic policy selection, which may become useful for broad class of economic structure. Principal component regression and vector error correction mechanism are put into framework for analysis.

Keywords: *Economic Policy, Economic Development, Nature Of Economy.*

JEL Classification: *E52, H50, O1.*

I. INTRODUCTION

Economic policy can take the form of changes in fiscal revenue and expenses, monetary alterations and their various combinations. Implementation of more than one policy may necessitate deployment of additional personnel while constraints of continuing same manpower with additional burden may lead to delay, under some circumstances may be policy lapses and imminent requirement of associated infrastructure for removing obligations would swell up cost items. Without proper

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implementation probability of enhanced cost will increase, not that of outcome realisation. Another aspect is lag structure of various economic policies required to get the intended result and its' effects sustained over successive periods. Generally policies having direct impact on focus area compared to those having indirect focus take lesser time for outcome to realise and for policies pursued in chain framework, more time is involved as well due to coordination of different chain components. In such case, time lag of policy implementation and outcome realisation may become positively correlated to chain length also.

When parameters for selection of economic policy are determined, considerations for this length should also be there as this may give idea about possible lag structure of policy output generation. Greater the length of action and interaction for a particular economic policy, more time will be taken to realise its implementation and effects. Given near full capacity utilisation, this may necessitate involvement of additional human resource and construction of requisite infrastructure. All these will aggravate financial burden for an economy, leading to reduction in available amount of net investible resources and for an economy suffering in lower level equilibrium, raising standard of living leaving aside distributional justification, will take longer time to materialise.

Normally implementation of economic fiscal policy follows this chain:

Expenditure ⇨ Investment ⇨ Multiplier ⇨ Higher Income ⇨ If It Is Real ⇨ Improved Standard of Living.

It is well-known that for successful operation of above process and minimisation of conjoined various leakages, deployment of required personnel and presence of soothing infrastructure is necessary and arrangement for required investment quantum needs to be ensured alongwith its proper channelisation, prudential consumer spending habits, population control for over-populated countries, reduction in poverty ratio, dissipation of stock piling and excessive price rise. These constitute cost side associated to proper implementation of the chosen economic policy. When the same objective is pursued through other economic policies which may bring required outcome earlier but if implementation necessitates lengthier process, economy will run under burden of associated higher implementation cost. For some economic policies, both time and expenditure may be inflated (*Andersen, 2009*).

Per head income can also be made higher in real sense by bringing expansionary changes in money supply and when an economy undertakes such policy to boost investment level, outcome may be realised in the following way:

Expansionary Monetary Policy ⇨ Money Supply ⇧ Interest Rate ⇩ Investment Multiplier Income ⇧ More Than Population and Price Level ⇧ Real Income Standard of Living

This way out involves more steps and additional processes than the earlier economic policy, lengthening time for its implementation and outcome realisation. In order to fulfil objectives, this time duration should be taken into account for

formulating policy prescription. If more time is available in framework to bounce back intended result, monetary policy can be depended upon while early and essential realisation argumentatively requires greater relance to be placed on fiscal policy. Furthermore, these additional processes require expertise in monetary policy formulation, presence of developed monetary system, regulatory and monitoring framework for expected interest and investment level fluctuation as even developed and efficient monetary systematic arrangement cannot ensure realisation of planned level of interest movement and investment quantum (*Friedman, 1973)*.

II. CONSTRAINTS IN SETTING OBJECTIVES OF ECONOMIC POLICY

For a developed economy, there is no shortage of investible resources and technological advancement. Once decided, presence of all those ingredients may lead to smooth implementation and realisation of set-out objectives. In developing and underdeveloped countries with low average level of real per capita income, inefficient banking system and prevailing non-banking sectors, setting up priorities among various objectives of increase in real per capita income level, suitable infrastructure provision to maintain living standard, curbing inflation, controlling population and developing required financial infrastructure to have monetary policy in the form of another instrument for fixing direction of economic drive, becomes inevitable due to investment lacunae (*Steil, 2001*). Low consumer income in such economies gets mostly spent in maintaining their daily necessities and nursing bigger family sizes, making average propensity to consume (APC) and marginal propensity to consume (MPC) very high, which in turn lead to a habit of lower propensity to save. On macro terms aggregate savings fund may not ensure viability and proper functioning of banking infrastructure as one essential instrument for monetary policy implementation in such economy. First priority should be given to direct economic policy of raising low level of income in order to realise presence, implementation and effectiveness of monetary policy through construction of necessary infrastructural network (*Mehta, 2013*). Framing suitable financial infrastructure without that may lead to double causalities of making banking infrastructure non-viable and low living standard prevailing at status quo level. Furthermore after developing required infrastructure for implementation, successful output realisation of monetary policy depends on presence of investment friendly economic environment and its sustenance. Despite of expected interest rate movement, investment quantum may not match the required level due to lack of inducement for investors coming from various factors generated favourable economics situations. Continuous inducement for investors may come from internal sector which needs improvement in standard of living as well as from external sector if that economy is equipped with such potentiality to be a participant in global trade, having good degree of connectedness with rest of world and dependence on impulse generated from economic upheavals of other such capable economies. Such economic repercussions may be associated to investment level fluctuation and its climate and this, without shock absorbing cushion, may emerge as an obstructing factor for successful outcome of monetary policy (*Gilchrist et al, 1999*).

In order to provide required inducement to investors and make sustainable investment, utmost importance needs to be attributed to continuous demand generation and this obviously necessitates rise in standard of living, measured primarily by real per capita income, its distribution and various other criteria. Focus of economic policy should be oriented to it alongwith growing up of associated working mentality and culture. Unless production takes place in real sense, presence of sufficient investment volume may loose its significance. Sustainable inducement should exist both for investment and work.

From this viewpoint, for parting with economic spendthriftiness owing to shortfall of resources, concerned time-lag of likely outcome realisation, bringing dynamicity to standstill position of low level equilibrium income resulting in lower level of real per capita income and breaking continuance of vicious circle of poverty, the best economic policy turns out to be fiscal policy for policymakers in developing and underdeveloped countries. Alongwith this, development of financial infrastructure is also necessary to curb exploitative practices by non-banking financial sector and channelise redundant expenses by ill-habited inhabitants as well as to speed up pace of developmental efforts initiated by the earlier economic policies (*Allen et al., 2013*). Policy prescription may be in favour of gradual tortoise movement by such economies, implying let fiscal multiplier to work, real per capita income increases, saving propensity becomes higher to ensure proportionate, if possible, full funding and viability of infrastructure construction for monetary sector and its target implementation. In today's world, there is another path for faster movement by availing various grants, aids and technical collaborations from different international agencies and partners in order to construct necessary infrastructure, provide backward regional development and income generating activities (*Jha, 2007*). This will assist in raising real income level and sustaining required demand to generate continuous encouragement and investment friendly climate for investors, overall a favourable economic environment to advance forward and hindrances lying in path of successful implementation can be lessened.

Presently world is experiencing globalisation and liberalisation in which every country is getting connected to other country and movement of factors of production is becoming less restrictive. Particularly capital is flying from one country to another country in form of direct investment (FDI) and portfolio involvement (FPI). For recipient country, presence of good financial infrastructure is mandatory for successful realisation of domestic country's economic policy as well as intended policy of investing partners (*Iþık et al, 2006)*. In absence of this most important prerequisite as most likely to be in underdeveloped and developing countries, FDI and FPI even if are found to be suitable for realisation of intended economic policy outcome, investors need to come forward and invest first for developing financial infrastructure and real income raising activities in order to implement their policies sustainably. Under such cases, their activities will certainly put reliance on government structure and its expansionary fiscal policy since infrastructure building and citizen real income rising, thought about all on macro

terms, needs public welfare consideration like that of a government of country (*Hammond et al., 2009*).

III. EXPECTATION FORMATION OF ECONOMIC POLICY

In developed economy, policy implementation becomes much more effective for advancement on technological front, perfect information dissemination and formation of rational expectation including all relevant past, present and most recent information in decision making by people (*Krugman, 1998*). They understand intended outcome of economic policy and incorporate their activities within that due to availability of all required information, accelerating both implementation and output realisation of expected economic policy. However, it becomes easier for residents to evaluate meaning of government expenditure programme and changes in it than that of minute and transitory alterations in money supply and its related statistics (*Kydland et al., 1977*). This pulls fiscal policy to advantageous layer in providing expected target oriented implementation. Furthermore, investible resources at disposal for fiscal expenses cannot fluctuate by greater margin but net capital inflow, influencing monetary policy formulation and expectation formation process (*Milani et al., 2012*) remains associated with the vulnerability of uncertain fluctuation due to interplay of global factors (*Berumen et al., 2007*).

In developing and underdeveloped economies standard of technology does not remain up-to-date, information dissemination takes place at slower rate and there remains tendency, which grow up gradually as well to undermine significance of being aware about adopted economic policy (*Goyal, 2002*). This makes national citizens to take decisions by forming adaptive expectation based only on past information. Economic policy is formulated taking into account all past, present and most recent reliable and relevant information, implemented and run by such concerned and informed authority but millions of participants take uncountable numerous decisions only by relying on long past information, generating a gap both in respect of time and required economic initiatives for implemented economic policy to shower in expected result. Present and most recent information becomes available to them after long period due to non-availability of timely information and intended effectiveness of economic policy gets lost somewhere in way. A few hand-count who somehow become able to undertake rational decision by utilising resources and technology at their disposal, in case of monetary policy due to greater dependence on fluctuating and ever-changing factors (*Kowalski, 2002*) as well as owing to lengthier chain of implementation, effectiveness is relatively reduced more.

IV. NATURE OF ECONOMY AND RELEVANCE OF ECONOMIC POLICY

Another factor which can cast important light on this topic is that of spending and saving propensity. In a typically underdeveloped country, lower real per capita income and family responsibility of citizens make them compelled to spend most of their income. This how spending habit develops and consequent higher APC and MPC increase relevance of fiscal policy selection and implementation while due to

very less frequent interaction with financial institution resulting from lack of saving propensity and repaying capacity, banking sector gets discouraged (*Obasan et al, 2012*) and both selection and implementation of monetary policy become handicapped, an extremely distant possibility. Priority focus behind selection of economic policy in such an economy should remain on raising real per capita income level to disentangle vicious circle of poverty, employment generation at a rate commensurate with that of population expansion and for that reliance is to be placed on spending friendly, relatively cost effective and time saving fiscal policy measures. In today's age of globalisation and liberalisation when an underdeveloped economy is becoming globally connected and investment is available from international agencies, countries and relationships, gradual development of financial sector of such countries should take place. Fiscal expenditure planned and executed by respective government will act as an instrument to channelise those resources into required areas and prepare platform for monetary policy to operate smoothly and effectively. This in turn will energise fiscal multiplier process by adding to existing pool of investible resources, leading to early realisation of intended objectives of implemented fiscal policy (*Bradford et al., 2012*). For a developing economy even though average per capita real income surpasses survival level, it takes time to develop required change in saving propensity and mode after gradually leaving characteristics of under level saving and redundant income spending habit. This makes effectiveness of fiscal policy still to sustain further even though selection and implementation of monetary policy start getting relevance through greater participatory activities in financial sector. For such an economy, focus behind selection and implementation of economic policy for further economic development is ought to remain on raising standard of living for inhabitants alongwith provision of necessary infrastructure, employment creation and enhancing saving propensity through adoption of various fiscal policy measures (*Muradoglu et al., 1996*). This makes financial sector internally competent and prepares ground for successful implementation of monetary policy based on both internal and external resources as well as hastens economic transition from developing stage to developed stage by curbing and balancing negative impacts of fiscal policy on investment level through undesirable interest rate movements (*Rena et al., 2011*). However, according to another viewpoint if reduction in domestic investment brought by higher interest rate from fiscal expansion gets over-compensated by capital stock flowing from other parts of globalised world and makes net investment positive, this may fulfil required objectives but that may lead to enhanced debt burden for such economy and stratified development of investors (*Togo, 2007*). Furthermore, added capital stock of different nature may provide impetus to advance forward for specified duration, preparing ground for transition from fiscal control to market control in investment flow allowed by controlled fiscal policies plagued with a financial structure not so modern having non-banking sector and its exploitative practices. Capital flow, expected interest rate regulation and effectiveness of monetary policy are correlated and it necessitates development of requisite financial infrastructure. Without domestic economy being rejuvenated and made investment friendly by

providing continuous inducement of sustainable demand coming from various internal sectors through increasing standard of living, investment and investors cannot achieve persistent return attributing flow of capital with characteristics of transitory, volatility and shiftability. When such an economy enters developed stage, higher living standard and saving propensity in various financial instruments increase relevance of selection and implementation of monetary expansion for further development. Adoption of capital intensive modern technologies and construction of advanced financial infrastructure enhance relative effectiveness of monetary policy (*Shin et al., 2003*) although on required time duration, infrastructure requirement and overall expense incurred for implementation of chain process of action and interaction, it is the other way round.

V. EMPIRICAL FINDINGS

Empirical part is based on data of Indian Economy related to Gross Domestic Product at Factor Cost (G) at Constant Price, Combined Fiscal Expenditure (E) and Money Supply M1 (M) over the period of 1970-2012 (*www.rbi.org*). Initially, entire period is analysed taking G as dependent variable and E, M as independent variables. Then, analysis is pursued for the sub-period of 1970-1991 and 1987-2012. Logarithm model (LM) is sought to estimate growth rate while principal component regression (PCR) is made for finding degree of dependence and finally, vector error correction model (VEC) is applied to measure lasting impact in G resulting from interdependence and lags through impulse response, variance decomposition and changes in G in relation to changes in E and M.

1970-2012

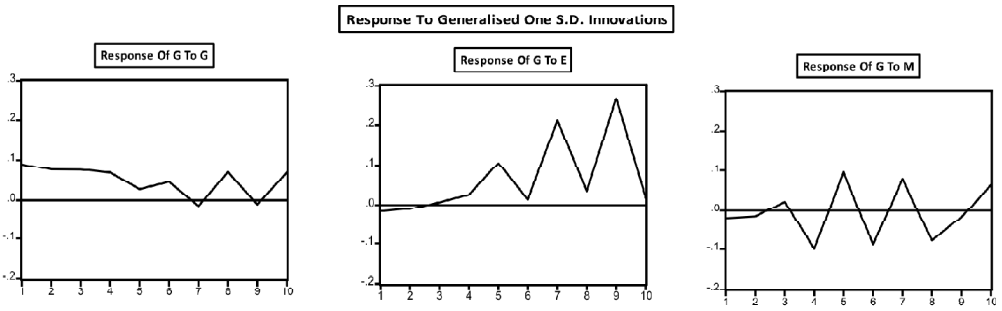
(LM) LOG (G) = 8.48 + 0.05 T. LOG (E) = 4.03 + 0.135 T. LOG (M) = 4.08 + 0.137 T

(PCR) G = 3.10 + 1.69 E + 1.39 M

(VEC) D(G) = -0.17 (G(-1) - 26.01 E(-1) + 24.67 M(-1) - 4.59) - 4.30 D(E(-1)) -3.99 D(E(-2)) - 2.14 D(E(-3)) -2.32 D(E(-4)) -1.47 D(E(-5)) + 4.21 D(M(-1)) + 6.22 D(M(-2)) + 8.96 D(M(-4)) - 0.29

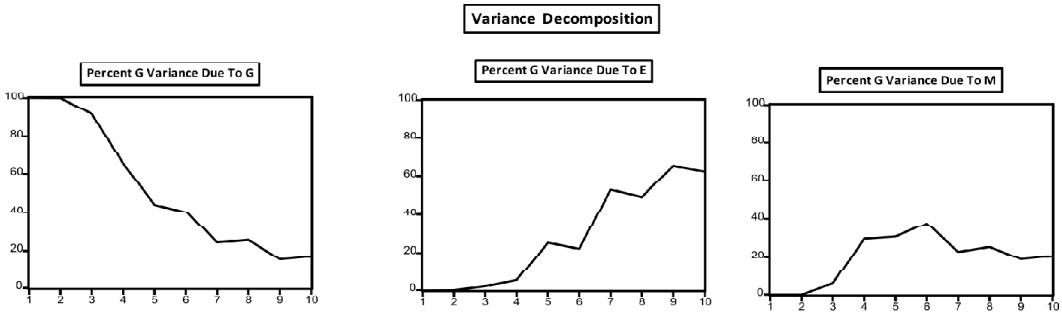
VEC equation generates the following impulse response curve (Fig. I) and variance decomposition curve (Fig. II):

Figure I



Above figure shows significant lag period impact on GDP_{FC} is higher for fiscal expenses than that of itself and money supply.

Figure II



Above figure shows greater proportion of variability in GDP_{FC} can be attributed to that in fiscal expenses than those in itself and money supply.

Changes derived from the VEC equation shows the following relationship:

D(G) = .54 D(E) + .80 D(M).

1970-1991

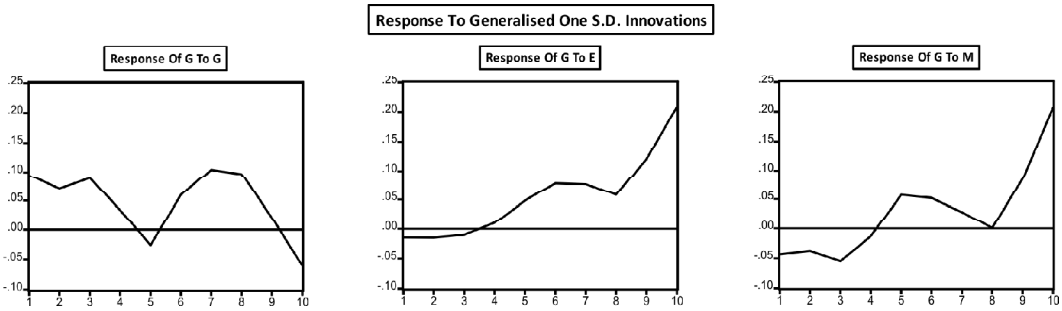
(LM) LOG (G) = 8.60 + 0.04 T. LOG (E) = 3.95 + 0.143 T. LOG (M) = 4.17 + 0.128 T.

(PCR) G = 1.97 + 4.69 E + 3.87 M.

(VEC) D(G) = -0.92 (G(-1) - 13.33 E(-1) + 2.36 M(-1) - 1.68) -10.45 D(E(-1)) + 13.02 D(E(-2)) + 12.28
D(E(-3)) -23.82 D(M(-2)) -30.18 D(M(-3)) + 0.26.

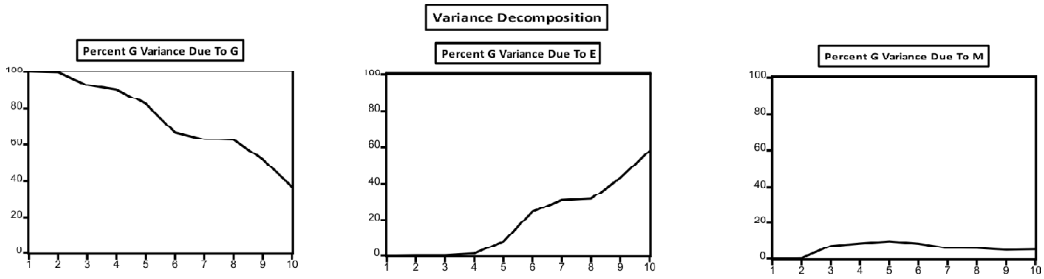
VEC equation generates the following impulse response curve (Fig. III) and variance decomposition curve (Fig. IV):

Figure III



Above figure shows significant lag period impact on GDP_{FC} is more pronounced for fiscal expenses than that of itself and money supply.

Figure IV



Above figure shows variability in GDP_{FC} can be mainly attributed to that in fiscal expenses than those in itself and money supply.

Changes derived from the VEC equation shows the following relationship:

D(G) = 4.29 D(E) +2.68 D(M).

1987-2012

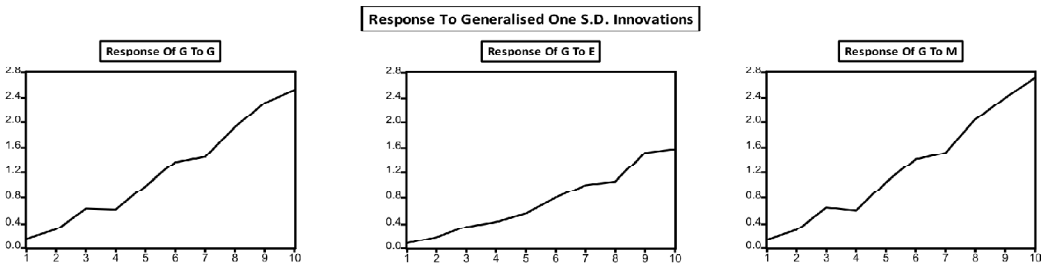
(LM) LOG (G) = 9.27 + 0.06 T. LOG (E) = 6.43 + 0.128 T. LOG (M) = 6.37 + 0.140 T.

(PCR) G = 4.15 + 1.51 E + 1.24 M.

(VEC) D(G) = 0.09 (G(-1) + 17.78 E(-1) - 45.92 M(-1) + 35.31) + 1.79 D(E(-3)) + 5.80 D(M(-1)) + 7.36 D(M(-2)) + 8.23 D(M(-4)) -3.50.

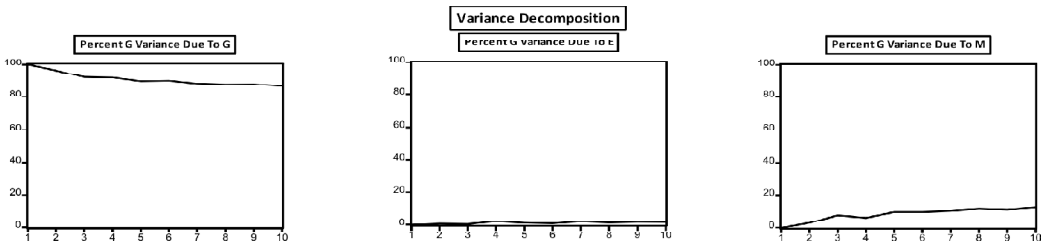
VEC equation generates the impulse response curve (Fig. V) and variance decomposition curve (Fig. VI):

Figure V



Above figure shows significant lag period impact on GDP_{FC} is lower for fiscal expenses than that of itself and money supply.

Figure VI



Above figure shows greater proportion of variability in GDP_{FC} is determined by those in money supply and itself than that in fiscal expenses.

Changes derived from the VEC equation shows the following relationship:

D(G) = .978 D(E) + .979 D(M).

Almost all these estimations and graphical representations point towards stronger responsiveness of gross domestic product at factor cost to fiscal expenses than simply changes in money supply for a developing country like India even though during the second period, its intensity is found to be relatively reduced with the initiation of worldwide programme of globalisation and liberalisation, leading to opening up of Indian economy.

VI. CONCLUSION

Other aspects which can assist in economic policy selection are improvement in respect of income distribution and employment generation. Fiscal expansion casts direct influence on both these aspects (*Auerbach, 2005*) and lead to general improvement from those perspectives whereas that of money supply turns out to be indirect and specific in nature. In Indian economy over the period of 1970-2010, population is found to increase at an annual compound growth rate of 2 per cent per annum (pcpa) and employment in general got higher at 1 pcpa. Compared to that both population and employment were expanded at greater rate of 2.2 and 1.96 pcpa respectively in initial sub-period of 1970-1991 when volume of fiscal expenditure was increased relatively at a greater rate while during second sub-period of 1987-2010 when relative growth rate of money supply was more, although population expansion rate became lower at 1.81 pcpa facilitating developmental initiatives, that of employment growth rate was only .24 pcpa, not even 1 pcpa. Regarding distributional aspect, in rural areas where majority of Indian people usually live, Gini coefficient of consumption distribution inequality is found to increase from .281 in 1973-74 to .282 in 1993-94 whereas greater rise is registered afterward to .291 (measured on the basis of Uniform Reference Period) in 2009-10 (*DGET And DCH, 2014, GOI*). Fiscal policy is generally guided by long-run perspective of government policy (*Brahmbhatt et al, 2012*) while monetary policy is more of adjustment machinery in form (*Holmes, 1969*). This makes general consideration embedded in fiscal policy while specific region and section oriented perspectives get importance in monetary policy formulation. Under fiscal policy, within governmental framework, rules and regulations, expenses are incurred and investments are channelised to every corner of an economy at required degree to alleviate regional and income inequality (*Zahir, 1972*) and this process, in turn, gears up general employment generation through operation of multiplier process (*Musgrave, 1959 and Ostrom, 1990*) while outcomes of monetary policy remain dependent on investors and prevailing investment and business climate. From available data of DGET, GOI it can be seen that during initial period (1970-1991) of relatively greater rise in combined central and state government expenditures, estimated general employment at major industries and services became higher

alongwith that for agriculture, hunting, manufacturing, construction, transport, storage and communications taken together and financing, insurance, real estate separately whereas during next period (1987-2007), when money supply was expanded comparatively at a greater CAGR, although general employment and employment in sectors agriculture, hunting, manufacturing, construction, transport, storage and communications taken together are found to diminish absolutely, a rising trend is depicted for that in financing, insurance and real estate. Furthermore, even after required interest rate fluctuation by monetary authority to materialise expected investment flow, actual investment may require more fiscal and monetary policy incentives in order to provide favourable economic situation (*Kopcke et al, 2005*). Both on micro and macro terms, investment quantum when mostly materialises as aggregation of all private initiatives, leaving requirement of widespread, advanced and efficient banking infrastructure and co-ordinating machineries, there remains a general tendency for such initiatives to concentrate in areas already developed and developing with deployment of expertise human resource as nothing to be found wrong when objective is to make and enhance volume of profit. This gives rise to the possibility of specific improvement in regional development, employment generation and income distribution.

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