PRICING POLICIES AND PRICE CONTROL IN DEVELOPING COUNTRIES

Saksena

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Preface

Although 'pricing policy and price controls' had been the subject of my interest, it was during my nine months' stay at Oxford as a Visiting Fellow at Queen Elizabeth House that I got an opportunity of thinking and working on it in a somewhat sustained and systematic manner that enabled me to write this small book. The book attempts to analyse some of the basic theoretical and practical issues which arise in the formulation and implementation of pricing policy and of a system of price controls, particularly with reference to developing economies like India's. It deals mainly with matters of general interest to all market economies: only two chapters are devoted entirely to India — one discussing the salient features of the price controls as they have been operating in India, and the other the issues relating to pricing policy in the context of public enterprises in India.

I must record my deep sense of gratitude to Dr Francis Seton of Nuffield College and Dr Frances Stewart, Fellow of Somerville College, under whose supervision this work was done at Oxford; and also to Mr Arthur Hazlewood, Warden of Queen Elizabeth House, and Mr Neville Maxwell, the programme co-ordinator who constantly helped and encouraged me in my work. I am indebted to Dr C.H. Hanumantha Rao and Dr Raja J. Chelliah (both presently Members of the Planning Commission, Government of India) with whom I have had several useful discussions on various issues prior to my visit to Oxford. I also gratefully acknowledge the help I received from Dr P.S. Sharma, Mr Kewal Ram, Mr Ishwar Das and Mr Chaman Lal (my colleagues in the Economic Administration Reforms Commission, Government of India) while in India during the preliminary stages of this work. I am also grateful to my wife Madhu, who was a source of constant inspiration, encouragement and help to me in writing this book.

I may mention that the present work does not in any way reflect the thinking or the views of the Government of India, but my own ideas on the various issues discussed, based on my own thinking and analysis of facts and empirical data, in my personal capacity as a student and researcher at Oxford.

Contents

1 The case for price controls and pricing policy

The term 'pricing policy' has gained currency among economists, administrators and politicians alike. The term implies some kind of control or regulation of prices or interference with the free play of market forces by an external agency to achieve certain objectives which may otherwise not be achieved. The external agency is invariably a central authority or the government which decides not only the objectives to be achieved, but also whether the need for intervention in the functioning of the market mechanism has arisen; the form or mode of intervention; as well as its timing and duration. The government has to, so to say, formulate a policy or guidelines for action and also evolve suitable legal, institutional and administrative frameworks for implementing and monitoring that policy. Pricing policy is thus not synonymous or co-extensive with price control — it is a much wider term which covers, *inter alia*, the following:

(a) the objectives sought to be achieved by price controls;
(b) the various forms which the interference with the market mechanism may take, ranging from a mere exhortation, advice or suggestion to the manufacturers or suppliers to total control of prices and quantities of the goods produced and their distribution;
(c) the laws enacted or the executive directions issued to the producers/sellers/distributors and the institutions set up, statutorily or otherwise, or administrative arrangements made or procedures evolved to enforce them and to monitor the progress and effects of all action relating thereto; and
(d) above all, a set of basic principles covering (a) (b) and (c) above.

The principles referred to in (d) above are not always economic principles but generally value judgements regarding what ought to be done, for whom and in what manner. These principles may reflect the basic philosophy, aspirations, ideals or ethical values, or sometimes even considerations of political or administrative expediency, which may form the basis of all economic policies, including pricing policy: they reflect essentially the kind of economic and social order and quality of life which might be the ultimate goal of all social and economic policies and endeavours, and may differ in both content and emphasis in different economies.

Economies are generally categorized as 'capitalist', 'socialist' and 'mixed' economies. In fact, both the purely capitalist and the purely socialist economies are only conceptual models, and in the real world all economies are mixed, having some features of both. Even the so-called 'socialist' economies have certain elements of capitalism as the free play of market forces is allowed to determine prices and production in some part of the consumer goods sector and a certain degree of competitiveness is often sought to be introduced in certain spheres to promote efficiency. The capitalist economies similarly have a large and expanding public sector, nationalized industries or industrial units which operate under competitive or oligopolistic conditions, and sometimes as virtually state monopolies. The distinction between the socialist and the capitalist systems, though sometimes somewhat blurred since both have public and private sectors and elements of both competition and monopoly, is still quite significant.

In the socialist economic system, the market mechanism is sought to be superseded or supplanted by the allocation of all economic resources through a central authority according to the principles and priorities decided by it, and is temporarily tolerated and grudgingly suffered in certain other sectors for achieving the objectives of the central plan. In a capitalist economy, while the government may intervene in the free functioning of the market mechanism in pursuance of various objectives, the endeavour is to work through the market and not to interfere with it as a system. The basic premise of the capitalist system is that the market mechanism, if allowed to work freely, would cause an optimum allocation of resources and create conditions for continuous growth in output and employment, and needs to be interfered with only to even out short-run fluctuations or to correct the imbalances or inequities which may sometimes arise due to its imperfect functioning or due to abnormal conditions created by exogenous factors like, for instance, war. The socialist system, on the other hand, while tolerating the market mechanism and even trying to make use of it in the transitional phase, aims at ultimately achieving a marketless, moneyless and stateless era of prosperity and plenty. The theory of scientific socialism, however, does not attempt to explain or establish how the working of the socialist system would usher in such a millenium: it only explains how the inherent contradictions of the capitalist system would cause its destruction, giving way to socialism where all means of production would be socially owned and operated. Markets, prices and some kind of price regulation are thus ubiquitous phenomena found in all economies irrespective of their ideologies or the nature of their economic organization.

The concept of pricing policy, which necessarily implies interference with the market mechanism or determination of prices by the free play of the market forces of demand and supply, is irrelevant in an economy where conditions of perfect competition prevail. In such an economy, the buyers and sellers of any commodity are so numerous and its quantity demanded or supplied by each one of them forms such an infinitesimally small portion of the total quantity demanded or supplied that no individual buyer or seller could possibly, by his own action, in any way influence the price of that commodity. Both the buyers and the sellers are thus price takers, and each seller has a perfectly elastic demand curve for his product at the prevailing market price and can sell any quantity at that price. Both also have perfect knowledge of the market conditions. Each product is perfectly homogeneous and perfectly divisible and the factors of production too are perfectly divisible and perfectly mobile. Each individual behaves rationally. If he is a consumer he maximizes his utility or satisfaction, given his scale of preferences, his income level and the market prices. Similarly, each producer or seller maximizes his profits given the technological conditions of production and the prevailing market prices of inputs and finished products. Consumers are governed by the Law of Diminishing Utility and producers by the Law of Diminishing Returns, so that each consumer is able to reach an equilibrium where he maximizes his utility, and each producer also reaches an equilibrium position where he maximizes his profits. These equilibrium positions are reached by 'trial and error', and the entire economy attains a position of 'general equilibrium' of prices and production. This is not due to any conscious co-ordination and planning by any visible agency, but is the result of unconscious co-ordination through the market mechanism. The system demonstrates a harmony of interests between society and the individual so that each individual, while 'he intends his own gain' is 'led by an invisible hand to promote an end which was not part of his intention';[1] and the activities of all the self-seeking individuals, each pursuing his own interest, result not in chaos and anarchy, but in an economic order which promotes the interest simultaneously of both society and the individual.

This economic order is a kind of economic democracy characterized by what is called 'consumers' sovereignty', where consumers ultimately decide what goods are to be produced and in what quantities, by casting their money votes in the form of prices they would be prepared to pay for various quantities of goods, which provide necessary signals to the producers and sellers of those goods. These price signals determine the direction in which economic resources flow, and also the factor prices, factor shares or reward which each factor of production would get, and move the entire system on to an equilibrium position of optimum allocation of resources. This is a position where 'welfare' is maximized: the welfare of each individual who maximizes his utility as well as that of the community in the sense of 'the sum of the utilities of the individual households in the community'.[2] From the producers' angle, this is a position where total profits are maximized under given technological conditions of production. This is an optimum position as any deviation from it or any reallocation of resources would reduce the total welfare of the consumers and the total profits earned by the producers, and also the level of efficiency of production. The conditions of this optimum, generally known as 'marginal conditions', have been carefully formulated by many economists and we need not go into them for the purposes of our analysis.

The need and relevance of pricing policy arises because no capitalist economy characterized by private ownership of the means of production and a freely functioning market mechanism actually corresponds to the model of a perfectly competitive economy. In this model, the price signals determine the allocation of resources and the resultant volume and composition of output, pattern of employment, factor shares and distribution of income. If the price signals operated properly, they would cause an optimum allocation of resources and should obviate the need for any interference with the market mechanism. The case for price control and pricing policy thus rests essentially on the failure of the price signals to operate in the desired manner.

For any kind of signals to operate properly and efficiently, it is necessary that they function independently of those who are to be guided by them, and that the latter are not able to manipulate them in any way; otherwise the signals lose all meaning. In the model of a perfectly competitive economy, the price signals do function in this manner because both the buyers and the sellers are so numerous that they cannot, by their individual action, affect the market price; and the possibility of their combining or joining together is also ruled out. They are thus price takers and not price givers. Such a situation does not exist anywhere in reality. Even if we assume that it did exist sometime in the past, it could have been expected to develop, and has in fact developed, into a situation where the suppliers or sellers do not always take the market price as given, and successfully influence it to their advantage. The competitive character of the perfectly competitive model itself creates conditions where competition does not remain perfect, and the producers acquire a certain degree of control over the market price. For if the market price is to be taken as given, the only way a producer or manufacturer can increase his profit is by technological improvements which reduce his costs and increase his profit margin. Technological changes are imperative in a competitive economy, and these have several major effects. Firstly, they tend to increase the size of the individual industrial units to suit the changing technology. Bigger industrial units using improved technology enjoy economies of scale and increasing returns or decreasing costs over considerable ranges of output. Secondly, the products do not remain homogeneous, and there emerges a wide range in each product consisting of several differentiated products. Thirdly, the factors of production or inputs do not remain perfectly divisible, as large, indivisible units of plant and machinery have to be installed; and the capital investment required for their acquisition and installation becomes 'lumpy' and cannot be varied in small quantities. Fourthly, the producers and sellers do not remain passive agents so far as the marketing of their products is concerned. In a world where no product is homogeneous and every product has a range and a variety of differentiated products, the only way to sell one's 'product' is by creating an impression in the consumer's mind that it is different from the similar products of other producers and in some way superior to them. Because of the availability of several similar competing, though differentiated, products, no producer can sell any quantity of his product at the current market price, and the demand for his product is not perfectly elastic at that price, even if we assume that he cannot influence that price by his own action alone. This leads to advertising and sales promotion drives, which are inconceivable in the competitive model which assumes perfect knowledge and homogeneous products.

Fifthly, the theory of harmony of interests of the individual and soiety breaks down. Changes in the quality, quantity and variety of goods, both over space and time, are taking place very rapidly and consumers have very imperfect knowledge about them, which sellers exploit to their own advantage. Moreover, because of external economies and external diseconomies arising in the process of production, there occur divergences between what are called 'marginal social benefits' and 'marginal private benefits' on the one hand (due to external economies) and 'marginal social costs' and 'marginal private costs' (due to external diseconomies) on the other. Sixthly, in a competitive situation characterized by continuous technological change, increasing size of industrial and business units and the scale of their operations, indivisibilities and lumpiness of investments, the basic premise of the perfectly competitive model ceases to hold good. The number of producers and suppliers generally tends to get progressively reduced as small producers are not able to survive in the competitive struggle (unless they combine to form a viable group or are given state protection in some form), and digopolies and monopolies emerge which manipulate production and prices in a manner which may not be in the interest of the economy or in the interest of certain sections of society, which may need protection against their activities. Seventhly, the so-called consumers' sovereignty of economic democracy may operate to the detriment of society or of large sections of the consumer public. Consumers' sovereignty may in actual practice mean not the sovereignty of the mass of consumers, but that of relatively few affluent individuals who have the largest number of money votes, and whose votes may actually decide the allocation of resources and the pattern of production. Even the bulk of consumers may not be able to exercise their money votes properly owing to sheer ignorance or to having been misguided by advertisements. This may result in an allocation of resources and a composition of national output which may not be in the interest of the consumers themselves, or it may result in the diversion of scarce economic resources to socially undesirable channels. In any case, consumers' sovereignty loses its meaning and significance when the producers or sellers, through product differentiation and aggressive advertising, create consumer preferences for goods which might not otherwise have been consumed, and change the demand pattern to correspond to the pattern of consumer goods which they find commercially advantageous to produce.

The so-called 'welfare economics', by using the model of perfect competition and the tools of marginal analysis, postulates a set of 'marginal conditions' which a perfectly competitive economic system tends to achieve. The achievement of these conditions implies maximization of welfare. Welfare is a normative concept involving value judgement. Welfare economics assumes that 'welfare' consists in people getting what they want in quantities corresponding to their scale of preferences and their capacity to buy as determined by their incomes and the prevailing market prices, which each individual by himself is powerless to alter. As we know, individuals need not necessarily be the best judges of their own interest, and may want things which may not always be desirable from their own or from society's point of view. An economic system guided solely by consumer preferences may, therefore, produce goods which may be ethically or socially undesirable. The concept of welfare optimum also implies that one allocation of resources and the resultant composition of output is as good as any other so long as it is in accordance with consumer preferences. It further assumes that an individual's welfare depends on his own consumption and is entirely unaffected by what others consume. Another unrealistic assumption underlying this concept is that the distribution of income has nothing to do with maximization of welfare, and 'the sum of utilities of the individual households in the community' (which is the concept of welfare adopted) is not affected by redistribution of income. In other words, it is assumed that the marginal utility of money is the same and remains constant for all individuals irrespective of the quantum of their money income, so that income distribution is not a variable affecting total welfare of the community, which is maximized. The concept of an equitable distribution of income is irrelevant in this scheme of things. All these are highly questionable assumptions which render the formulation of the marginal conditions for optimizing welfare a futile and meaningless exercise based on a basically wrong value judgement regarding what constitutes 'welfare', as well as wrong notions about the factors which determine the quantum of welfare which a perfectly competitive system is supposed to tend to maximize.

Although the theory of perfect competition and welfare maximization on which the case for *laissez-faire* or non-intervention with the free play of market forces rests represents a high degree of sophisticated scientific reasoning and analysis, it has limited practical significance because it assumes away almost all the complicating factors and involves a basic value judgement regarding the concept of welfare itself. This theory shows an obsession with concepts like optimum allocation of resources, maximization of welfare and efficiency of production and equilibrium under static conditions where consumer tastes and production technology do not change. Under such conditions, and further assuming perfectly divisible and homogeneous inputs and outputs in a world characterized by perfect knowledge and perfect mobility, the free play of market forces operating through price signals would result in the most efficient allocation of resources which would not only maximize production and productive efficiency of given resources, but would also maximize 'welfare' in a certain sense. Such a system would also attain an equilibrium in the sense that the entire system as well as the individual consumers and producers comprising it would reach their maximum positions. The entire model is so simple, is based on such simplistic assumptions, has so few economic variables, and is so devoid of complications, that it could be, and has in fact been, reduced to neat mathematical formulations. The basic questions which need to be answered in regard to this model and its policy conclusion of *laissez-faire* could be stated as follows:

(a) Do the assumptions of perfect competition hold good in the real world, and if not, do they not destroy the case for non-interference with the operation of price signals?
(b) Does the optimum allocation of resources under conditions of perfect competition also imply full employment of economic resources?
(c) Is the concept of 'welfare' which is said to be maximized in the perfectly competitive model valid?
(d) What is the significance and relevance of the concept of equilibrium in a dynamic setting and what are its policy implications?
(e) Is the attainment of equilibrium at a level where resources are optimally allocated the basic economic problem, or does that problem itself need to be restated? If so, how and what are the policy implications of that restatement?

As discussed earlier, the assumptions of perfect competition do not hold good in the real world. The imperfections of competition may also give rise to several distortions in the production pattern and to inequities in the distribution of income. Market imperfections may further cause inefficient use of scarce resources or their deliberate underutilization, quantitative restriction of output and its qualitative deterioration. These imperfections may necessitate interference with the market mechanism, including direct price controls. In certain cases it may become necessary to ignore the price signals because they might have been given by a tiny minority of consumers having a very large number of money votes or by wrongly motivated, ignorant or misguided consumers. Sometimes it may be considered necessary to produce certain goods for which there may be no demand and for whose production the market may have given no signal at all. For instance, in an underdeveloped country with a large agricultural population barely surviving at subsistence level owing to low yields in agriculture, there may be no demand for fertilizers in the initial stages of development due to the ignorance of farmers about their usefulness, but it may still be considered necessary to put up fertilizer plants at considerable cost and induce demand for fertilizers through publicity and extension methods. Such a country may also be lacking in the basic infrastructure, the market mechanism may never give any signals for its creation, and it may remain condemned to a sub-human level of existence unless investments are made in creating the infrastructure of rail and road transport, power plants, dams for irrigation and flood control, steel/cement/fertilizer plants, etc. In fact, the traditional theory of a market economy loses practical relevance in a backward economy embarking on a programme to initiate a process of self-sustaining economic growth for which the direct commandeering of scarce economic resources by the state may sometimes become a practical necessity.

The obsession with optimum allocation of given economic resources to maximize 'welfare' seems to be a hangover of the inebriation which had lulled the economists into the belief that all income is automatically spent either on consumer or on investment goods; that supply creates its own demand so that there could be no general excess or deficiency of demand causing glut or unemployment; that any short-run gap between saving and investment is eliminated by changes in the rate of interest, leaving the levels of income and employment unaffected; that there is stable equilibrium at full employment and any position of less than full employment is necessarily a temporary, transitional stage where economic forces constantly urge the system on to a position of full employment and this could not be an equilibrium position. Having deluded themselves with the idea of living in such an unbelievably blessed world, they further persuaded themselves to believe, by a seemingly clever use of the tools of marginal analysis (which were subsequently developed and perfected), that left to itself the system would not only ensure full employment of all economic resources, but also their optimum allocation, maximizing welfare and efficiency. There is, however, no reason to believe that the level of the 'welfare optimum' will always be the level at which all resources will be fully employed. The point where given resources are allocated optimally may very well be a point where all available resources may not be fully employed due to lack of effective demand, or due to 'specificity' and 'complementarity' of resources,[3] which may necessitate not only a certain level but also a certain composition of output to ensure their full employment. If 'full employment' is considered to be a desirable social and economic objective, the economy cannot be left to be guided solely by the price signals of a market economy, and state intervention in the free functioning of such an economy by undertaking investments in the lines not indicated by the price signals, or direct manipulation of price signals to make resources flow in the desired directions or away from those not desired, may be resorted to as a matter of conscious policy.

Another basic question, namely, whether the concept of 'welfare' implicit in the theory of 'welfare optimum' is itself valid, has to be answered in the negative. The concept is obviously normative in character, involving value judgement; and both the notions underlying it, viz. that the individual himself is the best judge of his own welfare and his welfare consists in getting things which he desires according to his scale of preferences, and that his 'welfare' in this sense is independent of what others desire or consume and is unaffected by the consumption or possessions of others, are questionable. As we know too well, in several cases individuals may have (or may be persuaded to have through misleading advertisements) mistaken ideas about what they really want; and what they want may not always be in their best interest. Similarly, welfare, being a state of mind, may, in many cases, be affected by the level and the standards of consumption enjoyed by others around and not merely by one's own consumption. A more serious objection to this concept of welfare is that it assumes that society's welfare is maximized when each individual comprising it maximizes his own utility or welfare, and that there is a basic harmony or identity of interest between the individual and society. This is an unrealistic assumption since the volume and the pattern of the output and the distribution of income in an economy guided solely by price signals given by consumers maximizing their welfare or utility, individually and collectively, may not be found to be socially desirable, equitable, just or conducive to the health or the growth of the economy. A modern 'welfare state' which undertakes the responsibility for providing a certain minimum level of income and essential services