



Friedman  
on  
INDIA

Foreword by Deepak Lal

Edited by Parth J. Shah



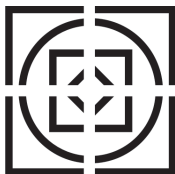
CENTRE FOR CIVIL SOCIETY



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## FOREWORD

In the heyday of Indian planning, in the 1950's, the government received advice from most of the leading economists in the world. It would be fair to say that nearly all of them supported the broad framework of the Second Five Year Plan and the *dirigiste* system of licensing and controls it inaugurated. There were only three notable dissenters from this intellectual consensus: Professor Shenoy from the University of Gujarat, Professor Bauer from the London School of Economics, and Professor Friedman from the University of Chicago. The latter's contribution is not well known, and the Centre for Civil Society is to be commended in bringing out this pamphlet containing the two pieces Professor Friedman wrote in the 1950's and early 60's about Indian economic policy.

It is a mark of the continuing and tragic failure of this *dirigiste* system - which the Manmohan Singh-Narasimha Rao reforms only partially dismantled-that, nearly a half century after they were written, these essays are still so relevant. The shameful neglect of human resource development, the counter-productive policy of industrial reservations which creates an industrial caste system, the limits of deficit financing, the 'rent-seeking' resulting from the politicisation of economic life, and the need to remove all trade and exchange controls to be replaced by a fully convertible floating Rupee, are all themes adumbrated in these essays which are still of importance for reforming Indian economic policy. Rather than being a mere historical testament, these essays point to areas where reforms are still needed if India is to redeem the pledge Pandit Nehru made on the eve of Indian independence 'to wipe every tear from every eye', but which the sclerotic economic system he created has made impossible to fulfil for half a century.

On a personal note, having been brought up in the shadow of the Nehruvian settlement, it took a stint in the Planning Commission in the early 1970's to make me question the 'catechism learned by rote' (p.20) identified by Friedman. I was forced to see the fundamental importance of Hayek's claim<sup>1</sup>, which Friedman also emphasises that, the division of knowledge in any real economy makes any form of centralised planning infeasible, leading to worse economic outcomes than even

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<sup>1</sup> see F.A.Hayek: "The use of knowledge in society", *American Economic Review*, vol.35, 1945, pp.519-30, reprinted in his *Individualism and Economic Order*, Routledge, London,1976.

the most imperfect market economy which makes use of the necessarily dispersed and decentralised knowledge required for making rational economic decisions. I was on the road to becoming a classical liberal, and wrote a small book<sup>2</sup> to try both to understand and question the intellectual climate of opinion fostered by 'development economics' which Friedman quite rightly saw as providing an important part of the explanation for the persistence of failed economic policies in India.

My only quibble with Friedman in these essays is his claim that the Hindu reverence for the cow is irrational! Elsewhere,<sup>3</sup> I have tried to explain both how the caste system arose and why, despite appearances it was not necessarily a brake on economic progress, and why the ban on cow slaughter is not as uneconomic as it seems. It is not these social customs but the 'traisons des clercs' of the intellectuals of the 1950's and early 60's which needs to be castigated for perpetuating India's ancient poverty. But there were, as these essays show, even in those dark days, there were a few important voices, which if heeded, would not have led to these last fifty years of wasted Indian promise.

DEEPAK LAL

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*London  
August 2000*

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<sup>2</sup> D.Lal: *The Poverty of 'Development Economics'*, Institute of Economic Affairs, London 1983, Harvard University Press, Cambridge Mass, 1985; 2nd revised and expanded edition, Institute of Economic Affairs, London 1997, MIT Press, Cambridge Mass, 2000, Oxford University Press, New Delhi, 2000.

<sup>3</sup> D.Lal: *The Hindu Equilibrium*, Clarendon Press, Oxford.



## PREFACE

When India attained its independence, it was strongly socialist in its orientation, its intellectual atmosphere having been shaped largely by Harold Laski of the London School of Economics and his fellow Fabians. In the initial decade after independence, a series of left-wing advisers, including Oskar Lange and Michael Kalecki from Poland, and Nicholas Kaldor and John Strachey from Britain, visited India. American advisers financed by the Ford and Rockefeller foundations were for the most part highly sympathetic to the central planning propensities of the Indian authorities.

In 1955, the Indian government was engaged in preparing its Second Five Year Plan—a practice reflecting the strong influence of the Soviet experience. In that connection, the Indian government asked the Eisenhower administration for assistance. The administration recognized an opportunity to counter the influence of the left-wing advice by sending two strong proponents of free markets. Neil Jacoby was one of the two. I was the other one. That is how I came to visit India in the fall of 1955 under the auspices of the U.S. International Cooperation Administration (as the foreign aid agency was dubbed at the time). Once I was in New Delhi, I was assigned to advise Mr. C. D. Deshmukh, the Minister of Finance.

I spent a very intense month in India, at the end of which I wrote the memorandum that is the second chapter in this publication. It was given to Mr. Deshmukh and to my superiors in the International Cooperation Administration, was circulated in the government, leaked in part to the press, and not heard of again until thirty-seven years later when it was published for the first time by Subroto Roy and William E. James in their record of a conference on India held at the East-West Center in Honolulu, Hawaii.<sup>1</sup>

As I reread it, I am impressed by two features: (1) its diplomatic tone, no doubt reflecting my status as a representative of the U.S. government; and (2) its continued relevance to the problems of India today. On the issues it covers,

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<sup>1</sup> 'Memorandum to the Government of India 1955,' pp. 163-176 in *Foundations of India's Political Economy: Towards an Agenda for the 1990s*, edited by Subroto Roy and William E. James (New Delhi: Sage Publications, (1992).

we know no more today about how to promote development than we did then. However, the intellectual climate of opinion is far less hostile today to the views expressed in my memorandum than it was then.

Some seven years after my first visit, my wife and I spent a bit over two months in India. This was part of a year's trip around the world that I spent studying monetary conditions in five countries: Yugoslavia, Israel, Greece, India, and Japan. This time I was in India strictly in a private capacity. We were able to travel widely; talk to many entrepreneurs, academics, economic journalists, government officials, and political activists; visit factories and universities, as well as do a good deal of touring. I gave a number of talks under various auspices and published a few letters and columns in newspapers.

After we left India, I wrote the piece that forms the first chapter in this publication, 'Indian Economic Planning.' Initially, I intended to revise it for publication in an American periodical such as *Fortune* magazine, but for various reasons I never did so. I did, however, send it to a number of friends for criticism. The most interesting response was from Professor BR Shenoy who is referred to in my memorandum.

I have been in India only once since our 1963 trip. That was in 1979 when we filmed briefly in India in connection with our television programme 'Free to Choose.'<sup>2</sup> Nevertheless, I have tried to follow at a distance the economic developments within India. I continue to be impressed by India's enormous potential and depressed by the contrast between that potential and the minimal progress that has been achieved in the forty-five years since I was first in India. The latest decade shows more signs of change. India may finally be on the way to realizing its potential. If so, it will be a blessing for the people of India and for the world as a whole.

**Milton Friedman**  
*Stanford, California*  
*March 29, 2000*

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<sup>2</sup> Our several trips to India are chronicled in our memoirs, *Two Lucky People* (Chicago: University of Chicago Press, 1998), pp. 257-269, 3305-316, 488.

# INDIAN ECONOMIC PLANNING

*by*

MILTON FRIEDMAN

It is now well over a decade since India embarked on a policy of “planned economic development”. The United States government has strongly supported this policy, contributing a total of \$4 billion in foreign aid through 1962. We have rightly regarded India as a key country in the struggle for the uncommitted nations of the world, as the major counterforce to the influence being exerted in the Far East by China. We have also rightly regarded the incredible poverty of millions as a challenge to the humanitarianism of the West. Unfortunately, Indian economic policy has not been producing the results that they and we hoped for and I do not believe it can do so. That was my tentative conclusion some eight years ago after a two months visit to India. It has been greatly strengthened by observations during a recent two months visit, and particularly by a comparison of the situation then and now.

On the positive side, there are clear signs of improvement since my earlier visit. The roads in the countryside are notably better, there are many more bicycles and automobiles in both city and country, beggars, though still numerous, seem somewhat less ubiquitous. There are any new buildings, some striking, and more and better hotels; new industrial plants and few rapidly expanding centers of small industry; there are new Universities and evident signs of the expansions of old Universities. Much of this and more is to the good. But unfortunately, the progress appears spotty, and some of the appearance of progress is misleading. Many of the most impressive new structures are signs not of progress but of waste, for example, factories producing items at for higher cost than that at which they can be purchased abroad. Most important of all, there is little that is evident to the naked eye in the way of improvement in the conditions of the masses of the people. On every side, there are extremes of unrelieved poverty that it is difficult to make credible to someone who has not been to India. As a friend from Britain remarked after his first visit to Calcutta where over a tenth of the population have no home other than the street: “One can adjust to a square mile of this kind of thing but when it

goes on for square mile after square mile, it is more than one can bear." These conditions seem to have shown little if any change in the past decade.

This kind of casual impression is most untrustworthy, especially when it concerns conditions at a level of living which the observer has never come close to experiencing himself. What the poor in India might regard as a major improvement, you and I might not be able to recognize. However, much objective evidence confirms these general impressions.

One bit comes from work done for a committee appointed by the Prime Minister to study changes in the distribution of income. The chairman of the Committee, Prof. P.C. Mahalanobis, is director of the Indian institute of Statistics, a member of the Indian Planning Commission, the author of the draft framework of the Second Five-Year Plan, and one of the people who has done most to shape present Indian ideas of economic planning. The report of the Committee had not yet been made public when I was in India but Prof. Mahalanobis, in private conversation, showed me some of the work he and his associates at the Indian Statistical Institute had done for the Committee. Data from sample surveys of Indian rural and urban households indicate that the poorest third or so of the populations experienced no increase whatsoever in food consumption per capita during the decade for the 50's - which roughly coincides with the first two five - year plans. And it must be recorded that food accounts for three-quarters or more of the total consumption expenditure of the poor.

Aggregate figures on the consumption of specific items support the general impression given by household surveys. The major items of consumption for the masses of India are food and cloth. The greater part of food consumption is accounted for by food grains rice, wheat, other cereals, and pulses. Indeed, at the bottom of the income scale, food grains alone account for half or more of total expenditure on all items of consumption. Per capita availability of food grains has fluctuated a good deal but with no steady upward trend: it was about the same in 1958 as in 1950, in 1960 as in 1955. The situation is not much different for cloth. The number of yards of cloth per capita is now no higher than in 1939. The consumption items that have shown the most rapid increases have been items like bicycles, sewing machines, automobiles - not luxuries by western standards by clearly so by Indian standards.

The official estimates of national income - that favourite magnitude of modern growth-men -give only a slightly more favourable impression. National income, corrected for price change, rose during the decade of the first two five-year plans at the rate of about 3 ½ percent per year, but population rose at the rate of 2 percent a year, so per capita output rose by about 1 ½ percent per year. And even these figures overstate the progress. In the first place, the official figures probably overstate the growth in output during the Second Five-Year Plan period because they make insufficient allowance of the price rise that occurred (this overstatement is almost surely much larger than the major error in the opposite direction, which is underestimation of the growth in the output of small-scale industry). In the second place, an increasing fraction of national income has taken the form of capital investment and government expenditures. The new and elaborate office buildings in New Delhi, the elaborate luxury Ashoka hotel built by the government in New Delhi, the strikingly well appointed and attractive guest houses, as well as all the new buildings, at the Universities newly constructed, and, of course, also the new automobile plants, fertilizer, steel, and other plants all these enter the national income at their current costs and regardless of whether they will ultimately add to the national output, as the fertilizer and steel plants may, or be a perpetual drain, as the automobile plants are and will continue to be.

For the purpose of judging progress, the increase in consumption is much more meaningful than the increase in total output, both because its measurement is less ambiguous and because the aim of development is, after all, to raise the consumption level of the populace. Even the official figures show that per capita consumption has risen at the rate of only one percent per year.

Some growth in total output but at a disappointingly slow rate and with a widening, rather than a narrowing of the distribution of income: that is the conclusion suggested by all the evidence. I met no Indian economist who did not agree with this general verdict.

Just how disappointing the rate of growth is can be judged by measuring it against a standard that is repeatedly set forth. Time and again one will hear as an article of faith in India that the economic and political pressure for development is so urgent that India must develop at a faster rate than Western

countries did. A standard cliché is that India must compress into decades what took other countries centuries. There is, of course, much merit to this position. The scope for improvement is tremendous, the desirability of improvement is unquestioned; and it should be easier and faster to imitate than to initiate. But the actually achieved rate of growth to date is lower than was achieved in Britain, the United States, and other developing countries during their early stages of development. It is lower than the current rate of growth in Japan, Greece, Israel, Formosa or in Italy, France, and Germany, even at the officially estimated  $1\frac{1}{2}$  percent per year growth in per capita output, it would take over a century of steady growth at that rate for India to reach the current level of per capita income in Japan, and well over three centuries to reach the current level of per capita in the United States. The current danger is that India will stretch into centuries what took other countries decades.

And all this under circumstances that have most been very favourable for economic growth. The achievement of independence from Britain in 1947 raised many real problems, particularly as a result of partition, the relocation of populations, and the bloodshed between Hindus and Moslems. But it also created real opportunities. For decades, the enthusiasm and energy of a sizable fraction of the ablest people of India had been devoted to the independence struggle. They had themselves been engaged in activities that were not merely neutral but actively hostile to economic development and they had persuaded a large fraction of their countrymen to do likewise. Independence released these energies and made them available to promote economic progress. Independence also fostered a weakening of rigid social and economic arrangements, increased flexibility in institutions, greater mobility of people, and in general an environment more suited than before to change. Finally, the years after independence saw a great inflow of resources from abroad. External assistance during the decade spanning the first two five-years plans averaged about  $1\frac{1}{2}$  percent of national income, which means that it provided something like a fifth of net investment; and external assistance was disproportionately concentrated in the Second Five-Year Plan period, when it amounted to about  $2\frac{1}{2}$  percent of national income or to over a fourth of net investment. One that score alone, growth should have accelerated during the Second Five-Year Plan rather than apparently slowing down a bit.

What is the reason for the disappointingly slow rate of growth? One frequently heard explanation is that it reflects the social institutions of Indians, the nature of the Indian people, the climatic conditions in which they live. Religions taboos, the caste system, a fatalistic philosophy are said to imprison the society in a strait jacket of custom and tradition. The people are said to be un-enterprising and slothful. The hot and humid climate of much of the land saps energy.

These factors may have some relevance in explaining the present low level of income in India, but I believe they have almost none in explaining the low rate of growth. Certainly the visitor to India is forcibly struck by the enormous waste of resources, in terms of his own system of values, produced by the holiness of the cow, to take the most obvious example of the economic effect of religious belief. India has one of the highest if not the highest number of cows per person in the world, yet the water buffalo is the primary source of milk, and of course beef is almost unavailable as food. Cows wander freely in the streets of major cities, most of them scrawny, poorly cared for, and of little or no economic value. Yet they invariably have the right of way and, poorly as they are fed, doubtless absorb a very large aggregate amount of foodstuffs that could be made available for human consumption. The rigid assignment of tasks to specific castes often means that two or three people are required to do a job that one person, willing to turn his hand to everything, could perform.

Similarly, human qualities are certainly important. A dramatic illustration from India is the differential experience of two groups of refugees from Pakistan after partition: the Punjabis and the Bengalis. The Punjabis have doubled the average agricultural yield in the area in which they resettled, and have besides been among the most enterprising, active, and dynamic business groups in India. The Bengali have had great difficulties in resettling, many of them are still in government resettlement camps some 15 years after partition, and they have been a drain on the country rather than a source of growth.

But none of this explains a lack of growth. Insofar as the religious and social customs make for inefficient use of resources, they will keep the Indian level of output lower than otherwise but they need not prevent it from rising at a rapid rate along that lower path. On the contrary, a change in religious and social attitudes, such as is unquestionably occurring, provides an additional

reason to expect growth. There need not be a complete reversal of attitudes. A 5 to 10 percent per year increase in total output would be a very satisfactory record need. To contribute to this, there is required only a small and gradual substitution of attitudes more favourable to the effective use of resources.

The same thing is true about human qualities. It is not necessary that every individual be an enterprising, risk-taking economic man. The history of every nation that has experienced economic growth shows that it is a tiny percentage of the community that sets the pace, undertakes the path-breaking ventures, coordinates the economic activity of the host of others. Most people everywhere are simply hewers of wood and drawers of water. But their hewing of wood and drawing of water is made far more productive by the activities of the minority of industrial and commercial innovators and the much larger but still tiny minority of imitators. And there is no doubt that India has an adequate supply of potential entrepreneurs, both innovators and imitators.

Indians who migrated to Africa to South East Asia have in country after country formed a major part of the entrepreneurial class, have been the dynamic element initiating and promoting economic progress. It is hard to believe that those who left India are radically different from those who stayed at home.

The clearest evidence that they are not is currently provided by the dramatic growth of small-scale industry in the Punjab. The most encouraging experience during my stay in India was a visit I made to Ludhiana, a medium sized town in the Punjab which is fast becoming a major centre for the production of machine tools, bicycles, sewing machines, and similar items, Items, and which has long been a major centre for the production of knitted goods. Here was the Industrial Revolution at its inception - I repeatedly felt that I was seeing in true life the descriptions of Manchester and Birmingham the end of the 18<sup>th</sup> century that I had read in economic histories. There are thousands of small and medium size workshops, with extraordinarily detailed specialization of function. Here was a three man shop where saddles for bicycles were being assembled from parts which in turn were made by other small enterprises. But here also was bicycle factory employing hundreds which purchased many of its parts from the smaller firms, and the output of which had been growing at the rate of 50 percent a year. One of the owners of the factory who showed me



around was particularly proud of the part he and his associates had played in helping their employees to establish independent firms. Here was a small open cubby-hole on the main street in which with the aid of a few tools, a thirty-ton press was being constructed, but here also a firm on a substantial scale making many machine tools, mostly with tools that it has in turn made itself. There is shortage of enterprise, or drive, or technical skill in Ludhiana. There is rather a self confident, strident, raw capitalism bursting at the seams.

One reason why Westerners so often feel that enterprise and entrepreneurial capacity is lacking in India is because they look at India with expectations derived from the advanced countries of the West. They think in terms of the large, modern corporation, of General Motors, General Electric, and other industrial giants. But it was not firms like this that produced the Industrial Revolution; they are, if anything, its end products. The hope for India lies not in the exceptional Tatas or similar giants, but precisely in the hole-in-the wall firm, in the small and medium size enterprises, in Ludhiana not Jamshedpur; in the millions of small entrepreneurs who line the streets of every city with their sometimes miniscule shops and workshops. If the tendencies so evident in Ludhiana could be given full rein, and not hampered and hindered in every direction by governmental interference and control, India could achieve a rate of growth that would exceed today's fondest hopes.

As this final remark suggests, the correct explanation for India's slow growth is in my view not to be found in its religious or social attitudes, or in the quality of its people, but rather in the economic policy that India has adopted; most especially in the extensive use of detailed physical controls by government.

"Planning" does not by itself have any very specific content. It can refer to a wide range of arrangements: to a largely laissez-faire society, in which individuals plan the use of their own resources and government's role is limited to preserving law and order, enforcing private contracts, and constructing public works; to the recent French policy of mixing exhortation, prediction, and cooperative guesstimating; to centralized control by a totalitarian government of the details of economic activity. Along still different dimension, Mark Spade (Nigel Balchin), in his wonderful book on *How to Run a Bassoon Factory and Business* defined the difference between a planned and an unplanned business in a way that often seems letter-perfect for India. "In an unplanned business",

he writes, “things just happen, i.e. they crop up. Life is full of unforeseen happenings and circumstances over which you have no control. On the other hand: In a planned business things still happen and crop up and so on, but you know exactly what would have been the state of affairs if they hadn’t”.

In India, planning has come to have a very specific meaning, one that is patterned largely on the Russian model. It has meant a sequence of five-year plans, each attempting to specify the allocation of investment expenditures and productive capacity to different lines of activity, with great emphasis being placed on the expansion of the so-called “heavy” or “basic” industries. A Planning Commission in New Delhi is charged with drawing up the plans and supervising their implementation. There is some decentralization to the separate states but the general idea is centralized governmental control of the allocation of physical resources.

Whether because of the adoption of the Russian model of economic planning or for other reasons, Russia and India have one feature in common that strongly impresses the casual visitor. In both, if I may pervert a phrase made famous by our present Ambassador to India, there is a striking contrast between public affluence and private squalor. In both countries, whenever one sees a magnificent structure, newly built or well maintained, the odds are heavy that it is governmental. If some activity is luxuriously financed and well provided for, the odds are that it is governmentally sponsored. The city in India which showed the most striking improvement since my earlier visit was New Delhi, with impressive new governmental buildings, residence and luxury hotels. I should add that although the public affluence is not notably different in the two countries, the private squalor is much worse in India than in Russia.

Though Indian economic planning is cut to the Russian pattern, it operates in a different economic and political structure. Agricultural land is almost entirely privately owned and operated; so are most trading and industrial enterprises. However, the government does own and operate many important industrial undertakings in a wide variety of fields from railroads and air transport to steel mills, coal mines, fertilizer factories, machine tool plants, and retail establishments; Parliament has explicitly adopted “the socialist pattern of society” as the objective of economic and social policy; a long list of industries have been explicitly reserved to the “public sector” for future development,

and the successive plans have allocated to public sector investment a wholly disproportionate part of total investment - in the Third Five-Year Plan, 60 percent although the public sector accounts at present for not much more than a tenth of total income generated. In addition, the government exercises important controls over the private sector: no substantial enterprise can be established without an "industrial" license from the government, existing firms must get government allocations of foreign exchange and also of domestic products in the public sector; and so on in endless variety.

The difference between India and Russia in political structure is at the moment even sharper than in economic structure. The British left parliamentary democracy and respect for civil rights as a very real heritage to India. Though I very much fear that this heritage is being undermined and weakened, as of the moment it is still very strong indeed. There is tolerance of wide range of opinion, free discussion, open opposition by organized political parties, and judicial protection of individual civil rights-except for recent emergency actions under the Defence of India Act.

The kind of centralized economic planning India has adopted can enable a strong authoritarian government to extract a high fraction of the aggregate output from the people for governmental purposes - Russia is a prime current example and China, though we know much less about her, may be another; Egypt under the Pharaohs is a more ancient example. This is one way, and I believe almost the only way, in which such a system can foster economic growth-if the resources extracted are indeed used for productive capital investment rather than for arms or governments. But this advantage- if advantage it be - of centralized economic planning, India is not able to obtain precisely because of the difference between its economic and political structure and those of Russia or China.

For the rest, centralized economic planning is adverse to economic development. First, and most basic, it is an inefficient way to use the knowledge available to the community as a whole. That knowledge is scattered among millions of individuals each of whom has some special information about local resources and capacities, about the particular competence of particular people, characteristics of his local market, and so on in endless variety. The reason the free market can be so efficient an organizing device is because it enables this

scattered information to be effectively coordinated and each individual to contribute his mite. Centralized economic planning substitutes the knowledge and information available at the centre for this scattered knowledge. The people at the centre may individually be exceedingly intelligent and informed much more so than the average participant in the economic process. Yet even so their combined knowledge is meagre compared to that of the millions of people whose activities they are seeking to control and coordinate. It is the height of arrogance - or perhaps more realistically, of ignorance - for central planners to suppose otherwise.

In the second place, growth is process of change; it requires flexibility, adaptability, and the willingness to experiment; above all, is a process of trial and error that requires an effective system for ruthlessly weeding out the errors and for generously backing the successful experiments. But centralized economic planning tends to be cumbersome and rigid. So-called plans are laid out long in advance and it is exceedingly difficult to modify them as circumstances change. Inevitable and necessary bureaucratic procedures mean that the right hand does not know what the left hand is doing, that a long process of files going up the channels of communication and then coming back down is involved in adjusting to changing circumstances. Above all, the unwillingness to admit error, and the political costs of doing so, mean that the unsuccessful experiments are rarely weeded out; unless they are failures of the most extreme kind, they will be subsidized, protected, supported, and labelled successes.

India's publicly operated steel plants provide a current example. These were built for India by foreign countries; one by the British, one by the West Germans, and one by the Russians. All are apparently technologically efficient and modern mills. They are repeatedly cited as great achievements of Indian economic planning. Yet, on probing, it will be admitted that their costs are much higher than those of the private steel firms, despite the much older and less modern facilities possessed by the latter. Part of the explanation is apparently the extension to their administration of the Civil Service administrative system developed for very different purposes. A senior civil servant, who has had no experience in steel whatsoever and has perhaps only a few more years to retirement, is posted to be in charge of a steel plant, and many of his subordinates will be similarly recruited. Whatever the explanation,

the inefficiency can continue because the firms are propped up by restrictions on the import of steel and by domestic prices that may be too low to restrict the amount demanded to the amount available and yet are high enough to give the private firms very satisfactory profits indeed.

A third major defect of centralized economic planning is the strong tendency for planners to go in for prestige projects- to leave monuments to their activity, perhaps in the form of flashy international airlines, perhaps of highly mechanized factories when more labour -intensive techniques would be better suited to the country's needs, perhaps of luxury hotels like the Ashoka, or perhaps of major dams when a large number of small scale tube wells might be far better.

These defects of central planning impressed me greatly when I was in India eight years ago. But despite them, I was then inclined to guarded optimism. In summarizing my conclusions at that time for the International Cooperation Administration (predecessor of AID), on whose behalf I had been in India, I wrote:

“The basic fact about Indian economic development is that there has begun a breaking down of traditional attitudes and social arrangements that promises to release great reserves of private energy and initiative. India is on the move. The underlying forces making for change are so powerful that I think India can stand much unwise-economic policy...

“Looking forward, I am optimistic about the chances for growth, not because of the projected Five-Year Plan but despite it. The ambitious plans for government investment and projects, if carried through, will I am persuaded involve waste of capital resources; impressive public plants are a sort of twentieth century Taj Mahal. But India can stand this waste provided it does not lead either to open inflation or to an extensive and deadening network of direct controls designed to suppress inflation”.

Unfortunately - and this is the major reason for my present pessimism- the second of these provisos has been contradicted. Price rises in India during the Second Five-Year Plan period have produced an extensive and deadening network of direct controls, particularly in connection with foreign exchange and foreign trade. These controls have not yet stifled completely

the momentum for growth, but they have distorted it greatly, have made for enormous waste of resources, and are a major factor undermining political freedom and democracy.

The Achilles heel of the Indian economy at the moment is the artificial and unrealistic exchange rate. The official exchange rate is the same today as it was in 1995. In the interim, prices within India have risen some 30 to 40 percent; whereas prices in the US, UK, and Germany have risen far less, at most by 10 percent. If the rupee was worth 21 cents in 1955, it clearly is not worth 21 cents today. And even in 1955, India was experiencing difficulty in balancing its payments. It was even then engaged in extensive foreign exchange control, import restrictions, and export subsidies.

The attempt to maintain an over-valued rupee has had far reaching effects –as similar attempts have had in every other country that has tried to maintain an overvalued currency. The rise in internal prices without a change in the official price of foreign currency has made foreign goods seem cheap relative to domestic goods and so has encouraged attempts to increase imports; it has also made domestic goods seem expensive to foreign purchasers and so has discouraged exports. As a result, India's recorded exports have risen much less than world trade on the whole, while the demand for imports has steadily expanded.

The pressure on the balance of payments has been officially met in three ways: first, by using up large foreign exchange reserves; second, by getting additional assistance and loans from abroad; third, by extending direct controls over imports and subsidizing export. There has been a fourth unofficial way, namely, black market transactions in exchange and the smuggling of goods. Though no records exist on this fourth way, there is little doubt that it has expanded greatly as it increasingly renders official statistics unreliable as measures of India's foreign trade transactions. For example, though the number of tourists entering India in recent years has been growing, the amount recorded in official statistics as spent by tourists has been declining.

Exchange control has not in fact been able to stimulate exports. They have stagnated or fallen. It has operated almost entirely by preventing individuals from importing as much as they would like at the controlled exchange rate.

In doing so, it has done immense harm to the Indian economic and political structure. There is no satisfactory criterion available to the planning authorities to determine what items and how much of each should be permitted to be imported. There is much talk of restricting “unessential” imports and permitting only “essential” ones. But this is just talk unless there is some way of determining what is and what is not essential. In the absence of a market test, there is in fact no satisfactory way to do so. When a family must reduce its expenditures, it does not cut out whole categories of goods; it cuts its expenditures a little here and a little there, balancing the loss from spending a rupee less on toothpaste with that from spending a rupee less on toothpaste with that from spending a rupee less on movies and so on in infinite variety. The same principle applies in restricting imports to the amount that can be purchased with the foreign exchange available. But how can planners at the counter have the necessary information about each of the tens of thousands of items imported? How can they know how much a little cut here will reduce exports of a hundred other items? How costly it will be to provide domestic substitutes, directly or indirectly? How much the consumers of the ultimate products would be willing to sacrifice in other directions for a little more of a particular import item?

The fact is that the planners cannot possibly know what they would have to know to ration exchange intelligently. Instead, they resort to the blunt axe of cutting out whole categories of imports; to the dead hand of the past, in allocating a certain percentage of imports in some base years; and to submission to influence, political and economic, which is brought to bear on them. And they have no alternative, since there is no sensible way they can do what they set out to do.

Automobiles provide a striking example of the economic waste produced by this policy. In the name of restricting “luxuries” to “save foreign exchange”, the importation of automobiles from abroad is in effect prohibited, whether these be second hand or new. But at the same time, new automobiles, copies of foreign makes, are being produced at very high cost in small runs under extremely uneconomic conditions at four different plants in India. These are available by one channel or another for the luxury” consumption it is said to be desirable to suppress. Many of their components are imported, and many

of those made in India use indirectly imported materials. The result is that not only is the total cost of the amount of motor transportation actually produced multiplied manifold, but even the foreign exchange cost is probably larger.

The results are most striking in the market for second hand cars. A car that I sold before I left the US for \$22 (a 1950 Buick) was being quoted in Bombay when I was there at 7,500 o 10,000 rupees or \$1,500 to \$2,000 at the official exchange rate and over \$1,000 at the free market rate. Clearly, the sensible rate and cheap way for India to get automobile transportation is o import second-hand cars and trucks from abroad. Aside from the direct saving through getting the cars cheap, this would have great indirect advantage in promoting technical literacy, using the abundant manpower resources of India, and conserving capital. But India in effect says, "We are too to buy second-hand motor vehicles, we must buy new ones"!

Some very crude estimates I have made suggest that the extra amount India is currently spending annually to acquire motor vehicle transportation is of the order of one-tenth of annual US aid. This fraction of our aid is simply being thrown away to support conspicuous production.

What is true of automobiles is true in industry after industry. India has become a protected economy in which items are produced at a multiple of the costs at which they could be obtained from abroad. And at the same time, foreign exchange is wasted in purchasing goods abroad for which it would be more economical to use domestic substitutes (like the domestic repair and maintenance of second-hand automobiles which would be a substitute for the import of materials for the production of new ones.)

Needless to say, in spite of the proliferation and extension of direct exchange controls, it has not been possible in fact to maintain the artificial exchange rate. Aside from black market transactions, the various explicit promotion schemes and restrictions on imports have the effect of making the actual exchange rate different from the official one. For example, a manufacturer of sewing machine heads who was exporting some told me that he sold the same head for 132 rupees in India, and for 7 pounds sterling abroad. This works out to an exchange rate of 19 rupees to the pound sterling compared with the official rate of 13 ½ rupees. Other rates that I calculated in the same way varied from 15 to 26 rupees to the pound. If similar comparisons of internal and external



price were made for import items, the range would be even wider. Through the adoption of expedient after expedient in attempting to shore up an artificial rate of exchange, the planners have in fact created a multiple exchange rate system that not one of them would be willing to defend as rational if he examined the whole structure explicitly.

Though the controls in the field of foreign exchange are the most widespread and destructive at the moment, their adverse effect is reinforced by a whole series of other domestic controls. For example, steel is rationed to users, who spend much time and energy is reshuffling allocations and distributing the steel more rationally. Some of the entrepreneurs at Ludhiana estimated that an eighth to a quarter of their working time was being spent on either getting allocations or finding ways to acquire the materials they needed by more devious channels.

Aside from the economic harm they do, the controls are doing enormous harm to the political fabric of Indian society. Corruption and petty bribery are of course universal, and not only in underdeveloped societies. But they have been reaching new heights in India. On my earlier visit to India, I heard almost nothing about explicit corruption in the higher ranks of the civil service, though much about political influence. On this visit, there was widespread talk on all sides, and in the press, about bribery of government officials, the securing of favours by contributions to political parties and so on and on, with even the naming of names, in private conversation, of very highly placed persons directly involved. A standard jest heard over and over was that while the U.S. might be an "affluent society", India was an "influence society". A major reason for the corruption is that the techniques of economic planning employed in India have put relatively minor civil economic value. An import licence, carrying with it price, can often be sold at once for double or triple its nominal value. Much the same is true of a permit to acquire steel at the controlled price. Industrial licence, access to credit on specially favourable terms, or to other special programmes designed to "promote" development in one direction or another, and so on, add further to the stimulus to corruption provided in all countries by large scale governmental expenditures, with the opportunities they offer for juicy contracts. C. Rajagopalachari, the first Indian Governor-General after Independence and currently the octogenarian leader of the opposition Swatantra (Freedom) party, has labelled the existing system

a license-and-permit- raj, and people of every political persuasion admit the aptness of the label. The westerner who has formed his opinion of India solely from what he has read about it is likely to have the impression that a strong central government is at times ruthlessly and always forcefully shaping private conduct to further what it regards as the public interest. In fact, it would be no less accurate to describe the situation as one in which powerful private groups are able, through political and financial influence, to use governmental policy as an instrument to further their own interests.

Corruption undermines the political heritage directly by destroying the moral and the efficiency of the civil service, and by undermining respect for law on the part of the public at large. But the factors that give rise to it operate in more subtle fashions as well. The newspapers, for example, are subject to newsprint rationing; moreover, they are for the most part owned by persons who also have large interests in industrial concerns heavily dependent on government for licenses, permits, and orders. It clearly is the better part of valour for them to mute their criticism of the government in power, and certainly this reader of the papers had the impression that they did so, avoiding any general criticism, and restricting criticism to specific points. For example, as a result of the Chinese episode, a not-negligible fraction of the intellectuals I met, even those strongly in favour of the general economic policies for the government, have become disenchanted with Nehru and believe that he should be replaced. Yet I read not a single editorial or column in any major English-language newspaper voicing such a view. Published statements to this effect were either in explicitly party organs or in small -circulation personal journals. I head of one journalist who had been discharged from a leading newspaper because of anti-Nehru comments in his articles. Three persons who circulated a public letter after the Chinese invasion urging that Nehru be replaced were held in jail for some months without ever being brought to trial and then re-released. While I heard different stories about the extent to which this event had even been reported in the press, apparently none of the news paper conducted a vigorous editorial campaign about the incident. The major protects were by private committees and through public meeting. As a final item, a leading businessman who was a strong backer of the Swatantra party cited as a sign of his courage and independence that he had given as much money to Swatantra as to Nehru's congress party!

Though these trends are important and may ultimately be decisive, let me repeat that, as of the present, India is, on any absolute scale, a remarkably free country with a high respect for civil and political right. That is why there is still so much hope and why it is so important to recognize and alter the policies that are threatening its internal freedom.

At one level, there is ground for optimism about India. I am myself still persuaded, as I was in 1955, that India lacks none of the basic requisites for economic growth except a proper economic policy. I believe that drastic but technically feasible changes in economic policy—the substitution of a freely floating exchange rate for the present fixed rate and elimination of the exchange controls, import restrictions, and export subsidies designed to prop up the present rate; and a similar policy of substituting the free market for direct controls in the domestic economic scene—could release an enormous reservoir of energy and drive and produce a dramatic acceleration of economic growth in India comparable to that which occurred in Japan after the Meiji restoration.

At another level, however, I am exceedingly pessimistic. The intellectual climate of opinion about economic policy is almost wholly adverse to any changes in the direction that seems to me required. There is a deadening uniformity of opinion in India, particularly among economists, about issues of economic policy. In talks to and with students and teachers of economics at a number of universities, personnel of the planning commission, economists in the civil service, financial journalists, and business men, I encountered again and again the same stereotyped responses expressed often in precisely the same words. It was as if they were repeating a catechism, learned by rote, and believed in as a matter of faith. And this was equally so when the responses were patently contradicted by empirical evidence as when they were supported by the evidence or at least not contradicted.

There is only one prominent professional economist, Professor B.R. Shenoy of Gujarat University, who is openly and publicly and at all effectively opposed to present policies and in favour of greater reliance on a free market. He is a remarkable and courageous man. In 1955, when the second five-year plan was in preparation, the government appointed an advisory committee of 21 professional economists to criticize the draft framework that had been

prepared by Prof. Mahalanobis. The committee submitted two reports. One, signed by 20 economists, was largely a restatement of the draft framework and contained hardly any critical comments, though doubtless many of the signers had strong individual reservations on specific points. The other was a minority report by Prof. Shenoy, which criticized the fundamental structure of the proposed plan, and pointed out in detail where difficulties would arise and what their character would be. If one reads Shenoy's report now, it sounds like a retrospective description of what happened rather than a forecast. But needless to say, though most economists display a deep respect for Shenoy's courage and personal qualities, he remains a prophet without honour in his own country.

There are a few younger and less well known economists who deviate from the dominate opinion, and there are many who share the main tenets of the dominant view yet differ on particular elements - for example, on the desirability of maintaining the present exchange rate. There are more numerous persons in the business world, particularly some connected with the Swatantra party, who recognize the defects of detailed centralized planning, and the virtues of a greater reliance on the market. But even among business men, most grumble about details but accept the views of the professional economists as necessarily right in the main. I shall not soon forget the tongue lashing I received from a prominent and highly successful manufacturer when I made remarks into which he correctly read implicit criticism of India's current economic policies. Of course, many of the currently most successful businessmen have a great stake in the existing system. The virtue of a free market is that it is a profit and loss system. If it were permitted to operate, it would quickly and ruthlessly weed out many who are currently protected by the ubiquitous controls. In India as in the United States, existing private entrepreneurs are in practice among the most effective enemies of free enterprise.

It will, I fear, take a major political or economic crisis to produce a substantial change in the course on which India is now set in economic policy, and I am not at all optimistic that such a crisis if it occurs, will produce a shift toward greater freedom rather than toward greater authoritarianism.

# A MEMORANDUM TO THE GOVERNMENT OF INDIA 1955

## THE GOAL

A 5 percent per annum rate of increase in real national income, seems entirely feasible, on the basis of both the experience of other countries and of India's own recent past. The great untapped resource of technical and scientific knowledge available to India for the taking is the economic equivalent of the untapped continent available to the United States 150 years ago. The basic question is one of method, of the social and economic arrangements that will best promote the conversion of these potentialities into realities while at the same time maintaining freedom and democracy and giving ever-widening opportunities to the mass of the Indian people. The belief that underlies these notes is that the basic requisites are a steady and moderately expansionary monetary framework, greatly widened opportunities for education and training, improved facilities for transportation and communication to promote the mobility not only of goods but even more important of people, and an environment that gives maximum scope to the initiative and energy of farmers, businessmen, and traders. The conquest of the technical frontier like the conquest of the geographical frontier requires a varied initiative by millions of individuals, flexibility of outlook and organization, and willingness to venture. The Government of India is doing much, and much that is highly effective, to bring these requisites into being. There is much more to do that at least in Indian conditions can be done only by the Government. But the Government also is following some policies and proposing others that are likely to hinder rather than promote economic development. The following comments, which are mainly restricted to such policies, deal with investment policy; policy toward the private sector; monetary policy; resources available to the public sector; and foreign exchange policy.

## INVESTMENT POLICY

### Over-Emphasis on the Capital-Output Ratio

There is a tendency not only in India but in most of the literature on economic development to regard the ratio of investment national income as almost the only key to the rate of development to take it for granted that there is a rigid and mechanical ratio between the amount of investment and additions to output. In the opinion of this writer, this seems a serious mistake. At the one extreme, output can increase even without investment; at the other, too high a ratio of investment may actually produce a lower rate of increase in income.

There are two reasons why the amount of investment and the increase in output can be, and empirically are, only loosely connected. First, the form and distribution of investment are at least as important as its sheer magnitude. Second, what is called capital investment is only part of the total expenditure on increasing the productivity of an economy. The first reason needs little additional comment. The second is perhaps less clear. In any economy, the major source of productive power is not machinery, equipment, buildings and other physical capital; it is the productive capacity of the human beings who compose the society. Yet what we call investment refers only to expenditures on physical capital; expenditures that improve the productive capacity of human beings are generally left entirely out of account. In the United States, for example, only about one-fifth of the total income is return to physical capital, four-fifths to human capital. By this writer's estimate similarly, only about one fifth of the annual rate of growth in the United States can be attributed to the direct effects of investment in the usual sense; four-fifths must be attributed to the growth in the productivity of human beings. Annual expenditures on improving the quality and quantity of human resources are at least as large as and perhaps much larger than investment as usually defined. Destroy the physical plant of the United States and leave the skills of the people and it would take but a few years to restore the initial position. Destroy the skills and leave the plant and the level of output would sink irretrievably. The cathedrals of medieval Europe, the pyramids of Egypt, the monuments of the Moghul Empire in India are all testimony to the possibility of a high rate of investment

in physical capital without a growth in the standard of living of the masses of the people. These considerations are especially important for India, precisely because its frontier is the frontier of technical knowledge and skill.

This is not to deny in any way the desirability of investment in physical capital. It is certainly highly important and is to some measure an indispensable concomitant of the development of human capital. But it is not the whole or even the most important part of the story. The danger is that concentration on it may lead to policies that increase physical investment at the expense investment in human capital; and even within the area of physical investment, may lead to increases in the kind of physical investment that we can measure at the expense of kinds that we cannot measure. We must be aware lest we become the victims of our statistical creations.

### **Emphasis on Two Extremes against the Middle**

The form of investment is no less important than its kind. The chief problem in the Indian program that impresses on the tendency to concentrate investment in heavy industry at one extreme and handicrafts at the other, at the expense of small and moderate size industry. This policy threatens an inefficient use of capital at the one extreme by combining it with too little labour and an inefficient use of labour at the other extreme by combining it with too little capital. The presumption for an economy like India's is that the best use of capital is in general somewhere in between, that heavy industry can best develop and be built upon a widely diversified and much expanded light industry. We may hasten to add that this is only a general presumption which may well admit of special exceptions. Perhaps, for example, the steel industry is one exception in India.

### **Attempt to Do Too Much in the Public Sector**

Indian thought may not have taken full account of the post-war experience of European countries in expanding the public sector. Country after country moved in this direction immediately after the war; to the best of the present writer's knowledge, the results were, in every case, disappointing. This experience has produced drastic change in the attitudes of the labour and left-wine toward nationalization and detailed state control over economic activity.

The elements in the parties that have not changed the approach are now being dubbed 'reactionary' by some of their fellows!

This point may be especially important for India. The areas for which only Government can take responsibility are here so large, so vital, and require such large investments that they alone would be a heavy burden on the limited administrative personnel of high calibre. It seems the better part of wisdom therefore to avoid any activities that can be left to others. The problem involves both the kind of activities taken into the public sector and the magnitude of investment. Some further comments are made on the latter in discussing the resources available to the public sector.

### **Attempt to Control Private Investment in Too Rigid and Detailed a Fashion**

- (i) Cutting off particular investment projects may not make resources available for other uses but may simply eliminate savings that would otherwise have been available. Much saving is made to finance specific investment projects. If it cannot be used for that purpose, it may well be directed to consumption or to the accumulation of bullion or its equivalent.
- (ii) It is impossible to predict in advance the lines of investment that will turn out to be the most productive, as the failure of so many private enterprises amply demonstrate. There is therefore great need for a system that is flexible and can change easily.
- (iii) Detailed direction wastes scarce energies and abilities of public servants in producing and enforcing regulations and of private individuals in trying to evade or avoid or change them.
- (iv) Given that the public sector gets the resources it demands, is not the market criterion appropriate for the allocation of the rest of investment? To frustrate it means to deny consumers freedom of choice and so to reduce the value to them of the goods produced.
- (v) Government does have a responsibility for seeing to it that the total of public and private investment is kept within the total resources of the community without inflation. But this can best be accomplished by monetary and fiscal policy, rather than by detailed regulation, leaving the



allocation of investment among private industries to be accomplished by the interest rate. In so far as this mechanism works imperfectly, measures to improve its operation seem preferable to supplanting it.

## **POLICY TOWARD THE PRIVATE SECTOR**

### **Protection of Inefficient Methods of Production**

**I**n addition to the Government controls already considered which are designed to direct investment, there are others whose purpose is mainly protective: the excise tax on factory-made shoes and factory-made textiles; reservation of markets, and the like. In the opinion of this writer, such policies seem misdirected. India's basic problem is the inefficient use of manpower; it is no solution to protect inefficiency, and the attempt to do so leads to a waste not only of human resources but also of physical capital. The extra money consumers have to pay for the products, let alone direct subsidies to producers could be channelled at least in part into investment. And there may even be actual disinvestment—we were told that some shoe machinery was lying idle and depreciating because of the tax.

There is a tendency to underrate the importance of nominally low taxes in promoting inefficiency. For example, there is a 10 percent tax on factory-made shoes. But half to two-thirds of the cost of shoes is the raw material. The tax therefore amounts to 20 percent or 30 percent of the value added by the factory, and it will not pay to produce shoes unless factory production is at least this much more efficient than hand production. The justification for these devices is to increase employment. The objective is fundamental, and would be worth achieving even at some cost in total output, but it seems to the present writer dubious that these means accomplish their objective even in the very short run, and certain that they work against it in the moderate or long run. What they do is to increase the number of people employed inefficiently; but they also decrease the number of workers in factories producing the same product, and in other industries stimulated by the higher income of the factory workers; the decrease is likely to exceed the increase but because it is more diffused and less obvious, it tends to be neglected.

## **Coddling of Private Industry in Certain Directions Combined with Severely Restrictive Controls in Others**

Just as it is inappropriate to discriminate in favour of the cottage industries, so it is equally inappropriate to discriminate in favour of factory industry or large concerns. Granting them special favour in the form of especially advantageous loans guaranteed markets, refusal of licenses to competitors, enforcing or even permitting private price-fixing and market-sharing agreements—simply encourages inefficiency and wastes scarce resources. If private industry is granted special favours by the Government, it is certainly inevitable that its use of these favours will be controlled; but this does not offset the harm done by the favours; it merely introduces new sources of rigidity and inefficiency. Business ingenuity is devoted to carving out protected sectors instead of to opening up new markets and lowering costs. There is no justification for private industry unless it is competitive, unless the right to receive profits is accompanied by acceptance of the risk of loss. Private industry should be made to stand on its own feet without either favour or harassment.

## **MONETARY POLICY**

### **Erratic Policy**

A stable monetary climate is a basic prerequisite for healthy economic growth. Yet over the past five years, monetary policy has been highly erratic. It first permitted and facilitated substantial price rises, then reacted too far in the opposite direction. More recently, monetary policy has again reversed direction and again threatens to go too far, this time in an inflationary direction. This erratic policy is recorded directly in the behaviour of the stock of money and of wholesale and retail prices, and indirectly, in a less rapid rate of economic advance than would have been feasible.

The present writer believes that monetary policy in India would be more stable and consistent if the monetary authorities paid more attention to the size of the money stock and less to other indicators, and if they took as their proximate goal, a steady expansion in the money stock (allowing for seasonal influences) at a rate of something like 4 to 6 percent per year. It may be noted

that detailed examination of the record of American monetary authorities persuades one that this general proposition is equally true for the United States, with a desirable rate of expansion of the money stock of 4 percent per year.

The importance of a stable monetary policy hardly can be overemphasized. There is probably no other single area in which mistakes can be more disastrous or appropriate policy more beneficial. The fact that it operates on a general level and makes its effects felt impersonally and indirectly is at one and the same time the reason for its crucial importance and for the widespread failure to recognize its importance.

### **Deficit Financing**

Deficit financing is currently proceeding at the rate of something like Rs. 150 to 200 crores a year. Given the generally deflationary trend of the recent past, such a rate doubtless can be absorbed for a time without a serious price rise. It is exceedingly doubtful, however, that it can be for more than a year or so. According to some rough yet fairly detailed estimates made by this writer, something less than Rs. 500 crores is the maximum amount that can be absorbed over the next five years without a substantial rise in prices. By this estimate, continued deficit financing at a rate of Rs. 200 crores per year over that period would produce a price rise of at least 30 percent, and perhaps much more.

## **RESOURCES AVAILABLE TO THE PUBLIC SECTOR**

**T**here seems to be a general agreement that planned expenditures in the public sector substantially exceed expected receipts, even after allowing for a shortfall of actual expenditures, for deficit financing to the extent of Rs. 1,000 to 1,200 crores, and for a substantial amount of foreign aid. If we are right about the safe amount of deficit financing, the actual gap is substantially larger than the amounts generally cited. This financial gap corresponds to a real resource gap. It can be filled without curtailing the Plan only by either getting additional resources from abroad; or making domestic resources more

productive over and above the 5 percent per year increase already allowed for in the estimates; or transferring resources from other uses. The transfer of resources can be brought about by additional taxation, forced savings, additional voluntary savings, or a reduction in private investment. Additional voluntary savings and a reduction in private investment can in turn be brought about to some extent by a monetary policy that allows interest rates to rise. Inflation is of course a possible danger, but it is not really a separate method of filling the gap; it is a form of taxation and, in the view of this writer, a particularly inefficient and inequitable form.

This only states the problem. We have not been able to study in detail either the tax structure of India or the financial structure for mobilizing and encouraging savings, so no independent judgement can be given on the possibility of filling the resource gap by the various means. Casual impression suggests that there is some possibility of increasing tax revenues without doing much harm, but that any substantial expansion in tax revenues or heavy reliance on any of the other methods except for foreign aid is currently subject to extremely serious limitations. If this is so, filling the gap by their use, if successful, might make public investment larger only at the expense of reducing the rate of growth of aggregate real income by killing incentives outside the public sector, eliminating potentially productive private investment, and producing either inflation or a deadening network of direct controls. This is a special case of the point made earlier about the loose connection between the rate of investment and the rate of growth of income. It may well be that under the circumstances, cutting the size of the program may be preferable to trying to fill the gap on the revenue side.

On the tax side, three comments may be made:

- (i) The small scope of direct income taxes seems an obvious defect in the tax structure. A more broadly based tax with lower exemptions and more effective administration might both raise considerable revenues and produce a more equitable distribution of the tax burden. (One recognizes that for a country like India there are special problems of administration and enforcement that this writer is incompetent to assess.)

- (ii) The use of excise taxes for the production of one method of production or one product as opposed to another not only promotes inefficiency but is also wasteful of revenue. A 10 percent tax on shoes would yield more revenue, do less harm to productive efficiency and cost the consumer little if any more than a 10 percent tax on factory-made shoes. As a side observation, is it clear that if the extra proceeds were used to facilitate the retraining and placement of hand workers it would be of less value even from the point of view of the employment problem?
- (iii) A minor possible source of additional revenue that would have favourable effects on efficiency is the auctioning off of licenses to use foreign exchange suggested as a possibility below.

## **THE FOREIGN EXCHANGE PROBLEM**

### **The Foreign Exchange Gap**

**I**t is generally accepted that present programs are likely to involve a substantial excess in the demand for foreign exchange over the available supply, even if allowance is made for foreign aid at roughly the present level. These estimates take for granted not only the investment program but also retention of the existing exchange rate and the existing structure of import and export controls. Even under these assumptions, the foreign exchange gap in part and perhaps in whole is a particular aspect of the total resource gap: any reduction in the total resource gap will automatically reduce the foreign exchange gap. Given the special foreign exchange resources that are likely to be available, we may guess that solution of the total resource gap would largely solve the foreign exchange gap as well.

### **Exchange Controls**

The existing structure of exchange-controls and their associated system of import and export licenses and of discrimination between sources of purchases, seem to this writer a major obstacle to the growth and progress of the Indian economy. They involve waste and inefficiency in the use of foreign exchange. They introduce delay, uncertainty, and arbitrariness into

domestic business activities. They impose on officials in charge of exchange control a task that is bound to be discharged most imperfectly, however able and devoted the officials may be. The criteria the officials use-and must use-tend to perpetuate the *status quo ante*, and therefore constitute an obstacle to dynamic change and adaptation in an area that traditionally has been one of the most dynamic sectors in the economy and the source of much of the impetus to change. Exchange controls necessarily involve the indiscriminate distribution of implicit subsidies to those granted import licenses, and they lend themselves to abuse as a means of granting administrative protection from foreign competition to inefficient or monopolistic domestic producers.

The elimination of the exchange-controls and import and export restrictions is thus a most desirable objective of policy. It must be recognized, however, that it would probably increase the demand for foreign exchange, but the likelihood of an increase means that elimination of controls would have to be accompanied by the introduction of some other means of rationing exchange. It should be emphasized that this increase in the demand for foreign exchange is not a fresh problem that would be created by the elimination of exchange-controls. The problem is there now. That is why controls are deemed necessary. The question is whether there are not less harmful ways of solving it.

### **Alternatives to Exchange Controls**

One alternative, which retains central control over the amount of foreign exchange to be released, is to auction off whatever amount of foreign exchange it is decided to release, permitting the purchasers to use it for anything they wish and in any currency area they wish. This would be a far more efficient system of rationing and would hinder internal economic development far less than the present system and at the same time yield some revenue. We have not been able to construct even a rough estimate of the amount of revenue, but it is unlikely to be of major magnitude.

It would be preferable to avoid this auctioning system as well. While it eliminates any distortion in the pattern of imports, it does not produce the appropriate adjustment of exports to imports. Only two other basic alternative modes of adjustment to changes in the conditions of external trades are available: first, to inflate or deflate internally in response to a putative surplus

or deficit in the balance of payments; second, to permit the exchange rate fluctuate. At least in the present worldwide monetary conditions the first is not desirable economically, since it puts internal conditions of trade at the mercy of changes in external conditions these are about as likely to result from vagaries in the internal policies of other countries as from changes in the 'real' conditions of trade. The preferable method is to let the exchange rate be determined in a free market—the method of a floating exchange rate that has been adopted by Canada with such conspicuous success.

It may be worth saying a few words about how a floating exchange rate eliminates any foreign exchange gap and means that, there are not two problems, at total resource gap and a foreign exchange gap, but only one, a total resource gap. Suppose the total program is in balance but, at the existing exchange rate, there is an excess of demand for foreign exchange over the supply. The result is to lower the rate. This makes India's products more attractive to the outside world, foreign products more expensive to Indians. The result is to lead to an increase in exports, thus making more foreign exchange available, to shift the pattern of investment within India away from kinds with a larger import component and toward kinds with a larger domestic resource component, away from production for the domestic market to production for the foreign market, and to shift consumption from foreign goods toward domestic goods. A putative foreign exchange surplus clearly has the opposite effects. In addition to these effects on trade, there are also, of course, effects on capital movements, which depend on whether the change in rate is regarded as temporary or permanent.

India's membership in the Sterling Area raises obvious difficulties in the way of India's acting alone, and may make it impossible for India to free her exchange rate except in concert with a similar move by Britain. However, if these difficulties could be surmounted, an independent movement by India might have very great advantages precisely because India is entering into a period of rapid economic change and is not a major financial centre. This writer believes there is more of an analogy between India's and Canada's positions than might at first appear. In a world of inconvertible currencies, a country that offers convertibility, albeit at a fluctuating rate, has a special attraction for investors and traders.

The problem of trade is frequently considered separately from that of the import of foreign capital. This is a mistake. Imports of goods may bring with them no capital directly but they bring businessmen and contact, and discovery of investment opportunities by people who are anxious to exploit them and who have contacts at home interested in such opportunities. Such continuous and intimate contact is likely to produce both a larger and, equally important, more productive flow of foreign investment than any number of missions coming out for brief periods with the objective of exploring investment opportunities.

### **Foreign Assistance**

Any foreign assistance will of course help to fill both the total resources gap and the foreign exchange gap. Its direct impact, however, is much greater on the foreign exchange gap. In consequence, foreign assistance is especially likely to permit an elimination of import and export controls without threatening the existing exchange rate. But it would be a mistake to suppose that foreign assistance, however extensive, would permit elimination of controls, a fixed exchange rate, and an independent domestic monetary policy for any length of time. Even though the exchange rate is in some sense in long-run equilibrium, accidental fluctuations will from time to time produce large drains on reserves and if there is no mechanism for adjusting to them, these drains may well make the short-run position untenable.

## **CONCLUSION**

If these comments have concentrated largely on the financial machinery of economic organization, it is not because that is the only or even the most important problem facing India but rather because, on the one hand, it is more within this writer's special competence, and on the other, it seems to be the area in which current policy can be improved most. The present writer is convinced that the fundamental problem for India is the improvement of the physical and technical quality of her people, the awakening off sense of hope, the weakening of rigid social and economic arrangements, the introduction of flexibility of institutions and mobility people, the opening tip of the social and



economic ladder people of all kinds and classes. And what gives an outsider like this writer a feeling of optimism and hope about the future of India makes one feel that India is on the move and will continue move, is that so much is being done and such a good beginning has been made on this fundamental problem of creating the human and social basis for a dynamic and progressive economy.

## **EDITOR'S EXCERPTS**

1. What is the reason for India's disappointingly slow rate of growth? Frequently given explanations are religious taboos, the caste system, a fatalistic philosophy, un-enterprising and slothful large population, hot and humid climate. These factors may have some relevance in explaining the present low level of income in India, but they have almost none in explaining the low rate of growth. The correct explanation for India's slow growth is not to be found in its religious or social attitudes, or in the quality of its people, but rather in the economic policy that India has adopted. India lacks none of the basic requisites for economic growth except a proper economic policy.
2. The hope for India lies not in the exceptional Tatas or similar giants, but precisely in the hole-in-the wall firm, in the small and medium size enterprises, in Ludhiana not Jamshedpur; in the millions of small entrepreneurs who line the streets of every city. If their enterprise and drive could be given full rein, and not hampered and hindered in every direction by governmental interference and control, India could achieve a rate of growth that would exceed today's fondest hopes.
3. The Achilles heel of the Indian economy is the artificial and unrealistic exchange rate. Automobiles provide a striking example of the economic waste produced by this policy. In the name of restricting "luxuries" to "save foreign exchange," import of automobiles from abroad is in effect prohibited, whether these be second-hand or new. But at the same time, new automobiles, copies of foreign makes, are being produced at very high cost in small runs under extremely uneconomic conditions. Many of their

components are imported, and many of those made in India use indirectly imported materials. The result is that not only is the total cost of the amount of motor transportation actually produced multiplied manifold, but even the foreign exchange cost is probably larger. The results are most striking in the market for second hand cars. Clearly, the sensible way for India to get automobile transportation is to import second-hand cars and trucks from abroad. Aside from the direct saving through getting the cars cheap, this would have great indirect advantage in promoting technical literacy, using the abundant manpower resources of India, and conserving capital. But India in effect says, "We are too poor to buy second-hand motor vehicles from abroad, we must buy new ones at home!"

4. In any economy, the major source of productive power is not machinery, equipment, buildings and other physical capital; it is the productive capacity of the human beings who compose the society. Destroy the physical plant of the United States and leave the skills of the people and it would take but a few years to restore the initial position. Destroy the skills and leave the plant and the level of output would sink irretrievably. The cathedrals of medieval Europe, the pyramids of Egypt, the monuments of the Moghul Empire in India are all testimony to the possibility of a high rate of investment in physical capital without a growth in the standard of living of the masses of the people. These considerations are especially important for India, precisely because its frontier is the frontier of technical knowledge and skill.
5. It will take a major political or economic crisis to produce a substantial change in the course of India's economic policy.
6. Economic planning is adverse to economic development. It is an inefficient way to use the knowledge available to the community as a whole. That knowledge is scattered among millions of individuals each of whom has some special information about local resources and capacities, about the particular competence of particular people, characteristics of his local market, and so on in endless variety. The reason the free market can be so efficient an organizing device is because it enables this scattered information to be effectively coordinated and each individual to

contribute his mite. Economic planning substitutes the knowledge and information available to government officials for this scattered knowledge. The people at the centre may individually be exceedingly intelligent and informed much more so than the average participant in the economic process. Yet even so their combined knowledge is meagre compared to that of the millions of people whose activities they are seeking to control and coordinate. It is the height of arrogance--or perhaps more realistically, of ignorance--for central planners to suppose otherwise. Secondly, growth is process of change; it requires flexibility, adaptability, and the willingness to experiment; above all, is a process of trial and error that requires an effective system for ruthlessly weeding out the errors and for generously backing the successful experiments. But centralized economic planning tends to be cumbersome and rigid. A third major defect of planning is the strong tendency for planners to go in for prestige projects—to leave monuments to their activity, perhaps in the form of flashy international airlines, perhaps of highly mechanized factories when more labour-intensive techniques would be better suited to the country's needs, perhaps of luxury hotels like the Ashoka, or perhaps of major dams when a large number of small scale tube wells might be far better.

7. There is much talk of restricting “unessential” imports and permitting only “essential” ones. But this is just talk unless there is some way of determining what is and what is not essential. In the absence of a market test, there is in fact no satisfactory way to do so. When a family must reduce its expenditures, it does not cut out whole categories of goods; it cuts its expenditures a little here and a little there, balancing the loss from spending a rupee less on toothpaste with that from spending a rupee on movies and so on in infinite variety. The same principle applies in restricting imports to the amount that can be purchased with the foreign exchange available. But how can planners have all the necessary information about each of the tens of thousands of items imported and make rational trade-offs? One alternative, which retains central control over the amount of foreign exchange to be released, is to auction off whatever amount of foreign exchange it is decided to release, permitting the purchasers to use it for anything they wish and in any currency area they wish.

8. The virtue of a free market is that it is a profit and loss system. If it were permitted to operate, it would quickly and ruthlessly weed out many who are currently protected by the ubiquitous controls. Private industry should be made to stand on its own feet without either favour or harassment. In India as in the United States, existing private entrepreneurs are in practice among the most effective enemies of free enterprise.
9. There is only one prominent professional economist, Professor B.R. Shenoy of Gujarat University, who is openly and publicly and at all effectively opposed to present policies and in favour of greater reliance on a free market. He is a remarkable and courageous man. He remains a prophet without honour in his own country.
10. The problem of trade is frequently considered separately from that of the import of foreign capital. This is a mistake. Imports of goods may bring with them no capital directly but they bring businessmen and contact, and discovery of investment opportunities by people who are anxious to exploit them and who have contacts at home interested in such opportunities. Such continuous and intimate contact is likely to produce both a larger and, equally important, more productive flow of foreign investment than any number of missions coming out for brief periods with the objective of exploring investment opportunities.

**CENTRE FOR CIVIL SOCIETY** is an independent, non-profit, research and educational organization devoted to improving the quality of life in India by reviving and reinvigorating India's civil society. India will be peaceful, harmonious and prosperous not by simply imitating other societies, but by building a system that complements, adapts and elevates its culture and traditions. Towards that goal, the Centre provides a forum to enhance public understanding of the nature, role and significance of civil society.

**WHAT IS CIVIL SOCIETY?** Civil society is an evolving network of associations and institutions of family and community, of production and trade, and of piety and benevolence. Individuals enter into these relationships as much by consent as by obligation but never under coercion. Civil society is premised on individual freedom and responsibility, and on limited and accountable government. It protects the individual from the intrusive state, and connects the individual to the larger social and economic order. Civil society is what keeps individualism from becoming atomistic and communitarianism from becoming collectivist. Political society, on the other hand, is distinguished by its legalised power of coercion. Its primary purpose is to protect civil society by upholding individual rights and the rule of law.

### **RELATIONSHIP BETWEEN CIVIL AND POLITICAL SOCIETY**

The rampant growth of the political society—the institutions of government—since independence has become a hindrance to the flourishing of civil society in India. It is only by rethinking and reconfiguring the political society that India will be able to achieve economic prosperity, social peace and cohesion, and genuine political democracy. The “principle of subsidiarity” demarcates the proper arenas for civil and political society, and for local, state, and central government within the political society. The principle suggests that the state should undertake those tasks that people cannot undertake for themselves through voluntary associations of civil society. The functions thus assigned to the state must be entrusted first to local governments. The functions that local governments cannot perform should be given to state governments and only those that state governments are unable to undertake should be delegated to the central government.

**THE CENTRE'S ROLE** The Centre's activities are based on this understanding of civil and political society. It endeavours to broaden the public debate on critical economic and social issues and to provide innovative, effective and enduring solutions. The programs and publications of the Centre help guide public policy and private initiative to rebuild and strengthen civil society. The Centre commissions rigorous studies from scholars and communicates findings to targeted groups – policy makers, opinion leaders and the media- and to the general audience through lectures, seminars, conferences and by publishing books, reports and commentaries.

The motivation behind the Centre is the poignant paradox of intelligent and industrious people of India living in the state of destitution and despondency.

The Centre was inaugurated on August 15, 1997 signifying the necessity of achieving economic, social and cultural independence from an alien state.

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