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RM-4695-AID
DECEMBER 1965

AID BARGAINING WITH INDIA: APPROACHES TO MORE EFFECTIVE USE OF U.S. BARGAINING POWER (U)

Alan P. Carlin and William A. Johnson

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PREFACE

This RAND Memorandum was prepared for the Agency for International Development. It is an outgrowth of an earlier RAND study for AID, An Appraisal of U.S. Capital Assistance to Less Developed Countries (U), RM-4594-AID, October 1965 (Confidential), to which the present authors contributed; and it is also based on a trip made by the authors to New Delhi in May 1965 at the request of the AID Mission to India. The present Memorandum is intended to be of general use to AID in reviewing the Indian program, and more specifically, it is offered as an illustration of the comments in the earlier report concerning (1) the importance of increased emphasis on macro-bargaining and (2) the general characteristics of the performance criteria that might be adopted by AID (see RM-4594-AID, Chapter II).

This Memorandum concentrates on two possible areas for macro-bargaining by AID; we recognize that there are others of importance, such as agricultural policy, that concern particular sectors of the Indian economy and may be best dealt with through bargaining associated with aid to that sector. One example is the use of conditions attached to P. L. 480 aid as leverage on India's agricultural policies.

Since this Memorandum was first drafted, the outbreak of serious fighting between India and Pakistan has greatly increased the importance of non-economic objectives for U.S. assistance to India, particularly the restoration of military stability. Nevertheless the economic objectives discussed here should remain of long-run importance if economic aid to India is to be continued. In fact, India's need for foreign exchange is likely to increase as a result of the recent hostilities and the heavy debt repayments falling due during the next five years. For this reason, it is opportune for the United States to consider ways of more effectively using its assistance to stimulate Indian development, which has long been the major objective of U.S. aid to India. Under the circumstances, India may also prove to be somewhat more willing to listen to U.S. advice.

For assistance during their trip to India, the authors wish to thank members of the AID Mission to India, especially John Lewis, C. Edward Lindblom, and Kenneth Kauffman. The study benefited also from discussions with many RAND colleagues, particularly Robert Slighton (who visited India at the same time as the authors), and Leland L. Johnson and George Rosen, who read and commented on the manuscript.

SUMMARY

This RAND Memorandum suggests several areas in which, through bargaining, AID might profitably persuade India to improve its economic policies. The incentives available to AID are variations in the amount of U.S. assistance given to India. The areas chosen are those where existing Indian policy appears to create serious and unnecessary impediments to economic development. Specifically, the Memorandum singles out the Indian government's price and allocation policies for foreign exchange and for a number of particularly scarce industrial and consumer goods.

The Memorandum begins by looking at AID's brief and only partly successful experience with macro-bargaining in India. Then it suggests a number of general considerations for selecting bargaining areas and bargaining instruments. In particular, the Memorandum suggests that the 1964 bargaining may not have offered sufficient incentives to India, that negative incentives (penalties) may be more effective in securing compliance, and that in the case of India a few specific policy changes are likely to be more effective criteria of achievement than aggregate measures of economic performance.

With respect to India's policy on foreign exchange, or, more generally, the balance of payments, the Memorandum suggests that the United States provide incentives for (1) an effective devaluation of the rupee (either by direct devaluation or other means), (2) changes in other government policies inimical to exports, and (3) replacement of the present system of administrative import controls by the price mechanism and various appropriate fiscal means. Various alternatives to devaluation itself are examined, with the conclusion that exchange auctions offer some net advantages.

The Memorandum then examines Indian domestic price and allocation policies, and contends that substantial returns are likely from incentives that encourage India to replace direct controls as a means of allocating particularly scarce commodities. Four alternatives to the present administrative allocation system are considered. The most

attractive of these involves a greater reliance on the market mechanism, with government control exercised through excise taxes.

Finally, some general comments are made about the role AID might play in encouraging the Government of India to make desired policy changes. Several advantages are seen in working through the aid-giving Consortium and in coordination with the World Bank. Particular attention is directed to the problem of overcoming the opposition of the Indian Administrative Services to a relaxation of direct controls.

CONTENTS

I. INTRODUCTION

A recent RAND Memorandum cites India as a country where AID has made little use of the potential bargaining power of its program aid.[1] An earlier study by Alan Carlin concludes that this is true for both program and project aid to India.[2] Edward Mason has made similar observations in his book on foreign aid policy.[3] This long-standing U.S. policy has often been defended on the grounds that India is engaged in a more serious development effort than most other less developed countries.[4] We do not challenge this statement, but we question its relevance to the proper role of bargaining as an instrument of U.S. aid policy in India. So long as India can significantly improve her performance by certain reforms she would not otherwise take, there is at least an economic case for doing so.[5]

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[1]F. T. Moore, A. P. Carlin, R. L. Slighton, W. A. Johnson, L. L. Johnson and A. H. Pascal, An Appraisal of U.S. Capital Assistance to Less Developed Countries (U), RM-4594-AID, 1965 (Confidential), Chapter II.

[2]Alan Carlin, "An Evaluation of U.S. Government Aid to India" (unpublished doctoral dissertation, Massachusetts Institute of Technology, 1964).

[3]"With respect to U.S. attempts to tie economic strings to aid, the receiving countries are distributed in a wide spectrum with India at one end and various Latin American countries at another. The American attitude toward Indian development policies and programs has, to date, been extraordinarily permissive. We have tended to take the various Five Year Plans and the accompanying policies as given and to concern ourselves with the problems of providing the required external financing." Foreign Aid and Foreign Policy, New York, Harper & Row, 1964, p. 43.

[4]"The U.S. aid administration has been willing to accept Indian plans and programs without much cavil largely because the Indian government has shown itself willing to make a serious attempt, at considerable sacrifice, to mobilize the country's own resources, because the planning effort has on the whole been careful and intelligent, and because in an economic situation of almost unparalleled difficulty India has made substantial progress." Mason, pp. 43-44.

[5]It has sometimes been argued that AID must or should set some sort of absolute standards applicable to all countries; if these standards (in this case, of country effort) are met, then no AID "encouragement" or intervention is needed. Whatever its political advantages, this approach does not permit maximum use of the leverage provided by aid.

For a number of reasons, this appears to be an opportune time to consider in some detail how the United States might attempt to encourage, through macro-bargaining,[1] significant changes in Indian policies that would promote more rapid economic development. We do not mean to imply that increased emphasis on project bargaining is not important, nor that increased macro-bargaining should be at the expense of improved project bargaining.[2] One reason why this is an opportune time to consider how conditions might be attached to U.S. aid to India is that there has been some pressure for much higher aid levels. If such increases are seriously considered, it would be worthwhile examining what conditions might be attached to them. At the same time, official thinking in a number of aid-giving agencies has increasingly favored the attachment of economic conditions to aid to India, and the Government of India has recently given considerable thought to the possibility of major changes in a number of economic policies.

The purpose of this Memorandum, then, is to present our views on worthwhile areas for concentrating U.S. bargaining power and on the specific reforms that might bring the highest returns. This study is intended to serve as an illustration of some of the more general points made in a previous Memorandum[3] concerning the importance of increased emphasis on macro-bargaining and the general characteristics of useful conditions that might be attached to U.S. aid. Before discussing general areas or specific reforms, however, we shall first review the

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[1] By macro-bargaining we mean bargaining with program aid or with project packages. Generally (but not always) this involves issues that transcend any one sector of an economy, such as might be appropriate for project bargaining.

[2] We do not subscribe to the view sometimes found in AID that project bargaining should in general be subordinated to macro-bargaining, that is, that few if any conditions should be attached to project aid so that more bargaining power can be brought to bear on the "more important" issues that can be dealt with through macro-bargaining. The arguments here are that the two types of bargaining are by no means perfect substitutes for each other and that much can usefully be accomplished to improve projects and change related policies even in countries such as India that have relatively good reputations for project preparation.

[3] Moore, et al., Section II.

brief history of U.S. bargaining in India for any lessons it may contain. This will be followed by a general discussion of (1) the benefits and costs of the various macro-bargaining instruments available, and (2) some general considerations in selecting bargaining areas.

THE FIRST ATTEMPT AT MACRO-BARGAINING

Prior to 1964 AID made little attempt to influence Indian government policies by macro-bargaining. Recent program assistance papers for India have indicated AID's general satisfaction with the direction of recent policy changes and a willingness to wait and see the consequences of those changes.[1] However, in the fall of 1964 AID modified its approach toward India. Perhaps because of an apparent lessening in India's zeal for reform, the United States offered to convert $100 million from project to commodity assistance if India agreed to certain conditions. Because of the slow market prevailing for the available project aid, this was thought of as an offer of increased assistance to India.

AID made three specific proposals. First, it volunteered to match additional allocations of foreign exchange by the Government of India for the import of fertilizers above an agreed level representing previous imports. Second, AID suggested a similar formula for imports of other commodities that might be needed for "bottleneck busting" to enable greater utilization of India's underutilized industrial capacity. Third, AID offered to increase its commodity assistance to dampen the adverse consequences resulting from further decontrol, notably hoarding and unduly large increases in the prices of decontrolled commodities.

After some hesitation, the Government of India accepted the offer of increased imports of fertilizers, perhaps because of the severity of India's food crisis, but could find little need for increased imports of other scarce commodities. Although a subsequent study

[1] For example, see AID, Capital Assistance Paper, India -- Commodity Program Assistance 1963-64, 1963, pp. 21-22; and India -- Commodity Program Assistance 1964-65, 1964, pp. 23-25.

financed by AID questioned the government's finding,[1] nothing has come of AID's second proposal. The third proposal was also rejected, ostensibly because of the Indian government's desire for a longer guarantee period than that offered by AID and undiminished fears of possible price inflation resulting from further price decontrol.[2]

AID's experience in India illustrates some of the problems involved in devising effective performance criteria. One reason given by AID officials in New Delhi for India's reluctance to accept fully the criteria set by AID was the government's apparent belief that, despite the shortage of suitable projects on hand, a shift to commodity aid did not mean, in effect, a long-run increase in total aid levels. This belief may have resulted from the "carryover" of Consortium[3] pledges for project aid from one year to the next, and the relatively high premium placed on new projects by India's policymakers. This premium may stem from the Indian government's preference for ambitious plan targets, the imminence of the Fourth Five Year Plan, and the preoccupation of Indian planners with creating new capacity rather than with achieving fuller utilization of existing capacity.

The proposed increase in commodity assistance would not have been identical to the type of program aid to which India has become accustomed. An important advantage of program aid, at least to the recipient, is its flexibility. Because AID's offer of greater commodity assistance was restricted to relatively specific uses, its incentive effects were limited. The government could not do whatever it wished with most of this increment, with the result that the appeal to Indian policymakers was reduced.

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[1]The study was prepared by Daniel G. Pfoutz on the basis of a trip to India during late November and early December 1964.

[2]These fears may have been particularly acute at that time because of the 1964 food crisis and resulting price increases.

[3]The Consortium is the group of cooperating aid-givers consisting of Western nations, Japan, and interested financial institutions.

If it is believed that projects would eventually be found to absorb all "carryover" project pledges, the offer of a shift from project to commodity aid implies a partial shift of assistance from the Indian government to the private sector. Projects sacrificed would have been concentrated in the public sector, whereas the increased imports of "bottleneck" commodities would have chiefly benefited private sector companies that are now operating at less than full capacity. Given India's ideological preferences, the sacrifice of a potential project in the public sector in exchange for a definite increase in imports of "bottleneck" commodities could well have costs for Indian policymakers.

Even if the United States had been able to devise criteria that implied a clearcut addition to its aid level, it is not obvious that the Government of India would have responded positively to the carrot offered by AID. Existing levels of foreign exchange support already make up a large part of India's, or at least the Government of India's, foreign exchange deficit. It may be that despite continued requests for additional program aid, the Indian government is relatively satisfied with the present level of foreign assistance, so that when faced with the alternative of increased non-project aid under specified conditions at the cost of further foreign debt, and possibly a loss of future projects, the government found that the costs exceeded the benefits. If this is the case, the introduction of performance criteria may have to be associated with threatened reductions in aid levels.

MACRO-BARGAINING INSTRUMENTS

The primary stumbling block to the use of the conditions proposed in this Memorandum will probably not be doubts about their economic soundness but the question whether their possible political costs to the United States can be justified by their economic benefits. Although the political costs are outside the province of economics, we can outline in general terms the economic and political benefits and costs of the available means for influencing a recipient government.

The offer of an increase in aid over current levels in return for prescribed policy changes or a given level of aggregate performance is generally more acceptable politically simply because no threat is involved, only an extra reward for approved behavior -- the carrot. Although cheaper financially for the United States, a threatened reduction in aid if the recipient fails to comply with certain conditions is likely to be much more politically explosive. Yet it probably applies more leverage on the recipient. It is more difficult to give up something one already has than something one hopes to get. This suggests that a stick is more likely to be effective than a carrot of equal size, and much less expensive. If an increase in aid levels is planned for other reasons, a gratuitous increase represents a missed opportunity for exercising politically inexpensive leverage. If, on the other hand, no increase would be contemplated except as an inducement for Indian policy changes, the price for any policy changes is likely to be very high, especially if the increase is considered permanent. The carrot is most likely to be justified as an element of bargaining if it is already regarded as desirable for other reasons.

In addition to incentives directly involving overall aid levels, the United States can also exert leverage through a variety of less direct and more subtle means. It is possible, for example, to affect the recipient's security by altering the period of various aid commitments, particularly in the case of P. L. 480 and program aid. It is also possible to threaten or offer to change the existing mix of program and project assistance. So long as India fails to use the available project assistance fully, any offer to alter the mix in favor of program assistance is, of course, effectively an offer to increase total aid, whereas an alteration in the opposite direction would decrease aid. A threat to eliminate "carryover" of Consortium pledges for project aid might result in a long-run reduction in project aid and could also be used as a bargaining tool by AID.

SELECTING BARGAINING AREAS

Perhaps the most important assumption made in drawing up a list of areas where the United States might concentrate its bargaining efforts is that a principal U.S. objective in such an effort is to secure a better performance by the Indian economy. Since the large scale of U.S. economic aid to India has long been justified on the grounds that it promotes Indian economic growth,[1] this would seem to be a reasonable assumption. We do not intend to imply by this that other political and military objectives are not important.

In selecting the various possible economic problem areas and specific issues for bargaining purposes, we have been guided by several considerations. The first is that these problem areas should include some of the more basic obstacles to India's economic growth. AID's recent attempt to relieve imbalances in the Indian economy by offering to increase assistance for scarce commodities would have been a short-run solution to a major obstacle to India's industrial growth. The question arises: Why are there shortages of many basic commodities? There is no one answer. In some instances shortages have resulted from the public sector's inability to achieve plan targets on schedule. In other instances, there have been shortages of commodities that India can neither produce nor import because of foreign exchange limitations. Still another major cause of bottlenecks has been the government's price policies. Unduly low prices have not only increased the demand for some controlled products, they have also discouraged greater production by those industries in which the private sector is responsible for new investment. If possible, AID's performance criteria might be directed toward eliminating the causes of bottlenecks, rather than their consequences.

A second consideration is whether the conditions attached to aid should concern specific policy issues or aggregate measures of economic

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[1]The importance of Indian growth to the United States, in turn, has often been defended on political, military, and geopolitical grounds.

performance. For example, if policy issues predominate, AID might threaten a reduction in future levels of assistance so long as the Indian government refuses to devalue the rupee. This approach has the advantage of being direct, and compliance or non-compliance can be relatively easily measured. However, this approach might also be interpreted by India as more direct interference in her affairs and therefore less acceptable. On the other hand, if aggregate measures of economic performance predominate, the United States might associate future increases in aid levels with autonomous increases in India's hard currency earnings -- greater exports to hard currency countries and increased foreign private investment -- leaving to the Indian government the choice of specific policy changes to achieve this end. Although not as direct, this alternative would still avoid the disincentive effects of increased levels of aid on India's attempts to solve her foreign exchange problems.

This Memorandum adopts the policy-oriented approach because that approach focuses attention on a few issues that we believe to be of critical importance for Indian economic development. When, as here, a few such issues can be readily identified, it is much easier to insist on the desired changes and to measure progress directly rather than to design aggregate measures that will have the same effect. In many cases aggregate measures run the risk of rewarding policy changes that meet the specific criteria but damage the economy elsewhere. Indiscriminate, random export subsidies, for example, might increase exports, but exports in which India might not have a comparative advantage.

In some areas AID may have to establish multiple conditions. For example, devaluation or export subsidies alone may not result in greater exports. It may also be necessary for India to remove certain impediments to exports, such as taxes and, for a few commodities, quantitative restrictions on the volume of exports.

Finally, it is useful to select not just those issues that are thought to influence Indian economic performance most directly but also those that are relatively tractable. Some performance criteria may hit serious opposition because of firmly held ideological and political convictions. For example, on purely economic grounds there is good reason to question the Indian government's policies for the location of industry. Yet these policies are closely involved with center-state relations and, more generally, with the fact that in India state boundaries are not only political demarcations, but also divisions between distinct cultural and linguistic areas. Regional loyalties are intense and existing policies that satisfy regional demands may be one reason for the stability of the Indian government.

Perhaps the most profitable policy areas for AID's leverage are those in which the Indian government has itself recognized the need for reform but has been partly or largely ineffective. We will look at two such general policy areas: (1) balance of payments policy, particularly problems associated with increasing exports and more efficiently allocating scarce foreign exchange, and (2) India's price policies and other direct controls over public and private sector activity. These areas will be discussed below. There is already some consensus among students of the Indian economy, both inside and outside the aid-giving agencies, on the importance of these areas and even on some of the specific remedies suggested for each area.

II. BALANCE OF PAYMENTS POLICY

Successful U.S. bargaining could make a major contribution to Indian development through changes in India's balance of payments policies. These changes would also result in a reduced dependence on foreign aid for any given level of aid. The potential benefits and the changes needed to bring them about are as follows:

(1) Increased Indian exports

- (a) A reduction in the price of exports to foreign buyers and/or increase in the profits of exporters
- (b) Changes in policies adopted for domestic reasons but inimical to exports.

(2) More efficient allocation of India's available foreign exchange

- (a) Replacement of administrative import controls by fiscal measures and the price mechanism
- (b) An increase in the price now paid by Indian importers for legal imports.

These changes have purposely been described in very general terms to emphasize their basic nature rather than their exact administrative form. This is important because there are a number of different forms that each of these changes could take. Although we argue that some changes are preferable to others, we believe that even the less preferred would lead to major improvements over the present situation.

EXPORT PRICING

Although Indian exports have grown steadily in the last few years compared with the stagnation of the 1950s, their performance is still discouraging despite their undoubted importance if India is to attain "self-sustained" growth. It has been particularly discouraging in terms of the critically needed exports to hard currency areas.[1]

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[1]C. E. Lindblom has computed that from 1960-61 to 1964-65 Indian exports rose at 7.0 per cent per year. When Eastern Europe is excluded,

Although numerous other factors are responsible for the lethargy of Indian exports, we believe that exports as a whole would be increased by some form of devaluation of the rupee. Devaluation would be more effective if an export tax or its equivalent were imposed on primary exports facing either an inelastic world demand or the prospect of retaliation by other principal exporters. Specifically, the most detailed discussion available of the elasticity of Indian exports concludes that devaluation would benefit cotton textile exports (about 10-13 per cent of Indian exports), reduce further market losses to Pakistan in manufactured jute (120 per cent of exports) and, most important, increase exports of many commodities of which India is a marginal exporter.[1]

The importance of export prices has not gone completely unnoticed by the Government of India. In the last few years the Government of India has introduced a number of indirect export subsidies, the more important of which are as follows:[2]

(a) Import entitlements. Import licenses are issued to exporters equal to twice the import content of specified exports up to 100 per cent of their FOB value. These licenses may be sold to other manufacturers who either manufacture products covered by the scheme or export a part of their output. I. S. Gulati has pointed out that the present system includes a number of perverse incentives and other failings.[3]

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however, this falls to 4.0 per cent. Excluding the onetime increase resulting from the addition of Goa to the Indian Union and other newly reported items not previously shown in the records, this figure falls to 2.8 per cent. See U.S. AID Mission to India, "Indian Import Controls" (unpublished), New Delhi, July 1965, p. 76.

[1] Manmohan Singh, India's Export Trends and the Prospects for Self-Sustained Growth, London, Oxford, 1964, pp. 327-332. Recently India has introduced export subsidies (tax credits) for tea and jute despite Singh's conclusion that the demand for tea at least is price-inelastic. Tea constitutes about 20 per cent of Indian exports.

[2] In addition, the Government of India has begun to rebate various excise taxes and import duties paid on exports and materials going into exports.

[3] I. S. Gulati, "Export Promotion Through Import Entitlement," The Economic Weekly, Vol. 27, May 22, 1965, pp. 859-864.

(b) Income tax credits. Since February 1965, exporters of certain categories of goods not generally eligible have been able to qualify for tax credits of 2 to 15 per cent of the value of their exports.

(c) Partial rebates of railway rates for specific exports.

No careful study has been published concerning the average effective subsidy now in force. But it can be said that the percentage of subsidy varies greatly (further confusing the already distorted signals given by the price mechanism concerning Indian comparative advantages), and that subsidies on the average have probably not gone far enough. We argue that it would be better to replace this patchwork by a larger, uniform subsidy (or a devaluation), except in the case of a few products facing an inelastic demand.

Which of these is preferable -- uniform subsidy or devaluation? There are a number of possible types of subsidies but in order not to distort the comparative advantages of various potential exports uniform *ad valorem* subsidy is to be preferred (except in the case of exports facing inelastic demands) over one that is limited to specified exports. The chief difference between a uniform *ad valorem* subsidy and devaluation are that the subsidy can be more easily varied to suit changing conditions or in response to new information concerning the effects of previous subsidies, whereas devaluation confers greater stability on the new effective exchange rate for exports. These considerations alone would suggest that, given the many uncertainties concerning the effects of such measures it might be better first to experiment with subsidies, and perhaps alter the exchange rate later on. But there is still another important consideration, namely, that the handling of subsidies involves much paper work, resulting in bureaucratic and other administrative problems.

The extent of the subsidy or devaluation is a more difficult question that deserves some study by AID. The inadequate evidence available to us suggests that a rupee value of 10 to 12 U.S. cents instead of the present 21 cents, after all other present subsidies have been removed, would not be too extreme.[1]

OTHER EXPORT POLICIES

India's export problems probably will not be solved by devaluation or subsidies alone.[2] One study, covering sixteen export commodities, concluded that for only one of these commodities, iron ore, have exports increased as a proportion of total world exports.[3] This proportion has remained more or less constant for several commodities and has fallen for most.

India's loss of foreign markets has been attributed, in part, to a conflict between export promotion and other goals of the Indian government, a conflict that, in the past at least, was generally resolved in favor of other goals. Central and state governments have

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[1] Import duties amount to about Rs. 4 billion annually. With the increases announced in August 1965, they are expected to come to perhaps Rs. 5 billion. Total imports (c.i.f.) average about Rs. 12 billion. On the average, then, the import value of a rupee has already been effectively devalued by more than 40 per cent. The extent of export subsidies is more difficult to determine. It is our judgment that only a substantial additional devaluation or its equivalent would significantly affect the demand for imports. It is of interest, although not necessarily significant, that the current open market price for rupee banknotes in New York is about 12 cents.

[2] M. Singh, pp. 9-176; and Benjamin I. Cohen, "A Study of the Export Policies of the Indian Government, 1951-1952 to 1965-1966" (unpublished doctoral dissertation, Harvard University, 1963). Cohen's conclusions are summarized in a subsequent article, "The Stagnation of Indian Exports," Quarterly Journal of Economics, Vol. 78, November 1964, pp. 604-620.

[3] B. I. Cohen, "The Stagnation of Indian Exports," p. 606. Even increased exports of iron ore have, to some extent, been illusory. Prior to World War II India exported large tonnages of pig iron, primarily to Japan. Since World War II, exports of pig iron have been displaced by exports of iron ore, also mostly to Japan. The aggregate value of Indian pig iron and iron ore exports, in constant prices, regained its pre-war level only in the early 1960s. India's increased exports of iron ore are, in part, a result of a structural change in the Japanese steel industry, not of India's export promotion.

imposed a number of restrictions and, in a few instances, absolute prohibitions on exports of traditional products. For example, exports of peanut oil have been prohibited from time to time to maintain a stable domestic price. As a result, India's exports of peanut oil, once nearly half of world exports, were negligible by 1960. Exports of cotton textiles have been sacrificed because of restrictions on investment in the machine textiles industry and high-cost production, encouraged by the government to protect textile mill workers and hand-loom weavers. These are only a few of the many policies that have in the past inhibited Indian exports.

Especially since 1962 the Government of India has modified some of its restrictive policies and has enacted a number of reforms intended to encourage greater exports.[1] This is, perhaps, one reason for some improvement in India's export position during the early 1960s. Yet several restrictive policies continue, and if traditional Indian exports are to increase as a result of devaluation, additional modifications in these policies may be necessary.

ALTERNATIVE FORMS OF IMPORT CONTROL

No less important than measures to increase exports is the question of the form that import controls should take. At present, India relies almost exclusively on administratively allocated import licenses to ration foreign exchange. Our suggestion is to replace this to the extent possible with a fiscal system under which economic policy objectives would be sought through excise tax and tariff policies. The allocation of foreign exchange is now the most effective instrument for determining actual developmental priorities. Our suggestion is that the allocation of exchange be determined largely by market forces,

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[1]Many of these reforms grew out of the report of the Mudaliar Committee. Government of India, Ministry of Commerce and Industry, Report of the Import and Export Policy Committee, New Delhi, Government of India Publication, 1962. See also India -- Commodity Program Assistance, 1964-65, pp. 30-36; and Singh, pp. 340-341.

with the help of greatly increased excise taxes on luxury consumer goods and a revision of tariffs to penalize components destined largely for luxuries that cannot be effectively controlled by excise taxes.[1] The only major exception to reliance on fiscal measures would be quantitative controls on the import of luxury consumer goods, preferably outright prohibition. If the Government of India insists on maintaining direct administrative controls over private sector investment, this could be done through the existing industrial licensing system, although on grounds of economic efficiency this might profitably be abolished, too.

The advantages of the proposed fiscal system have already been thoroughly examined in a recent paper by C. E. Lindblom. He identifies four principal reasons for recommending a change. In order to avoid repeating his analysis, we shall simply list these reasons and refer the reader to Lindblom's paper for the underlying argument.

1. "The efficiency with which individual enterprises and projects are operated can be greatly improved through fiscal control.
2. "A much improved allocation of foreign exchange and imports, hence reduction of their wasteful use, can be achieved.
3. "A new surge of development energy can be injected into the economy by the elimination of the uncertainties, the delays, and the vetoes which are conspicuous in the present system.
4. "A fiscal control system is essential to the volume of exports that India needs and intends to achieve.[2]

DEVALUATION AND ITS ALTERNATIVES

The previous section mentioned that part of the proposed new package of import controls is an effective devaluation of the rupee. The purpose, of course, would be to absorb much of the inevitable

[1]The supplementary budget introduced by Mr. T. T. Krishnamachari on August 19, 1965 included some major changes in the tariff structure generally in the direction favored here.

[2]U.S. AID Mission to India, "Indian Import Controls," p. 86.

excess demand for imports that would arise if the administrative allocations of import licenses were abolished by pricing imports out of the reach of their less productive users. Three methods of achieving this effective devaluation are worth careful consideration:

(1) Exchange auctions

(2) Devaluation itself

(3) A variable but administratively determined import "surcharge" or tariff.

Several studies have already considered in some detail one or more of these alternatives for India.[1] Nevertheless, it is worth examining several of the more critical issues, particularly from AID's point of view.

Control

The major advantage of the auction approach is that it enables the government to maintain as detailed a control as under the present system over the size of foreign exchange expenditures in the face of varying exchange receipts, particularly from foreign aid. This should appeal not only to those government officials with responsibility for maintaining India's foreign exchange resources, but also to the aid-givers, who may otherwise feel obliged to pick up whatever bill is presented to them. Devaluation and, to a much lesser extent, a variable surcharge, give less bargaining power to the aid-donors, because India could with some justification threaten to revert to the present administrative allocation system if sufficient nonproject aid was not forthcoming to meet the demand at whatever price India chose.

Besides the question of India's limited exchange reserves, detailed control over foreign exchange expenditures is particularly important at the beginning of any foreign exchange decontrol experiment.

[1]For example, "Liberalizing Exchange Control," Tata Quarterly, Vol. 20, October 1964-January 1965, pp. 1-29; J. Bhagwati, "Indian Balance of Payments Policy and Exchange Auctions," Oxford Economic Papers, Vol. 14, February 1962, pp. 51-68.

This is true for several reasons. The first reason is the great uncertainty inherent in any attempt to fix an effective exchange rate for imports after so many years of direct administrative import restriction. Even if devaluation is the ultimate objective, there is much to be said for exchange auctions as an intermediate step that will give some indication of the equilibrium value of foreign exchange to the economy. The second reason is the speculative effects of devaluation and variable surcharges. There is reason to believe that one immediate effect of both might be a great surge in imports by people who believed that the government would be forced to reimpose import controls. Exchange auctioning would eliminate this possibility. Presumably if devaluation or variable surcharges were later introduced, the demand and supply of exchange would have sufficiently stabilized at least to reduce the chances of a major speculative run on reserves. It is more likely, however, that there will be continuing major fluctuations in the demand for foreign exchange that could not be adequately controlled even by a variable surcharge within the available thin exchange reserves.

Stability

The objection most frequently heard in India concerning exchange auctions is the greater instability in effective import prices that would result. Although some of these objections can be attributed to the deeply rooted fears of the price mechanism found throughout the Government of India, there can be no doubt that variable surcharges and, particularly, exchange auctions would introduce considerable instability in import prices. But in any case, to frustrate attempts to rig the auctions, it would probably be preferable to establish minimum bids.[1] This would limit the downward instability of the market to something approaching that existing under variable surcharges.

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[1] This follows the Brazilian experience with exchange auctions. See Alexander Kafka, "The Brazilian Exchange Auction System," Review of Economics and Statistics, Vol. 38, August 1956, p. 311.

At the same time, the possibility for the price of exchange to rise would provide a much more accurate price response than would be possible under variable surcharges, even with the best of intentions on the part of the government. But even upward price movements could be subjected to a great deal of Indian government influence through limited increases in the exchange auctioned and controlled variations in public sector demand for imports. Where price rises could not be so controlled within fairly narrow limits, they would probably represent longer term supply and demand considerations. Various possible specific steps to minimize speculation under an exchange auction system are discussed later.

Applicability and Acceptability

The exchange auction and devaluation alternatives have the advantage that the new effective exchange rate would apply to both "visible" and "invisible" imports, which should face the same barriers to entry if their relative contributions are to be accurately assessed. The surcharge and auction approaches also appear to be more acceptable to the Indian Government, which seems to fear devaluation greatly. In part this fear may arise from the possibility of some loss of face if India initiates devaluation among the rupee currency countries.

Multiple Exchange Rates

A major complication for all three suggestions arises from the fact that country-tied U.S. nonproject aid is probably in excess of the amount that would be imported from the United States if all foreign exchange were sold at a uniform premium. The present system of administrative allocations not only decides who is to get foreign exchange, but also what kind and under what terms, and so on. As a result, the U.S. dollar and probably a number of the nonconvertible currencies would be in equilibrium at a discount from untied, convertible foreign exchange. This state of affairs would necessitate separate rates for any currency where this situation is likely to arise if all the available exchange is to be used. The effect would be to decrease the size and increase the instability and fluctuations in the foreign exchange markets that would be established. Since both the supply and demand for each type of foreign exchange is likely to fluctuate widely over time and the equilibrium prices would be very difficult to determine at the outset, this consideration virtually rules out devaluation, at least at an early stage in any foreign change decontrol process.

Because of the International Monetary Fund's long-standing opposition, the issue of multiple exchange rates may become one of the most important stumbling blocks in any attempt to decontrol imports. If the IMF is allowed or encouraged to take a major hand in any negotiations, the Indians might well be able to play off IMF opposition to multiple rates against whoever attempts to encourage import decontrol. It would be theoretically possible, of course, for the United States to untie nonproject aid to India thus avoiding most of the problem, but we assume that the United States would much rather see multiple rates.

The considerations outlined here suggest that there is considerable merit in pressing for exchange auctioning as opposed to either of the other suggested schemes.

FOREIGN EXCHANGE AUCTIONS

Exchange auctions could take many forms, and with the limited practical experience available concerning their use, it is difficult to choose exactly the optimum form for India. The following system would probably be as good as any.

The Government of India would conduct public auctions of foreign exchange certificates that would entitle the purchaser to (a) automatically obtain an import license or negotiate with the government for permission to make other types of external payments and (b) purchase a stated amount of exchange at the official exchange rate. The certificates would state any restrictions on their use (so as to meet the various restrictions placed on some foreign aid concerning the origin and types of goods and the problem of nonconvertible currencies) as well as the particular source of funds (for accounting purposes) where necessary in the case of some foreign aid funds. Only certificates with the same set of restrictions would be auctioned together. Presumably in time a pattern would develop in which certificates restricted to nonconvertible currencies would command somewhat different rates from those corresponding to their respective official exchange rates. Certificates restricted to dollar purchases from the United States would presumably command a somewhat lower price than unrestricted ones. The auctions might be held, say, weekly on different days of the week in Bombay, Calcutta, Delhi, and Madras. To discourage speculation, the certificates would not be transferable. To further reduce speculation and provide for tighter control over the rate of foreign exchange expenditures, the certificates should have only a limited period of validity, after which they would either become valueless or at least greatly depreciate in redemption value.

On grounds of economic efficiency, it should be emphasized that the restrictions on the use of the certificates should not be imposed for the purpose of providing special treatment to one class of goods or users (for example, public sector users, who are favored under the present licensing system). Separate auctions are proposed only as a method of taking account of externally imposed conditions on aid and dealing with the problem of nonconvertible currencies. For maximum effect, <u>all</u> foreign exchange purchases (both for imports and invisibles) should require the purchase of a certificate. However, the auctioning of certificates would have little real meaning in the case of project-tied aid since they would be tied to a specific project built by a designated organization. Yet, since it is important that the cost of the exchange used in such projects not be understated, it would seem advisable that the necessary certificates be sold directly to projects receiving aid at (say) the lowest accepted recent bid for similar certificates sold at auction.

There should be no delusions about Government of India opposition to most of the changes proposed in this section. Although opinions are changing, particularly in the last year or so, this is certainly the most controversial of the areas discussed in this Memorandum from the point of view of the Indian government.

Some high officials of the Indian government are said to consider devaluation an admission of failure on the part of the government and, therefore, politically unacceptable. A major gain from devaluation or its equivalent would be an increase in the domestic prices of commodities possessing a relatively large import component. However, there is the fear that this would, in turn, result in an inflationary spiral. Objections may also be raised that devaluation would not produce the desired result because of low demand and supply elasticities for imports and exports. In our opinion, these objections are, at best, of limited validity and, if correct, can be satisfied by a partial relaxation of the effects of the devaluation.

Of the various objections, fear of inflation is probably the most widely held in India. One effect of devaluation or its equivalent would be to increase the price of imported goods to anyone who has been able to purchase them at the official exchange rate. Devaluation would result in price increases only where the benefits of low import prices are now passed on to final consumers. This may be true for imports by government enterprises and a few large private sector enterprises subject to effective price controls. Where producers and middlemen pocket most of these benefits as economic rents, the result of devaluation might well be reduced profits for importers and not higher prices for final consumers. Moreover, the effect of any price increase will be at least partly offset by the price decreasing effects of devaluation, namely greater efficiency arising from an end to administrative allocation of imports and a reduction in underutilized capacity caused by shortages of foreign exchange. On the basis of a careful review of these and many other effects of the changes discussed here, C. E. Lindblom states "There is no reason at all to fear a general inflationary movement of prices attending a fiscal control system for imports."[1]

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[1] U.S. AID Mission to India, "Indian Import Controls," pp. 63-64. Jagdish Bhagwati comes to much the same conclusion in "The Case for Devaluation," <u>The Economic Weekly</u>, Vol. 14, February 1962, pp. 64-65.

One unusually strong Indian fear of an exchange auction system is that it might enable unspecified groups to corner the foreign exchange market. Although this may be a theoretical possibility, the capital needed for such an enterprise would be immense, especially if the suggestions made here were adopted concerning one general category of certificates rather than the system of preference categories that would presumably be favored by the Government of India. In addition, any would-be group would undoubtedly recognize that government officials, especially in India, would be unlikely to sit idly by while such an attempt was made.

Despite what has been said here, the evidence suggests that the Government of India has been doing a great deal of serious thinking about its balance of payments policies during the last year or two, and that it is more receptive to suggestions for changes in them than ever before. The limited information available to us suggests that the Government of India might be willing to accept without undue pressure a further major rise in uniform export subsidies and import tariffs.[1] Although this would certainly be a forward step worth bargaining for, it omits the most important part of the proposed set of changes suggested in this section -- elimination of the system of administratively allocated import licenses.

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[1]We regard the tariff increases included in the August supplementary budget as little more than a step in the right direction.

III. DOMESTIC PRICE POLICIES AND LICENSING PROCEDURES

The Indian government and various state governments directly or indirectly set prices for a number of commodities and services.[1] In many instances controlled prices have been kept relatively low with the result that they frequently do not cover all costs of production.[2]

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[1]In 1965 commodities subject to statutory price control were: scarce categories of steel (primarily flat products), nonferrous metals, aluminum, cement, kerosene, sugar, coal, coke, cotton, cotton yarn, some cotton textiles, woolen yarn, woolen articles, worsted weaving and knitting yarn, fertilizers, ethyl alcohol, and molasses. Commodities subject to nonstatutory price control were paper, petroleum and petroleum products, matches, bicycles, and motor vehicles. In addition the government fixes the prices of commodities and services produced by public sector enterprises, an example being railway rates. The central government also influences the prices of agricultural commodities and coastal shipping. State and local governments fix electricity rates, hotel rates, and rent ceilings.

[2]This pattern has been established for at least four commodities and services -- rail transport, steel, coal, and electricity. It has been alleged to hold for many others. Railway rate policies on coal have been examined in a study prepared for the World Bank. Surveys and Research Corporation and Coverdale and Colpitts, India Coal Transport Study, Washington, 1964, Vol. III. The ICTS cost estimates have been criticized by Alan Carlin, A Possible U.S. Policy Towards Indian Transportation: An Illustration of Improved Sectoral Policies, The RAND Corporation, RM-4379-AID, June 1965, Appendix B. Both Indian rates on coal and the ICTS cost estimates are thought to be too low. Passenger fares and rates on goods hauled long distances are also thought to be too low and rates on some finished goods too high.

Steel price controls have been examined by W. A. Johnson, India's Steel Industry: Industrial Growth and Economic Planning, The RAND Corporation, forthcoming, Chapter 5. It is estimated that if the average price received by steel mills in 1962 covered all costs of producing steel, it would have to have been increased by about 50 per cent. Despite decontrol of some types of steel in 1964, increases in steel prices to date have fallen far short of this percentage.

Coal prices have been examined in a recent study prepared for the Indian Planning Commission. Planning Unit, Indian Statistical Institute, Price Policy for Coal Undertakings, New Delhi, 1963 (mimeographed). The coal price changes suggested in that study (pp. 32, 43), vary from mine to mine, but on average would involve a 20 per cent increase over existing prices. The more recent India Coal Transport Study has estimated the average cost of coal to the Indian economy to be Rs. 29 per ton, roughly 20 per cent higher than

Low prices have not necessarily discouraged expansion of those industries in which the government has assumed primary or sole responsibility for new investment. However, in those industries in which private sector expansion is permitted, unduly low prices have acted as disincentives to new investment and are one reason for some of India's current commodity shortages. Perhaps the best examples are cement and fertilizer, industries subject to statutory price control by the government, left partly or primarily to the private sector for expansion, and whose inability to supply current demands has resulted in severe shortages.[1]

There are other reasons for imbalances in the Indian economy. In some instances the primary cause of a shortage may be a failure in plan implementation by the Indian government. Some shortages are a consequence of, or are at least complicated by, India's foreign

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the Planning Unit's weighted average estimate and 40 per cent higher than the weighted average price for standard grade coal charged in 1962. ICTS, Appendix C, pp. 58-68.

Electricity prices have been examined in another study for the Planning Commission. Planning Unit, Indian Statistical Institute, Price Policy for Electricity Undertakings, New Delhi, 1962 (mimeographed). Rate policies vary from state to state. In many states it was found that electricity rates, particularly rates charged large industrial undertakings and agricultural users, are too low. See also Report of the Energy Survey of India Committee, Delhi, Government of India Publication, 1964, pp. 158-159.

[1]For examples of the claim that cement and fertilizer shortages are partly a result of the government's price policies, see Eastern Economist, May 14, 1965, pp. 1128-1129, and Capital, April 15, 1965, p. 518 and April 29, 1965, p. 587. There are a number of other commodities that are now in exceptionally short supply in India. In late 1964 AID sent Daniel G. Pfoutz to India to determine which commodities constituted the most serious bottlenecks. In general, the Pfoutz report found the most persistent shortages to be in aluminum and nonferrous metals, particularly copper; certain types of steel, notably steel sheets, billets, tinplate, foundry iron, wire, and stainless steel; and basic industrial chemicals. There is also a persistent scarcity of electricity. The prices of all of these commodities are now or have recently been established by the government, and in the aluminum, foundry iron, stainless steel, and chemicals industries there has been a significant reliance on the private sector for expansion. Whether there is a causal relationship between the government's price policies and many of these scarcities is a question that can be answered only after further research. However, this relationship is often alleged in business and trade journals.

exchange scarcities. Changes in the government's price policies will not resolve all problems, but they could help to get rid of some of the economy's bottlenecks.

Not all price controls have succeeded. The government's ability to regulate prices has varied from industry to industry. As a rule the government has been more successful in controlling wholesale prices charged by a few large producers. It has been notably less successful in controlling the prices of goods and services produced by a number of small producers, and especially retail prices charged by middlemen.[1]

Low prices for basic inputs are defended as stimuli to India's industrial growth. In fact, occasional or persistent shortages of such industrial inputs as steel, foundry grade iron, coal, electricity, and cement have been major deterrents to India's industrial growth during the past decade. Controls are supposed to stabilize retail prices and benefit small consumers. However, the result of wholesale price controls, where effective, has frequently been a flourishing black or gray market and increased profits for businesses consuming controlled commodities and able to buy these commodities at controlled prices. As a rule only large consumers capable of buying directly from factories or enforcing government regulations have benefited from the government's price policies. Among the beneficiaries have been the various ministries, agencies, and factories of the government itself.[2]

Low prices for controlled commodities and services are only one consequence of the government's price policies. Small price

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[1]There are black markets for most scarce, controlled commodities. Although in general there is little published information about black markets, that for steel has been studied by a government appointed committee. The Raj Committee found the existence of a thriving market for scarce categories of steel, commanding prices up to 100 per cent more than the government's controlled prices. Raj Committee, Report on Steel Control, New Delhi, Government of India Publication, 1963, p. 53.

[2]As more and more government plants are erected in controlled industries, the government is also becoming a principal loser from its controls.

differentials for various grades of coal at one time encouraged the consumption of high-grade coking coal for steam generation while India's metallurgical industries were unable to obtain adequate supplies of coking coal. Small price differentials for various types of steel have also encouraged the production of poor quality steel, relatively heavy sections, and, in general, sections that require comparatively little rolling by India's steel mills.[1] Excessive telescoping[2] of railway rates for coal has encouraged the location of consuming industries in regions relatively distant from India's coal mines.[3] Some of these distortions may be justified because of external economies or the social and political objectives of the government. Even so, they have also involved a real cost to the Indian economy: the inefficient use of India's resources.

RECENT CHANGES IN PRICE POLICIES

The Indian government has recognized the weaknesses of many of its price policies, and during the past two years has carried out several reforms. On December 16, 1963, price and distribution controls were removed from sixteen commodities.[4] For most of these commodities, supply already equalled demand at controlled prices. For some, price and distribution controls were known to have failed. Therefore, decontrol was not expected to yield much change in prices, unless as a result of collusion in price setting by producers or middlemen. In March 1964, decontrol was extended to many categories of steel in

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[1] W. Johnson, India's Steel Industry, Chapter 5.

[2] The further the distance a commodity is hauled, the lower its rate per ton-mile.

[3] A. Carlin, A Possible U.S. Policy Towards Indian Transportation, p. 20.

[4] Rayon yarn, staple fiber, caustic soda, soda ash, hydrochloric acid, chlorine, calcium carbide, bleaching power, Chilean nitrate, muriate of potash, sulphate of potash, washing soap, tires and tubes, sheet glass, paper board, and natural rubber.

relatively abundant supply, in June 1964 to vegetable oils, and in December to tinplate.[1]

The Government of India has also revised some of its other price policies. It has made modest adjustments in freight rates. It has also brought pressure on the states to increase their electricity rates. The Food and Agriculture Ministry, in a reversal of its previous position, has committed itself to insuring price stability for food grains at levels that will be remunerative to farmers and will not discourage food output.[2] Finally, the Finance Ministry, to divert to the government the benefits that have accrued to traders and large consumers, has recently imposed substantial increases in excise taxes on such controlled commodities as nonferrous metals and scarce categories of steel.[3] It would appear that, in the past year or two, there has been some movement toward a more effective price mechanism in India.

Even so, India is far from having an effective price mechanism. Decontrol has been partial. There are a number of important commodities and services whose prices are still established, or at least

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[1]An Indian government study prepared in early 1965 found that the price of only one of eleven decontrolled commodities examined, caustic soda, had increased significantly since decontrol. Most other prices had remained constant and a few had actually fallen.

[2]For a policy statement by the Food Minister, Mr. C. Subramaniam, see The Times of India, Bombay, May 19, 1965, p. 9.

[3]For a discussion of the government's excise tax policies, see the Finance Minister's budget speech, February 1965. Conversations by the authors with an official of the Finance Ministry in May 1965 indicated acceptance of the belief that excise taxes should be set in such a way as to give consideration to both supply and demand conditions. Although excise tax increases may reduce excessive demands for controlled commodities, they are not the same as increases in producers' prices and will not encourage new investment by private companies manufacturing these commodities. Subsidies for new investment may be necessary if reliance on the private sector for expansion of controlled industries continues.

influenced, by the government. Moreover, decontrol of specific commodities has not meant complete freedom in pricing. The relative abundance of most decontrolled commodities and the threat of re-imposition of price controls and other reprisals by the government has, in many instances, discouraged substantial price increases. In the few cases where scarce commodities have been decontrolled, price increases have been specifically circumscribed. For example, in mid-1965 there was some talk of partial decontrol of cement. Cement producers could sell to the public at open market prices, but would have to sell to the government at lower controlled prices.[1] In short, even though there has been some movement toward a more effective price mechanism during the past two years, progress has been mixed and thus far has fallen far short of the creation of a free economy.

COMMODITY CONTROLS AND INDUSTRIAL LICENSING[2]

By and large the Indian government's direct controls (other than regulations on foreign exchange) fall into two broad categories, the administrative allocation of scarce inputs used in current production, and controls over the establishment of new enterprise in the private sector.

Other than foreign exchange, the most important commodities subject to direct distribution controls at present are cement, fertilizer, and scarce categories of steel.[3] These controls assume

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[1] Economic Weekly, September 11, 1965, pp. 1398-1399.

[2] Several studies have examined various direct controls by the government. A report examining industrial licensing procedures was recently commissioned by the government itself. Government of India, Ministry of Industries, Final Report of the Industries Development Procedures Committee (Swaminathan Committee), New Delhi, Government of India Publication, 1964. Direct controls have also been analyzed in recent unpublished studies by the International Bank for Reconstruction and Development. Much of this section is based on these studies.

[3] In August 1965 the Indian government decided to ration food grains in India's largest cities, with future rationing in other cities agreed in principle. In September it assumed responsibility for the distribution of four scarce industrial materials, copper, lead, zinc, and tin. The extent of these controls, and their effectiveness, are not yet known.

several different forms. Generally, a large user or distributor wishing to purchase these inputs must first send a request to the relevant government ministry or agency. His request is then processed with consideration given to the importance of the proposed use of the input and its availability. In addition, there is usually a system of priorities that enables some consumers to obtain scarce inputs ahead of others already granted input licenses.

In many instances the government's direct controls over the allocation of scarce commodities have not succeeded in their declared objective, that is, the diversion of scarce resources to the uses given priority in India's plans.[1] The immensity of the task of distributing scarce commodities by administrative decision has generally led to extraordinary delays in processing consumer's orders. It has also resulted in the use of rules of thumb by distribution agencies, such as across the board reductions in orders to equate allocations with supply. These rules of thumb have not always coincided with India's development needs. Black and gray markets have sprung up for most controlled commodities, with the result that frequently no one really knows, not even the government's controlling agencies, how the scarce commodities are actually used.

The government also regulates the establishment of new capacity. In general, the licensing of new government enterprise is guaranteed by its inclusion in the five year plans. However, most new investment by private sector enterprise must first be approved by the central or state governments. An industrial license must be obtained. Other licenses are needed by the prospective entrepreneur to authorize his importation of capital goods, to allow foreign collaboration in his venture, and to permit his issue of share capital.

The primary determinant for granting an industrial license is whether an industry is on the "banned" list, a roster of industries

[1]This argument is made in the IBRD studies. It is also made for steel by the Raj Committee, and by Johnson, <u>India's Steel Industry</u>, Chapter 5.

in which licensed capacity equals or exceeds the plan target. Private sector investment in a number of specific industries is also prohibited or circumscribed by India's 1956 Industrial Policy Resolution. This resolution has from time to time been relaxed, but usually only at times of extreme scarcity to allow expansion of existing private sector units in restricted industries. The main purpose of investment controls is to assure the development of industries according to guidelines established by India's five year plans. Like controls over the distribution of scarce commodities, investment controls have often failed to achieve this objective.

That licensing procedures have been cumbersome and have resulted in unnecessary delays is recognized by many of India's policymakers. In an attempt to speed up licensing for new investment by the private sector, the government recently made several changes in existing procedures. Even though these changes should expedite the licensing of private sector enterprise, controls over private sector investment still inhibit the full use of India's growth potential.

For example, the government's basis for issuing industrial licenses is the five year plan and several long term demand projections by the Planning Commission. Plan targets have been ambitious and have generally been underfulfilled. In the absence of meaningful monthly or yearly plans and mid-plan adjustments in targets, licensing authorities have often followed guidelines that are outdated and bear little relationship to the actual state of the economy. Despite the banned list, private investors have been relatively free to apply for licenses in most industries, including some in which existing units are operating at substantially less than full capacity.

The complexity of licensing procedures has also encouraged license collecting. A businessman may apply for licenses to erect, let us say, a pig iron plant, a stainless steel plant, and a foundry, even though he has access to resources adequate for only one of these ventures. Which plant he chooses will depend upon the licenses granted by the government and his own ultimate assessment of the relative merits of the projects. The result has been the issuance of licenses that do not represent future output, misinformation about the probable success of plan targets, and, once again, the creation of imbalances in the Indian economy.

Moreover, there is an incentive for a firm to apply for an industrial license to obtain additional allocations of scarce inputs. Because licenses for scarce inputs are generally distributed to private sector enterprise by some "equitable" formula, usually in proportion to capacity, a premium is placed on new investment that may not be utilized or utilized only partially. There is also an incentive to create firms "on paper" to gain a share of scarce materials. Once again, the licensing procedure fails to insure an increase in industrial output envisioned by plan targets.

Other defects of direct controls are discussed at length in some of the sources already referred to in the footnotes. In general, these controls are exceedingly complex, and their consequences exceedingly pervasive. There is no simple alternative to the existing system of controls. The retention of this system is tied up with India's plan strategies, her ideological preferences, her fear of price inflation resulting from commodity scarcities, and numerous other deeply held convictions of the government. Any changes in India's system of controls advocated by the United States, it seems to us, should reflect the fundamental ideologies of Indian policymakers. They should also reflect the government's desire to channel scarce resources to uses given priority by India's plans. Greater reliance on automatic controls, notably a workable price mechanism, would probably help to simplify existing procedures. However, total reliance on the price mechanism would almost certainly be resisted as inconsistent with a planned economy.

SOME SUGGESTED REFORMS

There are at least four alternatives to the Indian government's present system of price administration and direct allocation of scarce commodities:

1. The government could allow producers to sell scarce commodities on the open market.

2. It could conduct commodity auctions, purchasing scarce commodities from producers at controlled prices.

3. Retaining controls over producers' prices, it could raise excise taxes on scarce commodities so that selling prices would approximate prices set in a free market.

4. It could do away with most existing controls, but be ready to impose excise taxes on commodities that, in the opinion of the government, are being denied to priority users or for which producers and distributors have levied monopoly prices.

There are advantages and disadvantages to each alternative and, in all probability, no single one would both rationalize India's price system and be acceptable to the Indian government.

The free market for scarce commodities has the advantage of being impersonal and automatic. However, its adoption would probably be resisted by the government. A commodity auction would presumably result in the same price as the free market, assuming no change in the supply of scarce commodities, but would require the administrative decision: What proportion of the auction price should accrue to producers? Excise taxes with retention of controls over producers' prices would require an additional administrative decision, the choice of the tax itself. The greater the role of administrative decision, the greater the probability of continuing imbalances between supply and demand of commodities that are controlled at present.

There is concern in India that total decontrol could result in rapid increases in prices, unfair prices in markets that are not fully competitive, and the denial of essential commodities to priority users. For these reasons, the Indian government would probably prefer to have price increases effected through commodity auctions conducted by the government or through higher excise taxes. However, these alternatives to total decontrol could discourage greater production of scarce commodities. If the government establishes commodity auctions or increases excise taxes, it would also have to fix remunerative producers' prices or grant private sector investors subsidies on new investment in regulated industries. If it does not, the government would probably also have to accept primary or even full responsibility for new investment in these industries.

One of the major reasons for the administrative allocations of scarce inputs is the government's desire to assure their use for purposes given priority under India's five year plans. Priorities can also be assigned by modifications in the price mechanism. There might be separate auctions for scarce inputs, with each auction associated with a level of priority and access to each auction based on the priority granted to a particular user. Or subsidies might be granted to priority users, perhaps from revenues gained from commodity auctions or increased excise taxes. There are disadvantages to allocating priorities in these ways. Separate auctions and selective subsidies would increase the need for administrative decision. They would also introduce distortions into the price mechanism that could result in continuation of some of the disadvantages of the direct allocation system. Finally, separate commodity auctions could result in greater price instability if periodic shortages or surpluses were concentrated in a small number of auctions. Plan priorities might be better allocated by some other means. Yet concessions may be necessary to gain greater reliance on a market mechanism for distributing scarce commodities.

Government operated commodity auctions would have certain drawbacks. Most controlled commodities are much less homogeneous than foreign exchange. Separate markets would have to be established for commodities possessing different physical and chemical specifications. If, in addition, separate auctions are conducted for users possessing different priority ratings, the administrative complications of conducting orderly commodity auctions would be substantial. We do not consider government operated commodity auctions to be the most desirable alternative to direct controls.

In our opinion the Indian government could make more effective use of its limited powers to control the Indian economy if it allowed producers to price and market their own products, selectively levying excise taxes on commodities that earned excessive profits not re-invested by producers. This alternative would allow the market to distribute scarce commodities and would replace the many cumbersome distribution controls that are now in force. Yet it would also allow some government control over prices charged by producers. If the Indian government fears that a commodity shortage or collusion would result in undesirable producer price increases, it could increase excise taxes to divert to the government the economic rents earned by the sale of the commodity. The government could also effect an upper limit to selling prices by agreeing to imports at a price equal to this limit. Here AID might help by offering short-run contingency loans to insure that India's foreign exchange difficulties do not impede the government's desire for reasonable price stability.

Priority users within the government can still be assured the receipt of scarce commodities. The government might allocate increased revenues gained from excise taxes to cover the increased costs of priority users. However, to avoid distortions in relative prices that this system would create, the Government of India might, instead, establish more meaningful industrial licensing procedures. Given effective industrial licensing, commodity scarcities should not persist over long periods of time. Presumably, new investment could be diverted from industries where there is already excess capacity as a result of commodity shortages. However, if industrial licenses are to become effective implements for planners to guide the investment policies of the private sector, some changes in existing licensing procedures would also be necessary.

Because the Indian government probably would not agree to give up its industrial licensing system entirely, AID might more profitably seek certain desirable modifications in this system. One possible area for reform would be the more direct association of new licenses with approximate levels of capacity at which existing plants are operating in an industry. This might be done by administrative decision, but, perhaps better, it might instead be done through a system of license charges, the charge imposed on a new licensee varying inversely with an industry's sales as a percentage of capacity. Or the government might draw up several schedules of charges, each associated with the level of priority assigned to new investment in an industry. There are several ways in which a charge system could be devised to encourage investment in industries more or less in accordance with the priorities assigned by planners.

The base charge levied on all new licenses should be sufficiently high to discourage license collecting and the creation of fictitious companies meant to corner scarce commodities. Once a plant is nearly erected, a part of the charge might be refunded. However, refunds could not be equal to the original license charge or incentives intended to direct applicants to priority industries would be lost.

The suggestions made in this section are not meant to be definitive. There are undoubtedly weaknesses with the specific alternatives we have described. Our purpose here is to outline, in broad terms, what some alternatives might be. In general, we conclude that the present system of direct controls could advantageously be replaced by a more workable system of price incentives, much the same general conclusion that we reached in our discussion of India's foreign exchange problems.

IV. A ROLE FOR AID

We have argued for greater reliance by India on the price mechanism for distributing foreign exchange, basic commodities, and industrial licenses. Although the Indian government has eliminated or modified some of its direct controls during the past several years, there is still much that it can do to create a more workable price mechanism. AID might help to secure further movement toward this objective by the judicious use of its influence. This section suggests possible approaches by AID and points out some of the pitfalls that might be encountered.

AID bargaining would probably be more successful if it concentrated on a few sectors of the Indian economy where policy reforms are most urgent. In our opinion the most profitable policy area that AID might attempt to influence is foreign exchange. As a major contributor to India's supplies of foreign exchange it is particularly appropriate for AID to advocate reforms in this area. There is also some urgency for other reforms, especially where the government's policies have discouraged new investment by the private sector. Possible candidates are controls over the pricing of fertilizer and cement and the licensing of new private sector investment.

Although some knowledge is available about the effects of India's foreign exchange, price, and licensing controls, there is still much that can be learned. In particular, AID might finance, or at least encourage, an investigation of Indian imports and exports, particularly their responsiveness to price changes, possible equilibrium rates of exchange, and pricing and investment in such industries as fertilizers,[1] cement, nonferrous metals, and agriculture.

If particular levels of U.S. assistance were associated with specific Indian policy changes, ambiguity about AID's preferences and India's compliance would be reduced. However, there are advantages to letting the Indian government propose its own policy changes, so

[1] The Sivaram Committee appointed by the Indian government recently concluded an investigation of fertilizer distribution. We have not had access to its report.

long as these changes are meaningful. By shifting the burden of devising acceptable alternatives to direct controls to the Indian government, AID could channel the government's attention to the solution of some of the more serious problems confronting the Indian economy and, more important, could reduce overt U.S. interference in Indian affairs. In the same way AID could reduce the demands upon its own personnel.

There are a number of reasons why AID might work through the Consortium and in coordination with the World Bank as much as possible. Many of the Bank's views are similar to those expressed here. Moreover, if other aid givers cooperated, the promised changes in aid levels (and, therefore, the leverage exerted on the Indian government) would be magnified, and the onus for "meddling" in India's internal affairs might be diffused. Given the continued encouragement by the United States for larger contributions by other Consortium members, any reduction in aid levels by the United States would probably be imitated, even without overt participation by the Consortium. It might also be advantageous for AID to work in close cooperation with groups of specialists appointed from time to time by the World Bank to analyze country problems.

Undoubtedly, there will be opposition in India to the removal of many direct controls over the Indian economy. The idea that a relatively powerful government can efficiently control every facet of the economy through a system of administrative allocations seems to have taken deep root in India despite the movement away from this belief in other planned economies. Yet it does not seem to us that ideological considerations would make the adoption of a more workable price mechanism impossible. Although there are pronounced statist sympathies within the Indian government, the present government and the political alliance upon which it rests seems to us to be considerably more flexible in its economic views than its predecessor. Continued adherence to direct controls is perhaps not so much ideological as it is a reflection of inertia in Indian administration and the overwhelming magnitude of India's problems, which discourage any apparent relaxation of government controls.

There is, however, some danger that any strong advocacy of further movement away from direct controls could raise ideological controversy and prove self-defeating. To lessen this possibility, AID might attempt to keep the dialogue specific, in terms, say, of foreign exchange problems, cement controls, and industrial licensing procedures. Failing this, AID might stress that public sector as well as private sector enterprises should receive remunerative prices for their products and that other planned economies (including some that place much less reliance on the private sector than India) are turning increasingly to price incentives as important and highly effective implements of planning.

The political obstacles to further modification of direct controls, although substantial, may not be overwhelming. One economist familiar with India has observed that India's administrative control system is supported by an "unholy triad" -- private businessmen who profit from the allocation of scarce inputs at controlled prices, "mushy" socialists who oppose anything identified with capitalism, and middle level bureaucrats who possess great confidence in the Indian administrative system and considerable mistrust of a price mechanism.

Although some private businessmen benefit from existing controls, there are many who do not. Private sector undertakings in controlled industries have been among the strongest advocates of decontrol. Also, many consumers have become dissatisfied with existing controls because of complications, delays, sacrifices in services and quality, and, in many instances, illegal or quasi-legal costs that these administrative controls have created. It is not obvious that the overall reaction of the private sector would be opposition to a change in the existing system of administrative controls.

Nor do all Indians who are committed to planning and the "socialist pattern of society" oppose liberalization of the existing system of direct controls. In fact, several prominent Indians with known socialist sympathies have recently urged greater reliance on a price mechanism.[1]

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[1]Two examples are Dr. K. N. Raj, a prominent economist and chairman of the Raj Committee which recommended decontrol of steel, and Mr. C. Subramaniam, the present Minister of Food and Agriculture. Although

Support for decontrol has also been given by public sector enterprises that produce commodities subject to price controls.

Perhaps the most powerful opposition to a reduction in direct controls would come from the Indian Administrative Services. Direct controls over the allocation of scarce inputs have given various government ministries and agencies enormous powers that, in many instances, will not be relinquished willingly. Some price controls have, in effect, enabled the government to purchase needed inputs at subsidized prices. For commodities that are not produced in significant amounts by public sector enterprises, one result of decontrol accompanied by price increases would be increased budgetary costs of the Indian government not offset by increased revenues. Yet, in our opinion, the Indian Administrative Services need not be an insurmountable obstacle to further decontrol. In 1962 officials of the Ministry of Steel and Heavy Industries were almost unanimously opposed to steel decontrol. By early 1963 both the steel minister and the Raj Committee had declared for some measure of decontrol, and many of these same officials had also become proponents of decontrol in some form or another.[1] Given strong guidance from the top, opposition to decontrol by India's administrative services can be overcome.

Devaluation and exchange auctions have been opposed publicly by the Finance Ministry[2] and privately by important officials of the Development Wing of the Ministry of Commerce and Industry. This opposition may reflect the unwillingness of these ministries to relinquish powers derived from direct controls over foreign exchange. It may also reflect the desire by the Finance Ministry to minimize the rupee costs

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Mr. Subramaniam has urged higher prices for cultivators and was largely responsible for steel decontrol, he has also been instrumental in securing grain rationing in India's eight largest cities, a departure from his usual advocacy of less reliance on direct controls.

[1]This statement is based on interviews by one of the authors in 1962 and 1963.

[2]For example, see Capital, July 22, 1965, pp. 113-114. However, the Finance Ministry has imposed substantial import and provided export subsidies during the past several years.

of repaying India's foreign debt and its unwillingness to give up revenues from import duties if devaluation is to be a substitute for these duties. Or it may instead reflect an understandable reluctance to encourage speculation against the rupee. One of the functions of the AID Mission in New Delhi should be to pinpoint hard core opposition to desired policy changes so that, wherever possible, alternatives to direct controls or incentives can be devised that would reduce this opposition.

Even then, it will not be easy for AID to devise incentives that will overcome fundamental opposition to decontrol by the various ministries and agencies of the government. For example, let us assume that the principal stumbling block to an exchange auction system is the Finance Ministry. It might seem that a threatened reduction in aid levels resulting from India's failure to devalue the rupee or its equivalent would confront the Finance Ministry with still greater difficulties in financing the government's expenditures in foreign exchange and, for this reason, might tend to diminish the ministry's opposition to devaluation. However, the Finance Ministry might simply pass on a cut in aid to the private sector, perhaps by further restricting maintenance imports by this sector. Although the United States might prefer not to increase the difficulties of the private sector, there would be no easy way to avoid this consequence if U.S. assistance to India were reduced.

A primary justification for the high levels of U.S. assistance has been their contribution to India's economic growth. We have argued that India's growth has actually been hindered by many of the government's direct controls over the economy, and that the U.S. aid program has not done enough in actively encouraging the elimination or modification of these controls. Although it may not be easy to effect desired policy changes, some attempt by AID to secure this objective can be made and in the long run may be far more beneficial to the Indian economy than a permissive attitude.