READERS' VIEWS

Free Social Market

To The Editor, "Times of India"

Sir,—I agree with Mr. Y. V. Thatte (October 3) that to argue against all planning would be to deny its merits altogether. In under-developed economies, for the reasons I have indicated, to speed up development, planned provision by the State of certain basic industries and socio-economic overheads may be necessary. But this need not involve any tampering with the free social market economy, the principal ingredient of the correct policy formula for India: If (planned) public sector investment is limited to public savings and private savings voluntarily accruing to the State, we would avoid the two dangers of inflation or a forced diversion of scarce savings into low return investments, both of which would detract from a maximisation of the national product.

I agree, too, that certain qualities of the German people contributed materially to the phenomenal progress of West Germany. But any deficiencies in these qualities which the Indian people may suffer from will remain whether we take the road of planning or of the free market economy. Attributes of national character change but slowly. The more relevant factor is that. while a (total) plan necessarily involves wastages (which attend the inevitable errors of judgment on resource allocations and because of its built-in biases against quality, efficiency and due care of equipment), the free social market, economy, with its self-correcting pricing mechanism, continually tends to minimise and eliminate errors and wastages. Hence, the need for free market policies is particularly great in low income economies where the economic surpluses are meagre.

The immediate post-war period, being dominated by acute shortages of supplies and equipment, does not provide a convincing empirical test of the potentialities of the free market economy. Such a test is provided during the past decade by the remarkable progress of West Germany, Italy and Japan and. at present, of France. The semi-stagnation of *per capita* incomes in India since 1954-55 is evidence that. we cannot look for dividends from a policy of increasing intervention (in the name of the plan) in the economic life of the community, as this has approximated (to quote A. P. Herbert) to a case of "Let's stop somebady from doing something."

B. R. SHENOY.

Bombay, October [illegible]

II

To The Editor, "Times of India"

Sir,—Apropos Mr. Thatte's comments, let me point out two inconsistencies in his letter. In the first place, Prof. Shenoy's article does not purport to do away with planning, nor does it advocate a retreat to a *laissez-faire* economy

Secondly, to say that from 1[illegible] to 1951 there were no controls in India, and that "even then industries did not develop and those that did never bothered about social factors" is to slur over facts. The index of industrial production (1946-100) was 117.2 in 1951. Investment in new industries was worth Rs. 290 crores (excluding replacement). while major existing industries added tremendously to their pre-war capacity. All this was done at a time when the climate for investment was hardly congenial.

The immediate question before us today is not whether to follow the Erhardian policy *in toto* but whether to accept the fact that 'democratic planning' means sufficient planning and sufficient scope for free enterprise.

M. N. RAVAL.

Surat, October 5.

Friedrich A. von Hayek [illegible]
Hoover Institution Archives

B. R. Shenoy
DIRECTOR

SCHOOL OF SOCIAL SCIENCES
GUJARAT UNIVERSITY
AHMEDABAD-9

13 October 1959

Dear Professor Hayak,

After visiting Zurich and Beirut I returned to Ahmedabad on 21 September. I have benefited considerably by attending the meeting at Oxford. It has reinforced my confidence in the importance of the free market economy for accelerated economic growth, in particular, of under-developed countries. I was also glad to see so many eminent people supporting my line of thinking on Indian economic issues. It was a delight to meet you personally both at Oxford and in London.

2. I have taken up the idea of a panel discussion by members of the Mont Pelerin Society in India. I hope that the idea will materialise and that it would be possible for you to make the trip. It would be wonderful if you think you could find time to study Indian economic conditions and give the public the benefit of your reactions. I am forwarding to you separately, per registered book post, a copy each of the following :

1).	Problems of Indian Economic Development	1958
2).	Ceylon Currency and Banking	1941
3).	Stability of the Indian Rupee: A Review of the Foreign Exchange Situation.	1959

3. I enclose cutting of an article by me, which appeared in the Times of India, Bombay on 25 September 1959. The idea of the suitability of the free market economy for India is receiving some attention. My article is, in fact, a reply to the observations made by Mr. Iengar, Governor, Reserve Bank of India, in a speech at Bombay on my earlier suggestion that free market economic policies alone would suit best India's needs. I thought you may be interested in looking into the article. It produced some letters to the Editor; I enclose, too, cutting of my reply to

(contd..2)

one of these letters and the letter of a reader. It is good to see that the idea is catching.

With kind regards,

Yours sincerely,

B.R. Shenoy

(B.R. SHENOY)

Professor F.A. von Hayek
Committee on Social Thought
59th Street, University of Chicago
CHICAGO-37
Illinois
U.S.A.

October 20, 1959

Professor D.R.Shenoy
Director, School of Social Sciences
Gujarat University
Ahmedabad 9, Bombay, India

Dear Dr. Shenoy,

It was a great pleasure to hear from you after your return to India. I am glad that you enjoyed your stay in Oxford so much and I want to assure you that your participation in our meeting was equally valuable fruitful to us and to me personally in particular. I am sure you will understand if I admit that for years I had not taken too much interest in Indian affairs because they seemed to me a rather hopeless case and also because most of the Indian students I had met, particularly at the London School of Economics, were intellectually not a very attractive type. The result of our meeting is that my attitude to India has completely changed and that I do feel it again worth while to take an interest in developments in India and that I want to learn more about them. For tha t reason I am also looking forward with great interest to the arrival of the books you have kindly sent. I hope they will prepare me so that I shall be able to make useful contributions if your plan for a panel discussion of members of the Mont Pelerin Society in India ever materializes. What hesitation I had so far as my personal participation in it was concerned was due entirely to my profound ignorance of Indian affairs. But you can be assured that I shall now not only make a special effort to take part when occasion arises but also to prepare myself adequately for that task.

Thank you also for the cuttings from the Times of India which I read with great interest. The German experience certainly deserves to be much better known than it is, even in the West and it is a pity that Erhardt when he was in India did not speak up more decidedly. But we could make him probably do so if it were possible to bring him to India once more as a member of a team.

With many thanks and kind regards,
Sincerely yours,

F.A.Hayek

Chicago, December 1959

Professor B. R. Shenoy
University School of Social Sciences
Gujarat University
Ahmedabad 9
India.

Dear Professor Shenoy,

I have been authorized by the Council of the Mont Pèlerin Society to invite you to become a member of the Society.

As you probably know, the Society is devoted to the study of the problems of a free society and its main activity consists of the organisation of periodic meetings. It elects its own members who number at present about 260. The enclosed brochure contains a statement of aims, the Certificate and Articles of Incorporation, the By-Law, and a list of members as at January 1st, 1956, with two supplementary lists.

I sincerely hope that you will accept this invitation and join us in our future activities.

Our next meeting will be held in Germany from 5th to 10th September, 1960, at Schlosshotel Wilhelmshöhe near Kassel.

In indicating your acceptance to our European Secretary (Dr. Albert Hunold, Münstergasse 9, Zürich 1, Switzerland), please state your address in the form in which you desire it to appear in the new printed list of members which we expect to issue in the near future.

Yours sincerely,

F. A. Hayek President

Enclosure: brochure

MPS/L/1808

WEST GERMAN RECOVERY

Lessons For India

By B. R. SHENOY

THE remarkable progress of West Germany during the past 13 years—"the German economic miracle,"—under the guidance of Professor Ludwig Erhard, Minister for Economic Affairs, indicates the enormous developmental potentialities of the free social market economy (Soziale Marktwirtschaft.) But some (among others, the Governor of the Reserve Bank of India) think that the German example is not a safe policy guide for India.

Firstly, though German industry had suffered greater war damage, Germany had abounding technological and managerial how-how, so that a "take-off" was vastly easier than in India, where the "run away" of the basic needs of, development still largely needs building up. Secondly, the pace of recovery of an industrial economy from the depths of war devastation, being likely to be statistically high, cannot be taken as a measure of the more normal pace of expansion. Thirdly, the German and Indian economies are basically divergent; the latter is *predominantly* rural, suffers from chronic pressures of poverty and population, meagre savings and an acute scarcity of skilled labour and managerial talent. The know-how of heavy industries, in particular, is poor, and so on: under these scarcity conditions, the State: of necessity, must play an important part in initiating development based on a plan.

STATE AID

The need for State initiative is illustrated by the examples of European coutries and of Japan in the early stages of their industrialisation; there was scarcely an important factory industry in Japan that not owe its Initial venture to the State. Fourthly, Germany had the benefit of significant and timely foreign aid. Finally, even in Germany, Erhard's policy was a gamble; its success was in great measure due to the discipline and hard work of the German people. In India, it would be worse than a gamble, the task before us being beyond the capacity of free market forces.

Taking the first two considerations above together, it is obvious that in a highly industrial economy, given freer availability of supplies, recovery may be much more rapid than the pace of expansion in an under-developed economy, where progress must begin with the laying of the capital base. But the recovery phase of German development was completed by 1950, when the index of industrial production was 110 per cent. of 1936. It was during the following eight years that German national income (at current prices) more than doubled, the annual average increases in it being 15.9 per cent. (probably a world record for a sustained rise at this high rate), real wages went up by 60 per cent. the mark got transformed from a soft to a leading hard currency in Europe, the currency reserves rose to well above twice that of U. K., and German exports moved up from the fifth to the third (later, the second) highest rank in the world.

For 15 years economic activity in Germany was weighed down by controls and a "price-frozen inflation." Professor Erhard threw "into the waste paper basket in one swoop hundreds of degrees promulgating controls and prices." Hard work, coupled with discipline in consumption, voluntarily assumed under the universal urge for marching forward, yielded *phenomenal* economic surpluses, which got absorbed in capital formation. Gross 'savings (gross investment) in Germany varied, from 1950 to 1958, between 21 per cent. and 26 per cent. of the gross national product.

PLANNING

The war had destroyed 60 to 90 per cent. of most of the big German cities: the harbours, canals and rivers had been jammed with sunken barges and ships, and broken bridges had blocked her railroads and highways; of the 10.6 *million* houses and apartments, almost half were uninhabitable. When Erhard took over (1948), German industrial production was still 50 per cent.. of that of 1936 and a geographically restricted country had to cope up with a rush of refugees from East Germany and elsewhere, who numbered, during 12 years since the close of the war, 12 million, or 23 per cent. of West German population. German planners were quite firm that, in such a context, decontrol would be a catastrophe, that it would cause German industrialists to promote a Morgenthau policy, that a sick man cannot be tossed into cold water and be expected to swim, and that systematic planning and guidance of the economy alone could restore it to a healthy state.

German plan "experts" had "worked out in painful collaboration" with the American authorities a Long Term Plan (LTP). It is a tribute to the potentialities of the free market economy that actual production far exceeded the LTP targets, though the latter were deemed too high by the "experts." To take some examples, in 1952-53 industrial production was 145.5 per cent. of that in 1936 (as against the LTP target of 110 per cent.) private consumption per head improved from DM 768 in 1936 to DM 827 in 1952-53 (at 1936 prices,) a rise of 7.68 per cent. above the 1936 level (as against the LTP target of 20 per cent. *below* the 1936 level), and the exports in 1952 amounted to $4.04 million and in 1953 $4.42 million (as against the LTP target of $2.8 million.) Since the Wirtschaftwunder (economic miracle,) "even the factory workers are buying cars. Before the war, that was unheard of in Germany" (National Geographic Magazine, June 1959).

The explanation for the phenomenal economic surpluses which the free market economy produced is easily seen. The test and the measure of economic development is in the curve of production (of marketable output). For this curve to rise steeply the two basic needs are, firstly, full and sustained effort on the part of every individual in the field most congenial to his nature and, secondly, a maximisation of the economic surpluses to strengthen the capital-base of the economy, so that output per individual (and the production curve) may beep rising continually. This process of expansion would be endowed with stability if the effort to produce and the urge to save arc the result of the free mill and choice of individuals. Erhard's social free market economy answered these conditions eminently. The regime of controls and governmental regulations harassed enterprise and clogged the springs of production. Planned development (in the sense of a total plan), as experience has shown, detracts from a maximisation of the national product to a given supply of resources, as it produces internal conflicts and resistances, leads to wastages, which attend the inevitable errors of judgment on the distribution of resources, and has "built-in" biases against quality, efficiency and due care of equipment.

FREE MARKET

Taking the third consideration, because basic economic divergences exist between the Indian and German economies, it is not as if State control and intervention alone are the most suitable policy for India. As the pace of economic development rests on the magnitude of the economic surpluses (production less consumption—savings), the test of the eminent suitability of an economic policy is in the prospects which it may offer for augmenting these surpluses. Other considerations cited by the critics of the suitability of Erhard's policy for India are largely irrelevant. The fundamental forces reviewed above apply to all economies regardless of their pattern and structure, as the economic process, like the engineering process and the law of gravitation, is the same everywhere. The need for free market policies is particularly great in underdeveloped economies where incomes being close to the margin of subsistence, increased savings are unpractical

Continued on Page **8** Column 5

Lessons For India In West German Recovery

Continued **from Page** 6 Column 5

without stepping up production; this renders it imperative that every possible care be taken to avoid admir -ative and policy measures wh may dampen efforts and enterprise, even as in an area of scarce water supply prudence demands due care and attention of the few oases provided by nature.

Our economic policies, however, are moving more and more in the direction of the German policies when Erhard took over and, like them, are tending to have a wet blanket effect on enterprise and output. In the field of agriculture, which accounted for 45 to 51 per cent. of Indian national income, to the already existing restrictive legislation is threatened to be added other measures of a similar character. These factors have detracted from sustained and intensive effort; increased agricultural output depends more than ever on weather conditions. In the field of industrv. too, we have a wide range of [illegible]ering governmental interventi... and regulations. In cotton textiles, which account for 36 per cent. of industrial production, special impediments exist in the way of expansion. Add to this the problem of go-slow by labour; effort by industrial workers is estimated by observers at 50 to 75 per cent. of capacity.

FOREIGN AID

Coming to the fourth consideration of the critics of Erhard's policy to India, facts do not confirm the view that foreign aid significantly accounted for the rapidity of German development. It amounted to $3.12 billion (DM 13.10 billion) between April 1948 and the end of 1954 and represented 7.49 per cent. of the estimated total gross investment in Germany during this period. T is a gross figure, as, beginn- with 1950, Germany's balance of payments statistics show a net outflow of German capital under "private donations" and "private cap[illegible]" Foreign aid to India in the [illegible]t three years of the second Plan (Rs. 742 crores) represented 23 per cent. of the investment in the public and the corporate private sector (Rs. 3,200 crores).

Logic and experience (of the working of controls for 15 years) and Erhard's strength of conviction of his own policies do not support the view that Erhard had been engaging in a gamble. The experience of Italy and of Japan endows certainty to the outcome of free market policies; by pursuing them these countries harvested similar dividends. Since their adoption, national income (at current prices) rose at an annual rate of 11 per cent. in Italv and 15 per cent. in Japan.

In the context of the Indian official view that exchange control (and foreign exchange scarcity) and inflation are, so to speak, the inevitable attributes of a developing economy, it is interesting to hear Erhard say that exchange control is the "worst form of disorder," that it is "utterly ridiculous" to speak of its being necessary to maintain "order," and that whoever may rescue Europe from it "will have done more for Europe than all politicians, statesmen, M.Ps., business men and civil servants put together." The fundamental "disorder" caused by two decades of exchange control in India, in the field of production, prices, exports, concealments of incomes, anti-socialistic shifts in income distribution and black marketing confirms this.

INFLATION

On the issue of inflation and development, Erhard observes: "I absolutely deny that a strong expansion must be naturally or lawfully .combined with a general rise in prices." In fact, "no amount of economic progress can be big enough to offset even the most apparently harmless softening of the currency."

In under-developed economies private capital may not readily be attracted into basic industries in the early stages of development, because of the low returns and the long gestation period. To ensure unhampered and speedy growth of the economy, it becomes necessary for the State to provide these basic needs in socio-economic overheads. This would not, however, involve any tampering with the free market forces. It is also the responsibility of the State to prevent monopolies, trusts and cartels, as they are abhorrent to the rules of a free market economy. It follows that the safest and the best formula for an economic policy for India is free social market economy, plus planning, plus zero inflation

FREE MARKET ECONOMY FOR INDIA

by

B. R. Shenoy

The remarkable progress of West Germany during the past 13 years - "German economic miracle," - indicates the enormous developmental potentialities of the free social market economy (Soeiale Marktwirtschaft). But some (1) think that the ~~German example is not a safe policy guide for India.~~ The arguments advanced by the critics' may be stated briefly.

2. Firstly, though German industry had suffered great war damage, Germany had abounding technological and managerial know-how, so that a "take-off" was vastly easier than in India, where the "run away" of the basic needs of development largely need building up. Secondly, the pace of recovery of an industrial economy from the depths of war devastation, being likely to be statistically high, cannot be taken as a measure of the more normal pace of expansion. Thirdly, the German and Indian economies are basically divergent; the latter is predominantly rural, suffers from chronic pressures of poverty and population, meagre savings and an acute scarcety of skilled labour and managerial talent, the know-how of heavy industries, in particular is poor, and so on; under these scarcity conditions, the State, of necessity, must play an important part in initiating development based on a plan. The need for State initiative is illustrated by the examples of European countries and of Japan in the early stages of their industrialisation; there was, then, scarcely an important factory industry in Japan that did not owe its initial venture to the State. Fourthly, Germany had the benefit of significant and timely foreign aid. Finally, even in Germany, Professor Erhard's policy was a gamble; its success was in great measure due to the discipline and hard work of the German people. In India, it would be worse than a gamble, the task before the country being "beyond the capacity of free market forces."

3. However muchwe dislike these arguments - because we know them to be factually or basically wrong -, they hold the field in India to-day. Supporters of the free market economy, even in the universities, are in an insignificant minority; it will take a great deal of counter-argumentation and weight of adverse experience before opinion of persons that matter changes, There, however, is no point in my wasting your time in refuting the stand taken by these critics. But I believe it would be correct to say that, given freer availability of supplies, recovery in a highly developed industrial economy may be much more rapid than the pace of expansion in an under-developed economy, where progress must begin with the laying of the capital base and the creation of the necessary socio-economic overheads. Eut the recovery of German development may be said to have been completed by 1950, when the index of industrial production was 110.9 per cent of 1936, as against 33 per cent in 1946, and 39 per cent in 1947, which makes a recovery pace of about 27 per cent per annum. In the following 8 years German national income (at current prices) more than doubled, the annual average increases in it being 15.9 per cent (probably, a world record for a sustained rise at this high rate), real wages went up by 60 per cent, the mark got transformed from a soft to a leading hard currency in Europe, the currency reserves rose to well above twice that of U.K., and German exports moved up from the fifth to the third (later, the second) highest rank in the world.

4. I believe it is correct to say, too, that for 15 years economic activity in Germany was weighed down by controls and a "price-frozen inflation". Professor Erhard, Minister of Economic Affairs, threw "into the waste paper basket in one swoop hundreds of decrees promulgating controls and prices". (2)

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(1) The subject is receiving public attention. Official reaction to the idea of the applicability of the free market economy to India is generally one of disapproval; this was the theme of a talk by the Governor of the Reserve Bank of India to the Indo-German Social Centre, Bombay, on 8 August 1959.

(2) Ludwig Erhard, "Prosperity through Competition", London 1958, p. 13.

The almost electric effect which the change-back to the free market forces produced led to hard work; this coupled with discipline in consumption, voluntarily assumed under the universal urge for marching forward, yielded phenomenal economic surpluses, which got absorbed in capital formation. Gross savings (gross investment) in Germany varied, from 1950 to 1958, between 21 per cent to 26 per cent of the gross national product.

5. The picture of poverty presented by the immediate post-war situation in Germany was no less depressing than the picture presented by certain under-developed economies. This comparison is of significance because of the oft-repeated theory that the vicious circle of poverty, meagre savings, investments below the demographic rate and persistent economic stagnation, cannot be cut except through Communist techniques of planning or state intervention. The war, one reads, had destroyed 60 to 90 per cent of most of the big German cities, the harbours, canals and rivers had been jammed with sunken barges and ships, and broken bridges had blocked her railroads and highways; of the 10.6 million houses and apartments, we are told, almost half were uninhabitable. When Erhard took over (1943), German industrial production was still 50 per cent of that of 1936 and a geographically restricted country had to cope with the rush of refugees from East Germany and elsewhere, who numbered, during 12 years since the close of the war, 12 millions, or 23 per cent of West German population. I believe that this raised the rate of growth of the population of the country to well above the rate of growth which, many assert, weighs down the effort of under-developed countries to struggle out of economic stagnation. It is interesting to hear Prof'essor Erhard say: "It was a time when most people did not want to believe this experiment in currency and economic reform could succeed. It was a time when it was calculated that for every German there would be one plate every 5 years; a pair of shoes every 12 years; a sui every 50 years; that only every fifth infant would lie in its own napkins; and that only every third German would have a chance of being buried in his own coffin. That seemed to be the only life before us." (3) It is interesting to hear, too, that the German planners were quite firm that, in such a context, decontrol. would be a catastrophe, that it would cause German industrialists to promote a Morgenthau policy, that a sick man cannot be tossed into cold water and be expected to swim, and that systematic planning and guidance of the economy alone could restore it to a healthy state. That is precisely how the planners in India, too, are arguing to keep themselves in positions of power.

6. It is a tribute to the potentialities of the free market economy that actual production far exceeded the targets of the Long Term Plan (LTP), which the planners had "worked out in painful collaboration" with the American authorities, though the targets were deemed too high by the experts. It is good to read, for instance, that industrial production was 145.5 per cent of that in 1936 (as against the LTP target of 110 per cent), that private consumption per head improved from DM 768 in 1936, to DM 827 in 1952/53 (at 1936 prices), a rise of 7.68 per cent <u>above</u> the 1936 level (as against the LTP target of 20 per cent <u>below</u> the 1936 level), that since the Wirtschaftswunder (economic miracle), "even the factory workers are buying cars. Eefore the war, that was unheard of in Germany," and that the exports in 1952 amounted to $ 4.04 million and in 1953 to $ 4.42 million (as against the LTP target of $ 2.8 million).

7. The factors making for the phenomenal economic surpluses under a free market economy seem to be obvious. The test and the measure of economic development is in the curve of production (of marketable output). For this curve to rise steeply the two basic needs are, firstly, full and sustained effort on the part of every individual in the field most congenial to his nature and, secondly, a maximisation of the economic surpluses to strengthen the capital-base of the economy, so that output per individual (and the production curb) may keep rising continually. This process of expansion would be endowed with stability if the effort to produc save are-the result of the free will and choice of individuals. The free market economy answers these conditions eminently.

3. These basic forces and considerations apply to all economies regardless of their pattern and structure, as the cconomic process, like the engineering process, is the same everywhere. That is to say, because basic economic divergences exist between the Indian and German economies, it is not as if State control and intervention alone are the most suitable policy for India. As the pace of economic development rests on the magnitude of the economic surpluses (production less consumption), the test of the eminent suitability of an economic policy is in the prospects which it may offer for augmenting these surpluses. I believe, therefor,, that it is correct to say that the other considerations cited by the critics (listed in paragraph 2 above) are largely beside the point. The need for free market policies is particularly great in under-developed economies where incomes being close to the margin of subsistance, substantial

(3) Erhard, p. 10

increases in savings are unpractical without stepping up production; this renders it imperative that every possible care be taken to avoid administrative and policy measures which may dampen effort and enterprise, even as in an area of scarce water supply prudence demands due care and attention of the few cases provided by nature.,

9. I believe it is true to facts to say that the magnitude of foreign aid received by Germany does not confirm the view that it was a major factor accounting for the sustained rapidity of German development. Foreign aid to Germany amounted to $ 3.12 billon (DM 13.10 billion) between April 1948 and the end of 1954. (4) Statistics of the total gross investment in Germany for the whole of this period is not available (to me), the data I have access to beginning from 1950. But arough guess suggests that foreign aid may be of the order of 6 - 7 per cent of the total gross investment in Germany during this period. This is a gross figure; no allowance has been made in it for the outflow of capital from Germany, which took place during this period. Foreign aid to India in the first 3 years of the Second Plan (Rs. 742 crores) represented 23 per cent of the investment in the public and the corporate private sector (Rs. 3,260 crores).

10. Whether or not the application of the free market policies to Germany was a gamble, the experiance of Italy, of Japan and of other countries seems to endow certainty to the outcome of free market policies. Both the latter countries, by pursuing similar policies, harvested similar dividends. Italian national income rose (at current prices) at II.06 per cent, per year, from 1950 to 1958. During the six years ending 1957, Japanese national income (at current prices) rose at an annual rate of 14.97 per cent.

1 Indian economic policies are moving steadily and progressively in the direction of state intervention in the economic life of the community and state participation in trade and industry; as elsewhere in the world where similar policies have been tried, this is tending to have a wet blanket effect on enterprise and output. In the field of agriculture, which accounted for 45 - 51 per cent of Indian national income in recent years, to the already existing restrictive legislation against credit (money lending), land transfers, interest rates, foodgrains prices and the movement of foodgrains, are threatened to be added other measures such as ceilings on land holdings, co-operative farming (which some interpret as the termination of family farming and private ownership of land), full state-trading in foodgrains, etc. These measures and policies have had an adverse effect on the availability of credit to agriculture, have raised effective interest rates, deterred the larger land owners from capital improvement of land, have led to an undue cutting down of trees, and have caused "precautionary" splitting up of the larger holdings. These factors have detracted from sustained and intensive effort so that increased agricultural output depends more than ever on weather conditions. The division of the national market in foodgrains into zones, 5 for wheat and 2 for rice, has accentuated regional price variations (and has caused smuggling of grains by circuitous routes at wasteful transport costs). This involves a relative price penalty on the producers of foodgrains in the surplus areas and is a factor making for a shift of production away from foodgrains. Purchase of foodgrains by the State (through the STC) has driven up foodgrains prices unduly and has caused the trade and the farmers to withhold stocks, which has accentuated (market) scarcity conditions.

12. The industrial sector is subject to a wide range of governmental intervention and regulations. The position in the cotton textile industry, which accounts for 36 per cent of industrial production, is illustrative of their general character. The import goods content of the industry (machinery, accessories and spare parts, dyes, chemicals, cotton, and so on) hangs on the government's import licensing policy. Calculations of costs, and of availabilities of supplies to maintain a programme of production, may get out of control and eat into profit margins with an adverse turn in the import licensing policy; a tightening of imports may involve a hasty (and costly) search for substitutes. Progress of modernising equipment is conditioned by, in addition to the availability of import licences, the policies on rationalisation and the attitude of trade unions. The introduction of automatic looms beyond a certain quota, is conditional on the output being all exported, the failure to do so being subject to penalties. Production units, which are below the optimum size for full economy in management and efficient functioning, cannot add to the number of their spindles or looms, in an effort to reach the optimum level, if they are located in the larger textile centres ("surplus" states). The closing down of inefficient units involves a heavy penalty of compensation to the disengaged workers, at the rate of 15 days wages for every year of service. This penalty plus trade union pressure stand in the way of retrenchment of surplus labour; it is also one of the difficulties confronting full progress of rationalisation. Governmental resistance to closing down inefficient units has reached the point of the

(4) Erhard, p. 15.

State taking over these units for operation. In the "surplus" states, the more efficient units are unable to expand production to replace the reduced output ensuing from the closed down inefficient units. The production of dhoties and of prints is subject to upper limits; the production of dyed saries is banned; white saries produced by the mills must satisfy specifications of the size of their borders; there are limitations on the counts of the yarn to be used in the warp and the weft and on the quantities in the "reed" and "pick". The disposal of the output of yarn is subject to control.

In general, it is far from easy to adopt effective disciplinary measures against slack and inefficient labour. Some observers are of tho view that industrial labour in India, when not under the assembly-line compulsion, generally puts in effective work of one-third to one-fourth (or even one-half) below normal capicity. Under these conditions, it is not surprising that production should shrink at the first emergence of adverse factors. The striking progress of industrial production until recent years, notwithstanding these handicaps, is in the main due to, firstly, the abnormal profit margins which inflation and import restrictions provided and, secondly, the supply to industry of its import requirements at heavily subsided prices, which an unrealistic exchange rate involved.

13. Considerable damage has also resulted from continued exchange controls and impo-restrictions which have lasted for 2 decades. The experience of the working of these controls confirms the observation of Professor Erhard that exchange control is the "worst form of disorder" and that it is "utterly ridiculous" to speak of its being necessary to maintain "order". (5) These controls have introduced 3 sets of fundamental disorder in India. Firstly, a cut in imports has led to fabrication of domestic substitutes at high cost to the detriment of the national product; intensified import restrictions, by impinging on essential supplies, have slowed down industrial output. Secondly, it has caused a gap between the internal and the external prices of import goods and of gold, which inflation has widened. This has led to a scramble for, and traffic in, import licences, and gold smuggling; these transactions have involved concealment (into "black" earnings) from the tax gatherer of incomes of the order of Rs.200 to Rs.300 crores (abt. 2 to 3 per cent of the national income) each year, and to anti-socialistic shifts in income distribution. It has made a heavy dent on national morals. Thirdly, this purposeless activity has diverted scarce resources of the state into futile administrative and policing expenditure, while reducing tax receipts.

14. To the dampening effects of these measures on enterprise must be added the effects of inflation and the heavy tax rates. During the 3 years, 1955/56 to 1957/58, while national income in real terms rose by 5.4 per cent, money supply (despite the moderating influence of a depletion of the currency reserves by Rs. 465 crores and of foreign aid of abt, Rs.425 crores) expanded by 24.4 per cent. The resulting inflationary rise in prices, - the General index went up at an annual rate of 8.1 per cent per year during the past 3½ years - had an adverse influence on national output, through increasing consumption and dissipating savings, Income-tax rates in India are among the highest in the world. At certain income levels, the total personal tax paid by an individual (income-tax, super-tax, wealth-tax, expenditure-tax, and gifts-tax) may exceed his total income. Apart from the consideration that this cannot he defended under equity or social justice, it cramps effort on the part of some of the ablest men in the country.

15. The record of state corporations in India does not encourage the view that they offer a device for augmenting economic surpluses. In 1958/59, of 12 state corporations with a capital of Rs. 32 crores, the profit rate of the State Trading Corporation was 3 per cent and of the Sindhri Fertilizers and Chemicals less than 1 per cent. In the case of others, profits were either nil or the relative data were not available. In the same years, the Indian average of dividends on industrial securities was 6.27 per cent, after tax.

16. The trend in Indian national income seems to reflect the combined effect of these policies. In 1957/58, notwithstanding Plan effort, Indian national income is estimated to be down by 1.5 per cent, relatively to 1956/57. The rise in 1956/57 being 4.90 per cent, in the first 2 years of the Second Plan, the annual rate of increase in Indian national income was 1.73 per cent. Current population growth in India being 2.0 per cent per year, as against the earlier rate of 1.5 per cent, the Indian citizen at the close of the 2 years of the Second Plan was poorer than he was at the close of the First Plan. During the 3 years ending 1957/58, national income rose (5.4 per cent) by about the sane margin as the rise in population (4.5 - 6.0 per cent).

17. The fall in national income cannot be wholly ascribed to the effects of weather on agriculture though its contribution has been significant. Since 1948/49, this is the first year when we have experienced a decline in national output, though during

(5) Erhard, p. 229.

during this period, we have had bad harvests, too. The decline is, in part, attributable to Indian economic policies.

18. For accelerated economic development, the first task before India is to decide on the right economic policy. It appears obvious that the present policy of interference in the working of the pricing mechanism and in the economic life of the community (in the name of the plan and for attaining a socialist pattern of society) has to be abandoned. There are, then, 2 alternatives to choose from.

19. The first is Communist planning, whereby the planners exercise control over the productive resources of the community and its entire economic activity. By reducing resource allocations to the consumer trades, they reduce consumption to the minimum in order to step up capital formation to the maximum. It does not, however, follow that Communism offers the most favourable institutional arrangements for accelerated economic growth; as experience has shown, Communism is apt to produce internal conflicts and resistances, especially in the agricultural sector which, notwithstanding ruthless countervailing regimentation, would detract from a maximisation of the national product for a given supply of resources. Communism involves, too, "built-in" biases against efficiency, quality and a high care of equipment (which are incidental to the effort somehow to overfulfill the production quota). This does not conduce to a high ratio of output per worker for a given equipment and other resources. The maintenance of this ratio at a high level would, therefore, involve the maintenance of an un-relieved pressure of regimentation.

20, The other alternative is to adopt policies consistant with the free market economy. He who may rescue the country from its present economic policy and bring about a change over to a free market economy will have done more for speeding up Indian economic development than all the foreign aid that is being planned, or that the country has received. The position on the plane of ideas, to-day, is that the major economic difficulties confronting the country, namely the rise in prices and an acute scarcity of foreign exchange are ascribed to economic development; the belief is universal (among people that matter and also among the public) that economic development is not possible without inflation and exchange control (foreign exchange scarcity). (6) That these difficulties stem from the attempt to invest non-available resources is receiving acceptance far too slowly and reluctantly.

21. The choice between the 2 alternatives cannot be long delayed. Compulsions of plan finance may take the country to the parting of the ways sometime this financial year or the next. Total investment in the public sector (Centre and states) and the corporate private sector during the first 3 years of the Second Plan, amounted to about Rs. 3,260 crores. About 39 per cent of this (Rs. 1,270 crores) was financed by withdrawals from the currency reserves (Rs. 528 crores, or 16 per cent) and by foreign aid (Rs.740 crores, or 23 per cent). Currency reserves are nearly all gone, the surplus over the legal minimum reserves (Rs. 200 crores) as at 21 August 1959 being Rs. 96 crores. In 1958/59, budgetary operations and the public debt transactions of the banking system, viewed together, led to a record net issue of RS. 610 crores of created money. The country was saved from runaway inflation, which this might have caused, by the record foreign aid of the year (Rs. 360 crores). This coupled with withdrawals from the currency reserves (Rs. 46.60 crores) and reduced activity in the rest of the economy kept down the excess money issue to about Rs, 109 crores, leading to a comparatively moderate price rise of 5.3 per cent during the year (see attached table).

22. In 1959/60, placing foreign aid at the budget figure of RS 337 crores, and assuming the flow of savings into the public sector to continue at a rate suggested by the performance of the past 3 years (Rs. 350 crores), the savings gap in the projected plan investment of the year (RS. 1,121 crores) may be of the order of Rs. 400 crores. In desperation, the government may amend the currency law (as had been done twice in the past) and reduce the currency reserves, this time, to zero, following the good example of certain countries) and appropriate the whole of the remaining reserves for plan investment during the current year. This will only transfer the problem to the last year of the plan.

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(6) Here is an extract from the letter of resignation, dated 22 August 1959, of a Union minister: "Some people seem to think that prices are a function of supply and demand. This is far from the truth. In the complex economy, under which we are living, prices of commodities are affected by the export and import policy, budgetary and monetary policies. In a developing economy all these have an effect on prices."

23. Notwithstanding these difficulties, the blue print of the Third Plan is being prepared on the assumption of an overall order of investment of RS. 10,000 crores in 5 years, which is double the average investment rate of the first 3 years of the Second Plan. As may be expected, in a stagnant per capita income, national savings flowing into the plan, notwithstanding the pressure tactics used for augmenting it, have remained around 5 per cent of the national income. Assuming foreign aid to continue at about Rs. 300 crores per year, the visible resources for the Third Plan (including the public sector and the corporate private sector) are of the order of Rs. 4,250 crores.

24. Official thinking for an exit from this stubborn position is in the direction of more state intervention in economic activity as evidenced by the discussions at the Seminar on Planning, conducted by the All India Congress Committee, at Ootacamund in June 1959. The policies visualised have been described as "institutional and organisational changes of a comprhensive character, affecting both governmental and non-governmental agencies". Given these changes, the conclusion of the Seminar is that "it would be possible to mobilize resources' of the order of Rs.10,000 crores", (7) of which $\frac{2}{3}$ would be for public sector investment. The changes visualised include drastic measures of additional taxation, extension of state trading and co-operative farming.

25. I believe it is correct to say that, under free market conditions, overall national savings are a steady percentage of national income; this percentage changes but slowly, so that ordinarily, an increase in the quantum of savings would rest on the expansion of national income. Overall national savings cannot be expected to rise significantly by merely shifting profits from private trade to the coffers of the state through extending state trading or increased taxation, especially because past experience has shown that rises in revenue receipts are apt to be balanced by larger non-investment expenditure. The saving's habits of a people do not change because they now draw their incomesfrom a stete agency instead of from private firms. Co-operative farming is of value for plan finance only to the extent it inay augment the output of farms without augmenting equally the consumption per worker on the farms. This is expected to result from the application of modern methods of cultivation which the integration into optimum farms of the fragmented units might permit. Universal extension of co-operative farming may take decades to achieve, among other reasons because, firstly, integration of fragmented units is a formidable task in itself; secondly, the additional capital requirements of the reform would limit its progress and, thirdly, the personnel with the necessary competence and character to run the farms is far too scarce. This is too speculative a proposition to rely on for Third Plan finance.

26. Indian planners first fancied deficit financing to be an Alladin's lamp, within limits; after $2\frac{1}{2}$ years of discussion and a rise in the general index of prices by 91 points (27 per cent), we were convinced of the futility of relying on it for capital formation. (8) Their attention, then, shifted to the tax instrument and 2 years' experience has demonstrated its limitations. There is little doubt that the contrivance now in favour - institutional changes - will have to abandoned, in its term; one hopes that this will be done before too great damage results to the magnitude of the national product. There is no safer device of maximising this product than through a free market economy. It is also in line with the Indian tradition of tolerance, understanding and profound human sympathies.

27. The necessity for foreign aid for speeding up economic development of low income economics is evident in the situation; but it is important that such aid should be wholly absorbed in the economically most sffective capital formation. For this to happen, the essential pre-condition would seem to be monetary and exchange stability. During the First Plan, viewing economic operations in the aggregate, the amount of foreign aid (Rs. 211 crores) was wholly used up in financing the export of (foreign-owned)private capital (Rs.37 crores) and gold smuggling (estimated at an order of RS. 160 crores), - the domestic capital savings of the period (Rs. 3,150 crores) alone being applied to plan investment (Rs. 3,100 crores). Porcign aid, in other words, was in effect, converted mainly into the dead asset of gold and partly, exchanged for home assets owned by foreigners. It did not contribute to an augmentation of the national product, though the service charges on foreign aid are being drawn from this product. The Second Plan has added to non-developmental drain of foreign aid, To the claims on it for the finance of capital repatriation (9) and gold smuggling have now been added the claims of increased consumption ensuing from inflation (over-invcstment).Since foreign aid and domestic funds go into the same economic kitty, foreign aid would be drawn upon,

(7) Yojana, 28 June 1959 (8) See the budget speech, November 1956

(9) Net exports of private capital amounted to Rs, 25.8 crores in 1956/57 and 1957/58, the first 2 years of the Second Plan.

directly or indirectly, to finance the enhanced consumption. To the extent foreign rid docs not add to the capital base, the economic ability to repay the debt is not being built up. This raises the important question, whether foreign aid in a background of domestic inflation and basic economic disorders is in the best interests of the giver and of the receiving country; in addition to the doubt of the ability of the debtor to repay the debt, there is the consideretion that foreign aid, in certain situations, may patch up and, therefore, prevent the full manifestation of policy aberrations. In such cases foreign aid may have an element of disservice in disguise.

TABLE I

(Rs.crores, a crore being 10 million)

PLAN FINANCE

	1	2	3	4	5
	1956-57	1957-58	1958-59	1959-60	1 + 2 + 3
1a Plan Outlay (Centre A states)	639.00	846.00	981.00	I,I 21.00	2,466.00
2. Capital formation in the Corporate Private Sector(estimate)	270.70	260.00	265.00		796.00
3. 1 + 2	909.70	1106.00	1246.00		3,262.00
4. Drafts on Currency Reserves	221.30	259.90	46.60		527.80
5. Utilised Foreign Aid	128.90	252.80	361.10	337.00	742.80
6. Current Domestic Savings (3-4-5)	559.80	593.30	838.30		1,991.40
7. Net Issue of Money resulting from 1.budget operations and 2. the public debt(including samll savings) transactions of the banking system (including R.B.I.)	7.35	342.12	609.91		959.39
8. Plan Finance by Created Money (7-4-5)	-	-	202.21		202.21
9. 4 + 5	350.20	512.70	407.70		1,270.60
10. 9 as % of 3	38.48	46.36	32.72		38.95
11. 4 as % of 3	24.32	23.50	3.74		16.18
12. 5 as % of 6	14.16	22.86	28.98		22.77
13. Increase in Money Supply	128.57	75.94	109.04		313.55
14. Increase % in General Index of Prices	5.94	0.95	5.28		12.60
15. Savings less Created Money	559.80	593.30	636.09		1,789.19
16. Deficit Finance (1)	211.77	497.78	308.01		1,017.56

(1) Formal budget deficit + or - the increase or decrease in the permanent debt holdings of the banking system (including the Reserve Bank).