A Memorandum to the Government of India 1955

MILTON FRIEDMAN

[EDITORIAL NOTE: *This memorandum is dated 5 November 1955, and was written at the invitation of the Government of India, where the author was working for some months as a consultant to the Ministry of Finance. It has not been published before. The editors believe it remains relevant to Indian discussions today. The history of the advice given by other Western economists in the early years of the Indian Republic has been recently surveyed by George Rosen in* Western Economists and Eastern Societies: Agents of Social Change in South Asia 1950-1970 *(Delhi: Oxford University Press, 1985).]*

The Goal

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

INVESTMENT POLICY

Over-Emphasis on the Capital-Output Ratio

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

There are two reasons why the amount of investment and the increase in output can be, and empirically are, only loosely connected. First, the form and distribution of investment are at least as important as its sheer magnitude. Second, what is called capital investment is only part of the total expenditure on increasing the productivity of an economy. The first reason needs little additional comment. The second is perhaps less clear. In any economy, the major source of productive power is not machinery, equipment, buildings and other physical capital; it is the productive capacity of the human beings who compose the society. Yet what we call investment refers only to expenditures on physical capital; expenditures that improve the productive capacity of human beings are generally left entirely out of account. In the United States, for example, only about one-fifth of the total income is return to physical capital, four-fifths to human capital. By this. writer's estimate similarly, only about one fifth of the annual rate of growth in the United States can be attributed to the direct effects of investment in the usual sense; four-fifths must be attributed to the growth in the productivity of human beings. Annual expenditures on improving the quality and quantity of human resources are at least as large as and perhaps much larger than investment as usually defined. Destroy the physical plant of the United States and leave the skills of the people and it would take but a few years to restore the initial position. Destroy the skills and leave the plant and the level of output would sink irretrievably. The cathedrals of medieval Europe, the pyramids of Egypt, the monuments of the Moghul empire in India are all testimony to the possibility of a high rate of investment in physical capital without a growth in the standard of living of the masses of the people. These considerations are especially important for India, precisely because its frontier is the frontier of technical knowledge and skill.

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

Emphasis on Two Extremes Against the Middle

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

Attempt to Do Too Much in the Public Sector

Indian thought may not have taken full account of the post-war experience of European countries in expanding the public sector. Country after country moved in this direction immediately after. the war; to the best of the present writer's knowledge, the results were, in every case, disappointing. This experience has produced drastic change in the attitudes of the labor and left-wine toward nationalization and detailed state control over economic activity. The elements in the parties that have not changed the approach are now being dubbed 'reactionary' by some of their fellows!

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

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

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

POLICY TOWARD THE PRIVATE SECTOR

Protection of Inefficient Methods of Production

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

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

Coddling of Private Industry In Certain Directions Combined with Severely Restrictive Controls In Others

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

MONETARY POLICY

Erratic Policy

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

The present writer believes that monetary policy in India would be more stable and consistent if the monetary authorities paid more attention to the size of the money stock and less to other indicators, and if they took as their proximate goal, a steady expansion in. the money stock (allowing for seasonal influences) at a rate of something like 4 to 6 percent per year. It may be noted that detailed examination of the record of American monetary authorities persuades one that this general proposition is equally true for the United States, with a desirable rate of expansion of the money stock of 4 percent per year.

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

Deficit Financing

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

REESOURCES AVAIALABLE TO THE PUBLIC SECTOR

There seems to be a general agreement that planned expenditures in the public sector substantially exceed expected receipts, even after allowing for a shortfall of actual expenditures, for deficit financing to the extent of Rs. 1,000 to 1,200 crores, and for a substantial amount of foreign aid. If we are right about the safe amount of deficit financing, the actual gap is substantially larger than the amounts generally cited. This financial gap corresponds to a real resource gap. It can be filled without curtailing the Plan only by either getting additional resources from abroad; or making domestic resources more productive over and above the 5 percent per year increase already allowed for in the estimates; or transferring resources from other uses. The transfer of resources can be brought about by additional taxation, forced savings, additional voluntary savings, or a reduction in private investment. Additional voluntary savings and a reduction in private investment can in turn be brought about to some extent by a monetary policy that allows interest rates to rise. Inflation is of course a possible danger, but it is not really a separate method of filling the gap; it is a form of taxation and, in the view of this writer, a particularly inefficient and inequitable form.

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

On the tax side, three comments may be made: (i) The small scope of direct income taxes seems an obvious defect in the tax structure. A more broadly based tax with lower exemptions and more effective administration might both raise considerable revenues and produce a more equitable distribution of the tax burden. (One recognizes that for a country like India there are special problems of administration and enforcement that this writer is incompetent to assess.) (ii) The use of excise taxes for the production of one method of production or one product as opposed to another not only promotes inefficiency but is also wasteful of revenue. A 10 percent tax on shoes would yield more revenue, do less harm to productive efficiency and cost the consumer little if any more than a 10 percent tax on factory-made shoes. As a side observation, is it clear that if the extra proceeds were used to facilitate the retraining and placement of hand workers it would be of less value even from the point of view of the employment problem? (iii) A minor possible source of additional revenue that would have favorable effects on efficiency is the auctioning off of licenses to use foreign exchange suggested as a possibility below.

THE FOREIGN EXCHANGE PROBLEM

The Foreign Exchange Gap

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

Exchange Controls

The existing structure of exchange-controls and their associated system of import and export licenses and of discrimination between sources of purchases, seem to this writer a major obstacle to the growth and progress of the Indian economy. They involve waste and inefficiency in the use of foreign exchange. They introduce delay, uncertainty, and arbitrariness into domestic business activities. They impose on officials in charge of exchange control a task that is bound to be discharged most imperfectly, however able and devoted the officials may be. The criteria the officials use-and must use-tend to perpetuate the *status quo ante,* and therefore constitute an obstacle to dynamic change and adaptation in an area that traditionally has been one of the most dynamic sectors in the economy and the source of much of the impetus to change. Exchange controls necessarily involve the indiscriminate distribution of implicit subsidies to those granted import licenses, and they lend themselves to abuse as a means of granting administrative protection from foreign competition to inefficient or monopolistic domestic producers.

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

Alternatives to Exchange Controls

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

It would be preferable to avoid this auctioning system as well. While it eliminates any distortion in the pattern of imports, it does not produce the appropriate adjustment of exports to imports. Only two other basic alternative modes of adjustment to changes in the conditions of external trades are available: first., to inflate or deflate internally in response to a putative surplus or deficit in the balance of payments; second, to permit the exchange rate fluctuate. At least in the present worldwide monetary conditions the first is not desirable economically, since it puts internal conditions of trade at the mercy of changes in external conditions these are about as likely to result from vagaries in the internal policies of other countries as from changes in the 'real' conditions of trade. The preferable method is to let the exchange rate be determined in a free market-the method of a floating exchange rate that has been adopted by Canada with such conspicuous success.

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

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

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

Foreign Assistance

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

CONCLUSION

If these comments have concentrated largely on the financial machinery of economic organization, it is not because that is the only or even the most important problem facing India but rather because, on the one hand, it is more within this writer's special competence, and on the other, it seems to be the area in which current policy can be improved most. The present writer is convinced that the fundamental problem for India is the improvement of the physical and technical quality of her people, the awakening off sense of hope, the weakening of rigid social and economic arrangements, the introduction of flexibility of institutions and mobility people, the opening tip of the social and economic ladder people of all kinds and classes. And what gives an outsider like t writer a feeling of optimism and hope about the future of India makes one feel that India is on the move and will continue move, is that so much is being done and such a good beginning has been made on this fundamental problem of creating the human and social basis for a dynamic and progressive economy.