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*Part II*

# **The Anatomy of Exchange Control**



# **Import Control Policy: Criteria for Allocation and Effects**

This chapter considers the methods of administering imports that were generally in vogue during the period 1956–66. These methods were modified in favor of more flexibility in the period since 1966, but by 1969–70 the QR-regime had *de facto* regressed in the direction of the earlier methods reviewed here with only modest improvements.

We intend to describe the criteria used in the allocation of imports and to discuss their general economic implications.<sup>1</sup> More detailed statistical analysis of the implications for allocation of investments and capacity underutilization will be deferred until Chapter 13 in Part IV; later chapters in Part IV will also be addressed to an analysis of the QR-regime.<sup>2</sup> In the next chapter, we complement our analysis of the anatomy of import control with an analysis of the anatomy of export promotion until 1966 and its broad economic implications. And Chapter 4 brings together several of the partial, halting measures taken before the June 1966 devaluation to soften the restrictiveness of exchange and industrial licensing.

## **CRITERIA FOR ALLOCATION OF FOREIGN EXCHANGE**

We begin this chapter with a description and analysis of the criteria of allocation used in India, as part of the import and exchange control policy during 1956–66, to divide up the available foreign exchange among competitive users. These methods, which involved essentially the operation of a tight

regime of import (and complementary exchange) restrictions, were put into operation especially after the 1956–57 exchange crisis.

### **Organization and Procedures.**

The import and exchange policy regime, throughout this period, aimed at comprehensive, direct control over foreign exchange utilization. Thus administrative decisions had to be made over the allocation of foreign exchange for practically all uses in the economy. For the overwhelming bulk of imports, the government (except for a beginning in this direction after the budget in 1965) did not explicitly aim at using tariffs either to siphon off the resulting import premia or to regulate imports via the price mechanism, the only well-known exceptions being crude rubber, pulp and waste paper, cotton and kerosene. Reliance on the direct allocative mechanism was thus almost complete during this period.

The allocation of permissible imports was broadly by two administrative categories: private sector and public sector. Further, there was an important operational distinction between imports of raw materials, spares and components as against imports of capital goods and equipment. The allocation of different permissible imports by these categories among industries, and further still by firms and plants, was carried out by an elaborate administrative machinery which evolved through the period. Since the details of this evolution are of little economic significance, we confine ourselves here to describing the system as it was at its peak, around 1965, when it began to be "liberalized" gradually into the somewhat major changes that came with the devaluation of the rupee in June 1966.

For every six months, April 1 to September 30, and October 1 to March 31, the Foreign Exchange Budget Branch of the Department of Economic Affairs in the Ministry of Finance would prepare its estimate of available foreign exchange for the six-month period. When the first charge expenditures such as debt repayments and Embassy expenditures had been netted out, the residual estimate of available foreign exchange would have to be allocated among different users. Food, fertilizers, petroleum, oil and lubricants (POL) and defense would normally be pre-empted first.

The administrative allocation, at the next stage, was essentially at three points: (1) an allocation was earmarked for the different public sector undertakings, for both raw materials and equipment, and was assigned to the ministries within whose domain they lay; (2) the Iron and Steel Controller would get a bulk allocation; and (3) the Economic Adviser, Ministry of Commerce, would get a bulk allocation for the private sector's imports of raw materials, spares and components (excluding, among other things, iron and steel, newsprint and POL).

The industry and unit-wise allocations, under each of these heads, involved a variety of bodies. Frequently, the same unit would receive import allocations from different agencies: iron and steel from the Iron and Steel Controller, non-ferrous metals from the corresponding ministry department, other inputs from the bulk quota of DGTD (Directorate General of Technical Development) in the Ministry of Industry, and so on.

The licensing procedures, through which each unit had to process all imports, involved three license-issuing authorities: (1) The Chief Controller of Imports and Exports (CCI&E), (2) The Iron and Steel Controller (I&SC), and (3) The Development Officer (DO), Tools, Development Wing of the Ministry of Commerce and Industry. Except for iron and steel (cleared by the I&SC), and certain types of machine tools (licensed by the DO), the CCI&E controlled the issuance of all other licenses.

The licenses issued by the CCI&E, which constituted the main bulk, were divided into the following categories: (1) *established importers* (EI); (2) *actual users* (AU); (3) *new-comers* (not covered by EI and AU); (4) *ad hoc* (covering items such as State Trading Corporation imports); (5) *capital goods* (CG); (6) *heavy electrical plant* (HEP); (7) *export promotion*, given as import entitlements to exporters in specific schemes; (8) *miscellaneous categories*: such as *Railway Contract* (relating to orders placed by the Railways), *Replacement Licenses* (to replace defective or unsuitable imports) and *Blanket Licenses* (mainly for POL).

The procedures followed for each category of licenses, and the authorities involved in the process, reflected two major criteria: (1) the principle of "essentiality"; and (2) the principle of "indigenous non-availability." Thus imports, in terms of *both* magnitude and composition, were to be permitted under each category only if some designated agency of the government had certified that they were "essential" (as inputs or equipment for production). At the same time, some agency had to clear the imports from the viewpoint of indigenous availability: if it could be shown that there was domestic production of the imports demanded, then the imports were not permitted (regardless of cost and quality considerations). Thus, in addition to the license-issuing authority, there was a "sponsoring" agency certifying "essentiality" and a "clearing" agency for "indigenous clearance."

For *public sector* applications, the procedures were basically similar. Paradoxically, the procedures were even more complex at times—as when the sanction of the Department of Economic Affairs had to be obtained, *in addition* to indigenous clearance and essentiality certification, for many applications for raw material imports. Besides, in certain cases, the project authorities themselves had the authority to grant indigenous clearance and essentiality certificates. But these and others were, by and large, differences of detail.

### **Principles and Criteria of Allocation.**

The allocation of foreign exchange among alternative claimants and uses in a direct control system such as that just described would presumably be with reference to a well-defined set of principles and criteria based on a system of priorities. In point of fact, however, there seem to have been few such criteria, if any, followed in practice. We shall examine, in particular, the allocations arising from AU licensing.

There are basically two questions of economic significance which need to be asked here: (1) how were allocations by industry decided? and (2) how were these allocations further divided up among the constituent firms or units? We shall examine each of these questions in turn.

#### ALLOCATIONS BY INDUSTRY

As far as the allocations by industry were concerned, it is clear that the sheer weight of numbers made any meaningful listing of priorities extremely difficult. The problem was Orwellian: all industries had priority and how was each sponsoring authority to argue that some industries had more priority than others?

It is not surprising, therefore, that the agencies involved in determining allocations by industry fell back on vague notions of "fairness," implying *pro rata* allocations with reference to capacity installed or employment, or shares defined by past import allocations or similar other rules of thumb.

#### ALLOCATIONS BY UNIT

The principles and criteria adopted for further subdividing industrial allocations among constituent firms or units were equally without any rationale other than the spreading-out evenly of a scarce resource on a "fair" and "equitable" basis. There was a great variety of norms used, with significant possibility and occasional exercise of discretion. But the overwhelming bias of the system was toward some form of "equitable" allocations and cuts therein. This conclusion holds, not merely for the DGTD but also for small-scale sector allocations, the scheduled industries not on the books of the DGTD and the other classes of import applicants.

### **Quality of Information for Assigning Priorities.**

As we have already noted, numerous authorities were involved in the licensing procedure: sponsoring bodies, authorities granting indigenous clearance and actual license-issuing authorities. Each such authority presumed to act on some set of priorities, in principle, and therefore had to have reasonable information so as to enable it to exercise its functions meaningfully.

Although it was impossible to have a meaningful, well-defined set of priorities at any level in this bureaucratic machine, except in relation to overriding matters such as defense, no allocations were ever made without intensive scrutiny and examination of individual applications at each stage in the bureaucracy. The quality of the information on which these examinations and ensuing decisions were presumably based can be inferred from what is known about (1) the small-scale sector applications and (2) the working of the DGTD concerning imports.

#### SMALL-SCALE SECTOR

The State Directorates of Industries were the authorities which were supposed to process the import applications in the first instance and to attach Essentiality Certificates (ECs). While considerable time was indeed taken in granting these ECs, the quality of the information on which the relevant decisions had to be made was poor.<sup>3</sup>

#### DGTD

The case of the DGTD was hardly any better, despite its obvious advantages over the Directorates in charge of the small-scale sector. It is well known, for example, that capacity as well as capacity utilization data, both of which ostensibly were taken into account in making unit-wise allocations, are bad. Similarly, with respect to those units which must seek indigenous clearance from the DGTD, the DGTD directorates frequently maintained incomplete records of the indigenous suppliers, did not have sufficient information in adequate detail on what these suppliers could produce and of what quality, did not distinguish adequately between the mere fact of the existence of an indigenous supplier and the availability of the supply to an individual purchaser, and thus ended up occasionally withholding sanction even for critical imports.

The DGTD not merely tried to secure indigenous clearance prior to permitting imports but even seemed to determine the quantitative mix of permissible imports in many cases. Clearly the DGTD had, in the nature of the case, no capacity to form reasonable judgments on this issue in the absence of very detailed information on plant conditions—something that was automatically ruled out when we see that the DGTD carried on its book (1965) over 5,000 units.

#### **Priority in Favor of the Small-Scale Sector.**

While, however, clear criteria for the allocation of imports among alternative uses were generally conspicuous by their absence and the informational basis for decision-making was exceptionally weak, it might be con-



tended that certain broad priorities were pursued by the authorities. Thus, a typical defense of the import control system was that it was the only way of ensuring that supplies went on a "fair and equitable" basis to "small" entrepreneurs. This is not an argument for economic efficiency; but it is a valid argument for income redistribution *if* alternative ways of subsidizing the smaller entrepreneurs are not feasible.

But it is extremely difficult to take this defense of the import control system seriously. In point of fact, there is reason to conclude that the control system discriminated against the small-scale sector, as when import cuts in face of a sudden accentuation of the foreign exchange shortage fell relatively more acutely on the small-scale sector and much less on the (well-connected) larger firms. It does not follow, of course, that the small-scale sector would have either secured greater allocations or been more competitive if it had had to purchase imports in a free market. On the other hand, it does cast doubt on the usual claim that the import control system made the small-scale sector better off than under the alternative import regimes.<sup>4</sup>

### **Foreign Exchange Saved from Being Spent on Consumption.**

It might be contended that the import policy regime was directed at preventing scarce foreign exchange from being "frittered away" on consumer goods and that this general priority was strictly maintained by the import-licensing authorities. It is certainly true that, over the period of our study, direct imports of consumer goods were slashed. This was reflected in the steady reduction of EI licenses and the growth of AU licenses granted to producers. However, two important points concerning this question need to be made.

1. While imports of manufactured consumer goods indeed went down, it is pertinent to note that these were frequently offset by growth in domestic production of the same and other consumer manufactures. In the present context, where we are discussing the allocation of "maintenance" imports (i.e., imports of raw materials and intermediates), the following further point needs to be noted.

2. The maintenance imports necessary to support current production of domestic consumer goods industries were not negligible. Hazari has worked out estimates of the direct and indirect import requirements of consumption in India, divided by these two groups. He finds, for the years 1961-62 and 1963-64, that the proportion of *total* imports which went to support the level of consumption of "luxuries" was 7.6 and 8.5 percent, and that of "necessities" was 28.7 and 32.9 percent, respectively.<sup>5</sup>

In any event, it seems that, irrational as it may be to seek to prohibit imports of "inessential" consumer goods while permitting their production domestically, even such an objective could have been as readily achieved,

with none of the other detrimental effects of a full-fledged control system embracing all transactions, by a selective set of prohibitive tariffs or quotas on specific items sought to be excluded from imports.

### **Corruption and Frustration of Apparent Priorities.**

We have noted that the import control system worked on (1) incomplete and unsystematic information and (2) lack of any discernible economic criteria. Further, whatever limited allocational aims it may have had were frustrated, in varying degrees, by the corruption that inevitably arose from the large premia on imports under the control system.

There are essentially two different kinds of illegality which the control system generated: (1) since imports were remunerative in general, there were innumerable bogus claims to import license entitlement under the existing rules of allocation; and (2) since numerous restrictions obtained with respect to transferability of imports and import licenses, black markets arose to transact such illegal traffic. It has not been possible for us to quantify any of these illegal transactions in a meaningful manner, but there is little doubt that they existed widely.<sup>6</sup> We should also note that these illegal transfers of imports often must have served to increase economic efficiency by reducing the irrational inflexibility that the legal restrictions on transferability entailed.

## **ECONOMIC EFFECTS OF IMPORT CONTROLS**

What were the economic consequences of these methods of allocating foreign exchange in India's QR-regime? While we consider the consequences for resource allocation and capacity utilization, and the growth effects on savings, research and development, quality of production, inducement to invest and other aspects of India's economic performance in Part IV, we note here several other, mainly adverse, effects. In particular, we will consider: (1) delays, (2) administrative and other expenses, (3) inflexibility, (4) lack of coordination among different agencies, (5) absence of competition, (6) inherent bias in favor, *ceteris paribus*, of industries with imported, as distinct from domestically produced, inputs, (7) anticipatory and automatic protection afforded to industries regardless of costs, (8) discrimination against exports and (9) loss of revenue.

### **Delays.**

The working of any system of allocation will take a certain amount of time. Even if a free foreign exchange market were to operate, the participants in the market would have to expend time, for example, in acquiring informa-

tion about availabilities of different kinds of foreign exchange. In principle, the administrative system of allocations need involve no significant increase in time, and hence in "delays," over a price system under which scarce foreign exchange is rationed out in the market: the introduction of priorities would, in principle, be equally time-consuming in both cases, though the procedure would be different, since the price system would involve administrative decisions as to tax and subsidy incentives whereas the control system would involve administrative decisions as to quotas.

In practice, however, the exchange control system seems to degenerate into an inordinately time-consuming allocational device. There are essentially three reasons for this. (1) In a situation of general scarcity of foreign exchange, the definition of priorities becomes exceptionally difficult, as we have seen earlier, and the system ends up having to accommodate all conceivable demands on some "equitable" basis, while making a pretense of administering priorities, this pretense frequently taking the form of collection of yet more information from applicants and time taken in "scrutinizing" it and "arriving at an informed decision." Delays become, sociologically, the "conspicuous" substitute for exercise of priorities by the bureaucracy. (2) Equally important, the multiplication of the bureaucratic apparatus leads inevitably to files failing to move quickly and decisions being delayed because procedures are time-wasting. As we shall see shortly, much of the delay to which the Indian import-control system was subject can be put down to the inefficiency of administrative procedures. For example, where indigenous clearance had to be obtained by the DGTD from two or more other directorates, these were to be sought sequentially rather than simultaneously. (3) Finally, some significance must be attached, in explaining delays under the Indian allocation system, to the fact that, with files often moving from the bottom to the top in the Indian administrative system, they often fail to move until appropriate graft is paid to the lower-level clerks. If all graft were paid promptly, there should be no delay on this account; but newcomers and honest applicants are unlikely to conform readily to this widespread practice, hence delays occur on this count in the system as well.

### **Administrative and Other Costs.**

The elaborate bureaucratic machinery for operating the licensing mechanisms undoubtedly involved direct costs as also the costs resulting from the necessity for actual and potential entrepreneurs to maintain elaborate and frequent "contacts" with the licensing authorities. Admittedly, alternative allocation mechanisms also must necessitate "administrative" and information-gathering costs. But the specific type of "command" mechanism involved in the Indian QR and industrial licensing regimes added to these costs by mak-

ing necessary expenditures to ensure "file-pushing" by bribe-seeking bureaucrats at lower levels, for example. It is highly dubious, for example, that the considerable growth of Indian Airlines traffic into Delhi from the major industrial cities such as Calcutta and Bombay and the growth of the license-allocating bureaucracy in Delhi and elsewhere are anything but a net cost attributable to the regime. And if we could only disentangle (as we cannot) the job expansion in the bureaucracy which has resulted from the licensing machinery, much of the enormous expansion of current governmental expenditures during 1956-71 may turn out to be a net cost of the regime.

### **Inflexibility.**

The twin principles of "essentiality" and "indigenous non-availability" also imparted considerable inflexibility to the pattern of utilization of imports. This occurred via a rigid itemization of permissible imports, frequently by specified value for different items, both for AU and EI licenses.

At the same time, the theoretical premise that AU allocations were being made on the basis of well-defined priorities at the detailed industry level led the authorities to rule out legal transferability of the licenses among the different industries; and bureaucratic logic took the inevitable next step and eliminated transferability even among units within the same industry, thus making AU licenses (legally) *altogether* non-transferable by the licensee units. Needless to say, none of the imports under the AU licenses were allowed to be legally resold either (but were occasionally sold in the black market, of course).

The rigid pattern of permissible imports (only occasionally adjusted through changing the contents of the lists by discretionary action) and the non-transferability of the AU licenses and imports thereunder were bound to create inflexibility leading to economic inefficiency because:

1. the *total* AU allocations to individual units were neither made by well-defined priorities nor based on assessment of reasonably accurate and analyzed information, but were mostly based on notions of "fair sharing" with occasional injection of "pragmatism" and "judgment of cases on merits";
2. the *itemized* breakdowns were based on (a) indigenous non-availability which, as we have noted, was assessed with inaccuracy by the responsible bodies such as the DGTD, and (b) these bodies' assessment of the optimal mix of imported inputs, which again was more on an administrative and *ad hoc* basis than on any recognizable criterion of economic efficiency; and
3. there is considerable uncertainty about the availability of foreign exchange, leaving aside the general unpredictability of the entire economic situation, so that no "optimal mix" of inputs laid down in advance (even if worked out on the basis of well-defined criteria, accurately gathered avail-

able information and explicitly assumed future developments) can hope to be optimal *ex post*, thus requiring flexibility in the matter of the input-mix and transfers of inputs from one set of users to another.

Yet another implication of the inflexibility arising from the non-transferability of import licenses might have been an excessive holding of inventories by Indian firms. Indian inventories, especially the raw materials and intermediates held, compare unfavorably with those of firms in similar industries elsewhere. However, other factors on the Indian scene probably explain these large inventories. For example, interest rates in the Organized Industrial Sector are quite low, thus making inventory-holding relatively inexpensive; on the other hand, it is not clear that the relevant Indian interest rates (real or nominal) have been significantly lower than abroad. Lower efficiency in transport (and shortage thereof) would also make inventory-holding more valuable. Furthermore, inventory holdings, including raw materials and intermediates, appear to have declined (as a proportion of output) generally through the period of our study, for many industries.<sup>7</sup> Hence, while it makes *a priori* sense to argue that, *ceteris paribus*, an import control regime of the Indian type would tend to inflate inventory holdings, it would not be correct to argue that the empirical analyses currently available support this hypothesis.

### **Lack of Coordination among Different Agencies.**

The multiplicity of agencies dispensing imports further accentuated the difficulty in procuring desired imports on the part of the applicants. For example, the typical unit under DGTD jurisdiction would get its share in the bulk allocations by the Economic Adviser to the DGTD and would *also* get allocations of iron and steel from the I&SC's office as well as non-ferrous allocations from decisions made by the corresponding department (which, in turn, got bulk allocations for this purpose). Unfortunately, coordination of these allocations, either in initial allocations or in cuts therein, does not appear to have been a routine matter.<sup>8</sup>

### **Absence of Competition.**

In addition, the import allocation system in force had virtually eliminated the possibility of competition, either foreign or domestic. Foreign competition was ruled out because of the principle of "indigenous availability": every item of indigenous production, no matter how much its cost of production exceeded the landed c.i.f. price, was automatically shielded from competition through imports, indeed the onus being put on the buyer to show conclusively that he could not procure the item from indigenous producers.

At the same time, the possibility of domestic competition was, in turn, minimized by the combination of CG licensing (concomitantly with other industrial licensing provisions) and the method of AU licensing on a "fair-share" basis among rival firms in an industry. Strict CG and industrial licensing eliminated free entry by new firms as well as efficiency-induced expansion by existing firms. And the fact that each firm was entitled to its "share" of AU licenses, and no more, ensured that the efficient firms could not even (legally) enlarge output from existing capacity by competing away the scarce imports from less efficient firms.

Thus, all forms of effective competition, potential and actual, were virtually eliminated from the industrial system. The effects, therefore, were (1) to eliminate incentives to reduce costs per unit of output (as the penalty for sloppy operations was no longer incapacity to survive against more efficient rivals) and (2) to prevent production from being concentrated in the most efficient units (and industries).

### **Bias in Favor of Industries Using Imported Inputs.**

Under the actual-user system of allocation of imports, combined with the principle of indigenous non-availability, it may be expected that the *quantum* of import allocations would, *ceteris paribus*, tend to be inversely related to the availability of indigenously produced inputs.

But this, in turn, would lead to a bias in the effective incentive provided to the processes using relatively more imported inputs: they would be able to get relatively greater allocations of imports under AU licenses and hence obtain these inputs at import-premium-*exclusive* prices (which would include only the explicit tariff duty) whereas the other industries would have to buy import-substitute, indigenous items at premium-*inclusive* prices (since these items would fetch a price equal to the c.i.f. prices plus the import premium). The effective incentive given to the former industries or processes would thus be greater, other things being equal. And, while it may fortuitously be the case that some of these industries may require relative subsidization on economic grounds, there is no gainsaying the fact that the import system in India gave rise to these differential incentives purely as an incidental side effect.

### **Anticipatory and Automatic Protection to Industries.**

Another significant impact of the Indian import policy, under which the principle of indigenous availability was used to exclude or restrict imports in favor of purchase of domestic import-substitutes, was that protection was automatically extended to all industries regardless of cost, efficiency and comparative advantage. This automatic protection was further fully to be anti-

pated by every producer, merely as long as he was willing to make his capacity and production known to the relevant agencies (e.g., the DGTD) in charge of "indigenous clearance."

The influence of this policy on the pattern of industrial investments that emerged through the period must have been considerable. It is clear that the policy of anticipatory and automatic protection that inhered in the working of import policy served to divorce market-determined investment decisions from any guidelines that international opportunity costs (with suitable modifications) might have otherwise provided.

### **Discrimination against Exports.**

Our analysis of the import-control policy would be incomplete if we were not to mention the rather obvious fact that such a system discriminates against exports. The effective export exchange rate, on the average, was inevitably less than the effective import exchange rate (Table 2-1); and this was the case at the level of each industry also, until (from around 1962) the initiation and later intensification of significant export subsidization schemes began to redress, though not restore, the balance (and, in some cases, must have even led to a net subsidization rate in excess of the import rate).

Again, one of the important side effects of the principle of indigenous availability was that exportable items which therefore had to be manufactured with inferior-quality domestically produced inputs and capital equipment were, in turn, faced with enhanced difficulties in the highly competitive international markets. This was particularly the case with the new exports in the engineering industries, which in any case faced serious difficulties in cultivating foreign markets almost from scratch.

Further, since there was little flexibility for getting more inputs through bidding in the market, in view of the restrictive character of the import policy, and capacity also could not be expanded owing to equally stringent controls on entry, industries which needed flexibility in production in order to get hold of large foreign orders, whenever available, found themselves unnecessarily handicapped.

Clearly, from the beginning of the Second Plan until late 1964, the entire industrial licensing and import policy was unfavorable to manufacturing exports largely because it was devised with a substantially inward-looking bias.

### **Loss of Revenue.**

Another noteworthy and obvious effect of the import-control system was the inevitable loss of revenue that it involved in passing the profits on scarce imports on to the private sector.

TABLE 2-1  
EERs, PLD-EERs and PPP-EERs for Indian Exports and Imports during 1950-71

Year (1)	I <sup>e</sup> (2)	I <sup>p</sup> (3)	Imports		
			EER (4)	PLD-EER (5)	PPP-EER (6)
1950	0.823	0.773	5.58	6.79	8.78
1951	0.906	0.911	5.46	6.02	6.61
1952	0.793	0.909	5.56	7.01	7.71
1953	0.786	0.876	5.69	7.24	8.27
1954	0.752	0.873	5.78	7.69	8.81
1955	0.691	0.891	5.66	8.19	9.19
1956	0.775	0.923	5.56	7.17	7.77
1957	0.821	0.954	5.42	6.60	6.92
1958	0.838	0.960	5.37	6.41	6.67
1959	0.872	0.966	5.43	6.23	6.45
1960	0.929	0.975	5.41	5.82	5.97
1961	0.950	0.987	5.61	5.91	5.99
1962	0.961	0.996	5.76	5.99	6.02
1963	1.000	1.000	6.06	6.06	6.06
1964	1.105	1.010	6.19	5.60	5.55
1965	1.195	1.032	6.63	5.55	5.38
1966	1.338	1.060	9.23	6.90	6.51
1967	1.539	1.063	9.02	5.86	5.52
1968	1.531	1.078	8.97	5.86	5.43
1969	1.563	1.121	9.06	5.80	5.17
1970	1.660	1.168	9.45	5.69	4.88
1971	1.723	1.222	9.70	5.63	4.61

(continued)



TABLE 2-1 (concluded)

## Exports

Year (1)	$\alpha = 0$		$\alpha = 0.05$		$\alpha = 0.10$		$\alpha = 0.20$		
	EER (7)	PLD-EER (8)	EER (9)	PLD-EER (10)	EER (11)	PLD-EER (12)	EER (13)	PLD-EER (14)	PPP-EER (15)
1950	4.39	5.33	4.46	5.42	4.53	5.50	4.67	5.67	4.40
1951	4.17	4.61	4.24	4.68	4.31	4.75	4.44	4.90	4.35
1952	4.30	5.43	4.37	5.51	4.44	5.60	4.53	5.78	5.21
1953	4.42	5.62	4.49	5.71	4.56	5.80	4.71	5.99	5.27
1954	4.43	5.89	4.50	5.98	4.57	6.07	4.70	6.25	5.45
1955	4.47	6.46	4.54	6.57	4.61	6.67	4.75	6.88	6.11
1956	4.54	5.86	4.62	5.96	4.69	6.06	4.85	6.26	5.76
1957	4.54	5.53	4.69	5.71	4.84	5.89	5.14	6.26	5.97
1958	4.59	5.48	4.75	5.67	4.91	5.86	5.22	6.23	5.94
1959	4.65	5.34	4.77	5.47	4.89	5.61	5.13	5.88	5.62
1960	4.67	5.03	4.85	5.22	5.02	5.41	5.38	5.79	5.60
1961	4.68	4.92	4.85	5.11	5.03	5.29	5.38	5.66	5.57
1962	4.70	4.89	4.88	5.08	5.06	5.26	5.41	5.63	5.59
1963	4.75	4.75	4.93	4.93	5.12	5.12	5.49	5.49	5.49
1964	4.75	4.30	4.94	4.47	5.12	4.64	5.50	4.97	5.05
1965	4.75	3.98	4.94	4.14	5.13	4.29	5.51	4.61	4.79
1966	6.79	5.08	6.95	5.20	7.12	5.32	7.44	5.56	5.93
1967	6.78	4.41	6.95	4.52	7.12	4.63	7.47	4.85	5.22
1968	7.08	4.62	7.25	4.74	7.43	4.85	7.78	5.08	5.58
1969	7.15	4.57	7.34	4.70	7.54	4.82	7.92	5.07	5.73
1970	7.20	4.34	7.39	4.45	7.57	4.56	7.93	4.78	5.64
1971	7.18	4.16	7.38	4.28	7.57	4.40	7.95	4.63	5.65

NOTES: 1.  $EER$  = Effective Exchange Rate. This is calculated for exports by taking into account the export duties and dividing the figure for duties collected by total exports and so deriving the average duty rate for exports in each year. As for export subsidies, on non-traditional exports, we will see later in this volume that these were given in various ways and are impossible to quantify with any degree of accuracy. Hence we have taken three subsidy rates ( $\alpha$ ) at 5, 10 and 20 percent to arrive at subsidy-inclusive  $EER$ s. We would argue that the  $EER$ s up to 1962 are best treated as ones not involving any subsidy; the 1962-64 are probably best taken as involving 5 percent subsidy; 1964-65 as involving 10 percent subsidy; and 1965-66 as involving 20 percent subsidy. Since the revival of subsidy after the June 1966 devaluation took a little time, it is best again to think of the transition through export subsidy rates at 5, 10 and 20 percent through the years 1966 to 1971.

2.  $I_t$  and  $I_t^p$  are the Indian wholesale price index and the (import-share) weighted partner-country wholesale price index, respectively. 3.  $PLD-EER$  is obtained by deflating the  $EER$  by  $I_t$ .

4.  $PPP-EER$  for imports is obtained by multiplying the  $PLD-EER$  by  $I_t^p$ . For exports, an alternative price index, reflecting partner-country weights in *exports*, was constructed and similarly utilized.

5.  $EER$  for imports takes into account only the average tariff rate, computed as the duty collected divided by total imports. It excludes the premium on imports. This premium has been difficult to obtain with any degree of reliability because of the enormous number of (non-transferable) import licenses involved: as we have discussed in Chapters 2 and 3. It may be noted here that the import premia have often been close to 100 percent during most of the 1960s.

SOURCES: *International Financial Statistics*, December 1969, July 1971, 1972 Supplement, January 1973, International Monetary Fund. *Direction of Trade*, annual issues, 1950-53, 1954-57, 1958-62, 1960-64, 1966-70, International Monetary Fund. *Statistical Yearbook*, 1972, United Nations. *Basic Statistics Relating to the Indian Economy*, 1950-51, 1966-67, 1950-51 to 1968-69, 1950-51 to 1970-71, Government of India, Department of Statistics, Statistics and Surveys Division, New Delhi. *Explanatory Memorandum of the Central Government Budget*, annual issues from 1952-53 to 1973-74, Government of India, Ministry of Finance, New Delhi.

(1) Where the imports were channeled through traders, as with EI licenses, there is little reason to doubt that the import premium fully reflected the scarcity value of the items. It may therefore be expected that, if the government had channeled these imports through its own agencies *or* auctioned them off *or* levied suitable tariffs, the scarcity premium would have accrued to it as revenue.<sup>9</sup>

(2) For the AU imports, it may again be expected that the entrepreneurs who obtained them would nonetheless proceed to charge for their outputs the prices that the market would bear. Hence, the effect of raising tariffs by the "implicit" premium on AU licenses, for example, would not generally have been to affect the price of the outputs but merely to cut into the profits that accrued to the entrepreneurs purely as a result of access to scarce inputs. However, under cost-plus pricing, this result would not follow and it could not be argued that there was a simple loss-of-revenue effect thanks to the import-control system. In view of the fact, however, that several import premia got seriously reduced without there being a significant rise in final prices, subsequent to the devaluation of June 1966, we are inclined to argue that profit maximization, rather than cost-plus, seems to be a better approximation to the behavior of Indian firms.<sup>10</sup>

### **Distributional Impact.**

We may finally touch on two important "distributional" questions that have been raised in defense of the direct-allocational system of import regulation used in India.

1. It has, for example, been argued that the method of AU allocations such that each unit gets *some* share of the scarce imports ensures that employment is not eliminated in inefficient units which would, under an alternative (market) system, fail to bid successfully for the imports. Concerning this argument, we may quote what one of us wrote elsewhere.<sup>11</sup>

This argument, however, assumes that the increase in employment in the efficient firms which get more inputs under the [market system] is less than the decrease that accompanies the failure of the inefficient to get exchange (which may be true if the inefficient firms are labour intensive). It should also be remembered that a policy that creates extra real income will promote greater capital formation and employment in the longer run.

2. The other argument is superficially more difficult to dispute. It relates to the fact that *regional* constraints in a country such as India make it impossible to leave allocations of scarce imports (and materials) to the market. Since value is attached by each state to production and investment in themselves, it is not possible to take the position that allocations should be by

economic criteria alone and that income transfers should be made as compensation to the states that do not attract inputs or investments. In short, the problem of allocating resources in a federal country such as India involves economic solutions similar to those that would have to be provided in customs unions or free-trade areas among sovereign countries where constraints have to be provided in the shape, for example, of the distribution of manufacturing investments as a whole among the constituent countries.

But if this is indeed the case, the question again is whether the "subsidization" of the states that are likely to "lose" in a system of market-ruled allocations of AU imports should be undertaken through an import-control regime with all the disadvantages we have discussed or whether it is not more sensible to achieve the politically required allocations among regions or states by direct subsidization policies, such as differential corporation taxes among regions, which would at the same time permit the import policy to be run on sounder lines. We have little doubt, in the light of our analysis, that this latter would be very much the better course.

## NOTES

1. This chapter draws on the more detailed analysis in Bhagwati and Desai, *India*, pp. 281-334. It may be read in conjunction with Part IV for a continuous and comprehensive analysis of the total economic impact of India's import control methods.

2. See Chapters 6, 7 and 9 for further discussion of export policies and performance since the June 1966 devaluation. Chapter 14 deals with the economic implications of an improved export performance (made possible by a change in India's QR-regime) within the framework of a multi-sector, multi-period planning model.

3. For evidence see the *Report of the International Perspective Planning Team on Small Industries* (1963) and the *Report of the Raj Committee on Steel Control* (1963). While their critical observations mainly concerned the distribution of scarce domestic materials, there is no reason to expect that the allocation of import licenses by state directorates was any more systematic or informed.

4. For a discussion of the discrimination against the small-scale sector that is intrinsic to the operation of the import control mechanism, see Bhagwati and Desai, *India*, pp. 281-311.

5. B. R. Hazari, "The Import Intensity of Consumption in India," *Indian Economic Review*, October 1967.

6. We were unable to successfully use the partner-country-data comparison technique to detect faked invoicing of imports or exports. For a discussion of this technique and the problems in using it, see the contributions by Bhagwati, Richter and Morgenstern in J. Bhagwati, ed., *Illegal Transactions and International Trade: Theory and Measurement* (Amsterdam: North-Holland Publishing Co., 1974).

7. Note, however, that a declining ratio of inventories to output with reduced foreign exchange under the QR-regime does not necessarily contradict the hypothesis that such reduction under the QR-regime leads to a higher ratio than such reduction without a QR-regime.

8. It is arguable, of course, that coordination procedures may have led to more delays; but we doubt this and rather think that sequential clearances are likely to have been more dilatory.

9. Indeed, this is what it sometimes, but all too infrequently, tried to do when it transferred the import trade in certain high-premium commodities to the State Trading Corporation, as with caustic soda. However, even with STC imports, frequently the STC did not charge the buyers full premium.

10. Of course, the post-devaluation situation was also characterized by a significant increase in availability of imports for AU licensing, thanks to foreign aid, and soon thereafter large-scale recessionary tendencies also reduced the demand for imports. However, the immediate import effect in the three months after the devaluation was not affected by these complications and does seem to support the conclusion in the text.

11. J. Bhagwati, "Indian Balance of Payments Policy and Exchange Auctions," *Oxford Economic Papers* (February 1962).