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Chapter 3

Export Policy and Performance, 1951-66

The preceding analysis of import control may now be complemented by the analysis of export policy, to fill out the total picture of the anatomy of the trade and exchange rate regime in India.[1] Our analysis will embrace the period 1951–66 although our main focus will be on the sub-period 1956–66. From the viewpoint of the anatomy of export policy, it is useful to think of this sub-period as divided into Phase I: 1956–62, and Phase II: 1962–66. The former period is characterized by an essentially passive export policy; the latter by a growing attempt at export subsidization to offset the effects of the overvaluation of the exchange rate.

We shall begin with a brief analysis of export performance during Phase I, but extend the period back to Phase IV, 1951–56, so as to draw on earlier work by Manmohan Singh.[2] Then, in considering Phase II, we shall draw on the work of Bhagwati and Desai and throw into sharp relief the criteria of export subsidization and the economic efficiency thereof. This period represents an ideal research area for understanding the anatomy of export subsidization in the context of an overvalued parity. The reader may further be reminded that in the present volume we extend the analysis of export policies and performance to the post-1966 period in chapters 6, 7 and 9 in Part III, while also examining the economic implications of improved export performance in the framework of a computable planning model in Chapter 14 in Part IV.

EXPORT POLICY AND PERFORMANCE DURING THE 1950s: PHASES IV AND I

The onset of the QR-regime and Phase I, during the Second Plan virtually from its first year 1956–57, is now known to have been accompanied by a significant deterioration in India's export performance. During the First Plan, in Phase IV, the value of Indian exports had collapsed from its Korean War peak in 1951 and had stagnated; and this stagnation continued until 1961, implying a falling Indian share in world exports and a falling ratio of exports to GNP.

This picture is only filled out, rather than substantially altered, if we examine the behavior of export volumes and prices separately over the period. Table 3–1 contains these estimates. These indicate strongly that the First Plan period (Phase IV), while it showed *on the average* an improvement over the previous three years' average export performance, largely achieved this thanks to the large price gain during the two Korean War boom years, 1951 and 1952. On the other hand, there is a continuous though mild improvement in the average export *volume* since 1952, which is masked in the value figures because of the post-Korean War decline in prices. As against this, the Second Plan period (Phase I) shows stagnation in both average prices and volume. For the decade as a whole, leaving out the Korean War boom, the stagnation in both average price and volume is quite striking.[3]

The picture that emerges from the aggregate behavior of export values, volumes, and prices is reflected in the performance of individual commodities. Table 3–2 shows the breakdown of Indian exports by principal commodities through this decade. Table 3–3, containing estimates of the linear regression equation $x = a + bt$ (with x as the export value and t as time) fitted to the data on each item for 1952–53 through to 1960–61, shows that, except for cashew kernels, iron ore and coffee, there is no upward trend of statistical significance to be found in the export performance of any of the commodities.

Further, if we examine the principal export commodities, many of them exhibit not merely a dismal rate of growth of earnings; they are also characterized by a falling share in the world market. We note here that, in five major export items adding up to over 50 percent of total export earnings—jute manufactures, tea, cotton textiles, vegetable oilseeds and oils and unmanufactured tobacco—there was a discernible, and at times considerable, reduction in India's share in world trade.[4]

The detailed analysis, by commodities, of India's faltering export performance through the 1950s by Manmohan Singh has led Bhagwati and Desai to conclude that, except for a few items such as iron ore, this decade's stagnation of export earnings is to be largely attributed to domestic policies which

TABLE 3–1

Export Earnings, Volume and Price Indices, 1948–66

Calendar Year	Value of Indian Exports (U.S. $ Millions) (1)	Export Value Index (1958 = 100) (2)	Export Price Index (1958 = 100) (3)	Export Volume Index (1958 = 100) (4)
1948	1363	112	90	124
1949	1309	107	90	119
1950	1146	94	98	97
1951	1611	132	143	96
1952	1295	106	117	89
1953	1116	91	100	92
1954	1182	97	102	94
1955	1276	104	100	105
1956	1300	106	101	101
1957	1379	113	101	110
1958	1221	100	100	100
1959	1308	107	100	107
1960	1331	109	109	101
1961	1387	114	111	105
1962	1403	115	106	112
1963	1631	134	106	126
1964	1749	143	106	134
1965	1686	138	112	124
1966	1606	132	111	119

SOURCE: *International Financial Statistics,* Supplement to 1966–67 issues, March 1968, International Monetary Fund.

frequently led to falling shares in India's traditional exports and an inadequate expansion of new exports (in the absence of any export promotion on that front).[5] This analysis is also supported broadly by our aggregative regression analysis in Chapter 14 which underlines the role of domestic production and availability (and hence of the price paid to producers which is a function of the effective exchange rate on exports) in explaining the exports of important, traditional items such as tea and jute textiles, and the probable role of the 1966 devaluation in explaining the improved performance of the new, non-traditional exports.

Bhagwati and Desai have made a notional calculation of the loss of export earnings that followed from the failure to maintain export shares. As-

TABLE 3–2

India's Export Earnings from Principal Commodities, 1951–52 to 1960–61

(Rs. millions)

	1951–52	1952–53	1953–54	1954–55	1955–56	1956–57	1957–58	1958–59	1959–60	1960–61
1. Total exports	7,288.9	5,723.0	5,261.6	5,884.7	6.038.5	6,130.3	5,845.2	5,531.9	6,299.0	6,329.4
Commodity composition										
2. Jute manufactures	2,697.3	1,289.2	1,137.6	1,237.8	1,182.5	1,188.1	1,109.2	1,011.5	1,090.0	1,317.2
3. Tea	939.4	808.6	1,021.6	1,477.4	1,091.4	1,451.4	1,136.5	1,296.9	1,290.9	1,235.9
4. Cotton fabrics	521.5	620.6	636.4	633.1	566.3	629.6	584.7	454.8	641.5	576.5
5. Vegetable oils	236.1	255.4	48.9	200.2	343.5	155.9	105.9	63.7	148.1	85.4
6. Iron ore	10.0	37.0	58.2	42.1	62.7	93.1	118.6	96.5	145.9	170.3
7. Manganese ore	156.9	217.6	242.7	129.2	107.2	258.1	297.0	136.4	119.9	140.6
8. Mica	132.1	90.1	79.9	67.2	83.7	87.7	86.6	95.8	100.4	101.5
9. Unmanufactured tobacco	161.4	130.3	110.2	117.6	106.5	124.8	146.3	146.8	135.3	146.1
10. Coffee	5.5	13.9	14.6	76.4	14.9	66.9	67.3	78.9	63.3	72.2
11. Cashew kernels	90.5	129.8	109.9	107.0	129.2	145.3	151.6	158.5	160.5	189.1
12. Manufactured leather	250.2	201.1	249.7	205.8	225.2	209.7	209.2	188.6	304.5	248.5
13. Spices	291.7	205.9	162.0	104.3	93.1	78.0	80.1	80.1	144.6	166.4
14. Coir yarn and manufactures	102.8	71.6	81.5	84.5	89.4	96.9	82.8	82.1	88.6	90.0
15. Raw cotton	136.7	193.3	94.0	101.9	296.9	134.6	90.8	166.2	100.6	70.0
16. Lac	148.7	74.4	67.6	105.5	117.1	94.6	68.5	57.0	62.9	63.2
17. Raw wool	49.0	84.1	58.7	86.1	97.3	104.0	110.8	96.6	122.1	77.2
18. *Subtotal* (2–17)	5,929.8	4,422.9	4,173.5	4,776.1	4,606.9	4,918.7	4,445.9	4,210.4	4,719.1	4,750.1

NOTE: Statistics relate to Indian fiscal years beginning 1 April.

SOURCE: Statistics published by the Director-General of Commercial Intelligence and Statistics, Calcutta. Reproduced from Bhagwati and Desai, *India*, p. 372.

TABLE 3–3

Linear Regression Equations for Export Volume and Price Indices and Selected Export Earnings, 1948–61

Item Regressed on Time (Equation: $x = a + bt$) (1)	Period (2)	Unit (3)	Estimated Coefficients and Their Standard Errors: Constant Term (a) (4)	Regression Coefficient (b) (5)
1. Value of Indian exports	1948–61	Rs. millions	1,289.11	1.80*
			(78.33)	(9.87)
2. Value of Indian exports	1951–61	Rs. millions	1,319.98	−1.62*
			(87.94)	(12.97)
3. Value of Indian exports	1953–61	Rs. millions	1,149.39	25.83
			(45.10)	(8.01)
4. Export price index	1948–61	1958 = 100	119.42	−1.54*
			(7.63)	(0.96)
5. Export price index	1951–61	1958 = 100	118.27	−1.77*
			(7.95)	(1.17)
6. Export price index	1953–61	1958 = 100	97.33	1.07
			(2.39)	(0.42)
7. Export volume index	1948–61	1958 = 100	88.58	1.44
			(3.11)	(0.39)
8. Export volume index	1951–61	1958 = 100	91.61	1.41
			(3.56)	(0.52)
9. Export volume index	1953–61	1958 = 100	98.89	1.02*
			(4.30)	(0.76)
10. Jute manufactures	1952–61	Rs. millions	1,220.07	−9.28*
			(73.65)	(13.09)
11. Tea	1952–61	Rs. millions	1,017.74	36.69*
			(145.08)	(25.78)
12. Cotton fabrics	1952–61	Rs. millions	635.33	−8.32*
			(42.48)	(7.55)
13. Vegetable oils	1952–61	Rs. millions	230.75	−14.88*
			(67.95)	(12.08)
14. Iron ore	1952–61	Rs. millions	11.51	16.02
			(11.93)	(2.12)
15. Manganese ore	1952–61	Rs. millions	222.54	−7.87*
			(52.29)	(9.29)
16. Mica	1952–61	Rs. millions	74.17	2.79
			(5.85)	(1.04)
17. Unmanufactured tobacco	1952–61	Rs. millions	109.60	3.94
			(8.78)	(1.56)

(continued)

TABLE 3–3 (concluded)

Item Regressed on Time (Equation: $x = a + bt$) (1)	Period (2)	Unit (3)	Estimated Coefficients and Their Standard Errors: Constant Term (a) (4)	Regression Coefficient (b) (5)
18. Coffee	1952–61	Rs. millions	15.65	7.28
			(15.91)	(2.83)
19. Cashew kernels	1952–61	Rs. millions	99.46	8.57
			(9.08)	(1.61)
20. Manufactured leather	1952–61	Rs. millions	201.62	5.06*
			(25.56)	(4.54)
21. Spices	1952–61	Rs. millions	146.47	−4.53*
			(35.23)	(6.26)
22. Coir yarn and manufactures	1952–61	Rs. millions	78.31	1.39*
			(4.65)	(0.83)
23. Raw cotton	1952–61	Rs. millions	184.61	−9.18*
			(51.77)	(9.20)
24. Lac	1952–61	Rs. millions	96.02	−3.41*
			(14.92)	(2.65)
25. Raw wool			76.56	3.28*
			(12.94)	(2.30)
26. Subtotal (10–25)	1952–61	Rs. millions	4,420.41	27.55*
			193.55)	(34.39)

NOTE: Values of the regression coefficient marked with an asterisk are not significant at the 5 percent level of significance.

SOURCE: Rows 1–9 calculated from Table 1–1; rows 10–26 calculated from Table 3–2. Reproduced from Bhagwati and Desai, *India*, p. 373.

suming the 1948–50 shares for the major commodities—jute manufactures, tea, cotton textiles, groundnuts, linseed oils and oilseeds and tobacco—and assuming that unit values and world volumes would not have changed from the observed levels each year, they have worked out the hypothetical earnings that would have accrued to India. They treat these as somewhat optimistic estimates, as it is probable that attempts by India at maintaining her share (in jute and tea, in particular) would, in many cases, have tended to depress the unit values.[6]

Their resulting estimates are reproduced in Table 3–4. They are quite striking. The overall improvement in feasible export earnings, over the ten years 1951–60, comes for these five commodities to around 16.5 percent of the actual performance. If we add to the estimated improvement of Rs.5,740 million a rough estimate of the potential improvement in three other items—

coffee, manganese ore and leather—we get close to an overall figure of about Rs.6,200 million.[7]

In Chapter 14, we shall examine how far policies resulting in such an improved export performance might have helped improve also India's economic performance. Immediately, however, we proceed to analyze the salient features of the export promotion efforts mounted during 1962–66, the period which constituted Phase II.

EXPORT POLICY AND PERFORMANCE FROM 1962 TO 1966: PHASE II

The policy of neglect of the export sector was rationalized later as "export pessimism." It characterized Phase I during the Second Five-Year Plan and was to give way during the Third Five-Year Plan to an escalating policy of export subsidization. By 1966, the subsidies embraced a large fraction of India's exports and included substantial rates; the period 1962–66 was thus clearly Phase II. The total export performance during this period improved in consequence of these subsidies and as a result of an expansion of trade with the socialist bloc (Table 3–5).

The success of the subsidies in countervailing the effects of the overvalued exchange rate and promoting exports was obvious in relation to the emerging exports of new manufactures and did much to counter the export pessimism which partly underlay the Second Plan but was also largely the product of that Plan's poor export performance.

But, while the subsidization reduced the average degree of overvaluation, one of its remarkable features was that it was as selective, chaotic and cost-unconscious as the process of automatic protection for import substitution. Thus, the subsidization was relatively energetic; but it was *not* efficient in the neoclassical sense and, as many instances of value-subtraction (at international prices) strongly underlined, wasteful in consequence.

In this section, therefore, we describe briefly the methods of export subsidization and analyze their efficiency implications. In particular, our discussion will indicate why the June 1966 devaluation was announced: essentially to enable the government to sweep away the chaotic and inefficient pattern of subsidization and replace it with the uniform and stable export incentive implied by the devaluation.

Policies of Export Subsidization.

Export subsidization policies took essentially two major forms: (1) fiscal measures, and (2) import entitlement schemes (which entitled exporters to premium-carrying import licenses). In addition to these measures, which

TABLE 3–4

Estimation of Expansion of Export Sales If Volume Shares Were Maintained at 1948–50 Levels

Commodity (1)	1951 (2)	1952 (3)	1953 (4)	1954 (5)	1955 (6)	1956 (7)	1957 (8)	1958 (9)	1959 (10)	1960 (11)	1951–60 Total (12)
(A) Jute manufactures											
A.1: Hypothetical incremental export earnings (in Rs. millions)	323.06	154.66	170.00	147.75	172.29	207.85	202.03	242.78	329.50	408.74	2,358.66
A.2: A.1 as a percentage of actual export earnings	13.44	9.47	15.36	12.17	13.92	18.47	17.58	23.58	29.75	32.55	
(B) Tea											
B.1: Hypothetical incremental export earnings (in Rs. millions)	58.53	62.29	0.40	275.49	265.21	47.43	192.47	138.68	167.22	290.12	1,497.84
B.2: B.1 as a percentage of actual export earnings	6.23	7.70	0.03	18.64	24.29	3.26	16.93	10.69	12.95	23.47	
(C) Cotton textiles											
C.1: Hypothetical incremental export earnings (in Rs. millions)	76.11	86.31	26.05	Negative	Negative	37.08	Negative	42.05	Negative	254.12	521.72
C.2: C.1 as a percentage of actual export earnings	8.06	11.64	4.08			5.95		7.29		36.84	
(D) Unmanufactured tobacco											
D.1: Hypothetical incremental export earnings (in Rs. millions)	Negative	Negative	Negative	41.66	38.39	21.35	65.53	8.78	47.39	51.36	274.46
D.2: D.1 as a percentage of actual export earnings				35.42	36.04	17.10	44.79	5.97	35.02	35.15	

(E) Groundnuts and oil											
E.1: Hypothetical incremental export earnings (in Rs. millions)	Negative	Negative	40.07	164.60	Negative	70.57	153.50	138.89	59.87	94.85	722.35
E.2: Hypothetical incremental export volume as a percentage of actual export volume			228.08	152.12		163.93	10,762.50	445.00	82.39	438.18	
(F) Linseed and oil											
F.1: Hypothetical incremental export earnings (in Rs. millions)	26.94	Negative	16.96	179.76	Negative	Negative	57.58	17.02	26.98	39.62	364.86
F.2: Hypothetical incremental export volume as a percentage of actual export volume	66.40		257.89	1,700.00			208.39	54.30	102.62	437.68	
Total of A–F: Total hypothetical incremental export earnings (in Rs. millions)	484.64	303.26	253.48	809.26	475.89	384.28	671.11	588.20	630.96	1,138.81	5,739.89
Total hypothetical incremental export earnings (in Rs. millions) as a percentage of total actual export earnings from these commodities	10.65	9.76	8.56	22.06	14.47	10.82	21.76	19.77	18.78	31.21	16.45

SOURCE: Calculated on the basis of average volume shares in 1948–50, from pp. 15, 38, 57, 74, 75, 99, 101, and 130, of M. Singh, op. cit. The hypothetical incremental export earnings for jute manufactures, tea, cotton textiles, and unmanufactured tobacco are derived by first multiplying the 1948–50 volume shares by the volume of world trade and then multiplying the result by the unit price of exports i.e., Indian export earnings divided by Indian export volume. For groundnut and linseed oil, the hypothetical incremental export *volume* is first derived on the basis of 1948–50 shares; the hypothetical incremental export earnings are then derived by multiplying this incremental volume with the unit price of all oil and oilseed exports. The export value figures of tea, unmanufactured tobacco, groundnut and oil, and linseed and oil are on a financial year basis. Reproduced from Bhagwati and Desai, *India*, p. 392.

TABLE 3–5

Exports by Major Destinations, 1956–57 to 1960–61 and 1961–62 to 1965–66

(Rs. millions)

Destination	Average: Second Plan	Average: Third Plan	Change	% Change on Second Plan Total	% of Total Change
Socialist countries	357	1,133	+776	217.37	49.11
W. Europe	2,323	2,383	+60	2.58	3.79
(E.E.C. therein)	(467)	(574)	(+108)		
(E.F.T.A. therein)	(1,759)	(1,702)	(−57)		
Asia and Oceania	1,597	1,900	+304	19.04	19.25
(Japan therein)	(303)	(554)	(+250)		
Africa	475	522	+47	9.89	2.95
(U.A.R. therein)	(109)	(160)	(+51)		
Americas	1,286	1,679	+393	30.60	24.90
(United States therein)	(928)	(1,311)	(+384)		
Total	6,037	7,617	1,580	26.17	100.00

SOURCE: *Basic Statistical Material Relating to Foreign Trade, Production and Prices*, Volume XIII—Part II, Government of India, 1967. Reproduced from Bhagwati and Desai, *India*, p. 397, with minor corrections and expression of percentages to two decimal places.

improved the direct profitability of export sales, there were also some promotional activities, in the form, for example, of budgetary appropriations for market development, which indirectly raised the profitability of foreign sales to domestic producers and traders.

FISCAL MEASURES

Among the fiscal measures which the export drive was based on were: (1) exemptions from sales taxes on final sales and refunds of indirect taxes, domestic and customs, on inputs; (2) direct tax concessions; (3) outright subsidies; and (4) rail freight concessions.

1. Exemptions and refunds from indirect taxes (sales, customs and excise) were generally made available to Indian exporters, although their incidence was not always as intended owing to dilatory procedures and inefficiencies. These exemptions, refunds and rebates applied to both imported components and to exported outputs.

Drawbacks of import duties were introduced for raw materials used in exported finished articles (including art silk fabrics, cars, dry radio batteries, electric fans and cigarettes) in 1954. Rebates of excise duty were announced in 1956, with immediate applicability to the raw materials used in exported ready-made apparel, tents, and sugar products and to direct exports of cotton and silk fabrics produced on powerlooms. The scope of both these measures was considerably enlarged during the 1960s, though several inefficiencies of procedure and insufficient accessibility to the drawbacks and rebates persisted through the ensuing years. The exemptions from *sales* taxes raised even more difficulties in practice.

While no breakdown of the refunds, rebates, and drawbacks actually earned on different export items is available, it is estimated that the refund of excise duties in 1963–64 was around Rs. 58 million.

2. More important were the *direct* tax concessions, which had been made in three successive budgets. The first, and somewhat hesitant, step was taken with the 1962 budget which gave a non-discriminatory tax concession to exporters. Apart from its non-selectivity, the subsidy was characterized by its being calculated on profits from exports (with the tax rate being fixed thereon at 45 percent instead of the standard 50 percent).

The 1963 budget added a different kind of tax incentive. It was both selective and related, not to profits, but directly to the f.o.b. value of exports—at 2 percent thereof.

The 1965 budget took the further striking step of giving selective concessions, described as tax credits, at *different* rates to different industries. The rates went up to as far as 15 percent and were extended to a larger number of industries. Yet, in relation to the import entitlement schemes which are discussed below, the incentives were relatively small and confined to a small range of exports.

3. In addition to the tax concessions granted through the budget, which therefore must be classified as subsidy equivalents, there were two other major forms of subsidization in the system: (a) open, cash subsidy by budgetary appropriation for sugar; and (b) disguised cash subsidy, in the shape of losses incurred by the STC on exports of certain commodities, which were "financed" by profits on other (essentially import) trade.

4. With respect to rail freight concessions, as early as 1960 the Ministry of Railways had agreed to grant reductions in freight rates to selected commodities for transportation between specified destinations. The commodities covered ranged from motor vehicle batteries and oil pressure lamps to textile machinery and bicycles: they were essentially non-agriculture-based manufactures whose exports were a recent phenomenon.

An examination of the eligible routes and corresponding concessions indicates that the intention was to offset the transport cost "disadvantage" to

exporters, even sometimes to the point of providing progressively concessional rates as distance increased (as with manganese ore)! As the export drive intensified, this aspect of rail freight concessions was to have more appeal for the authorities in charge of export promotion, despite its obvious contradiction of economic logic. The notion that transport costs may reflect real costs to the economy and the fact that, if anything, the "shadow" freight rates were almost certainly higher than those charged on a non-concessional basis, seem to have concerned none of the authorities in charge of the export drive.

In addition to these direct fiscal measures, involving explicit or implicit subsidization of exports, at budgetary expense, there were also (a) budgetary grants for promotional activities, such as the Market Development Fund, under which the activities of the numerous Export Promotion Councils were financed along with research exhibitions and market surveys geared to export expansion, and (b) special allocations of scarce items at controlled prices, including priority access to rail space and allocations of domestic materials, such as iron and steel, which constituted effective subsidization insofar as these facilities and materials, if purchased at (black) market prices, would have been otherwise more expensive.

Import Entitlement Schemes

While the export promotion measures deployed by the Indian Government had, therefore, numerous aspects (including outright subsidies and tax concessions), the principal instrument of export promotion soon became the import entitlement schemes, under which eligible exporters received import licenses, fetching high import premia, *pro rata* to the value of exports effected. By early 1965 the import entitlement schemes already had a very considerable coverage.

The rates of import entitlements. Even a cursory examination of the rates schedules for import entitlements under the export promotion schemes (as, for example, for engineering and chemicals) shows that wide variations existed in these rates for different products. When the criterion used for fixing these rates was sought, governmental declarations seemed to yield definitive answers. Take, for example, a typical statement:[8]

> The most important feature of these schemes is that a specified percentage of the f.o.b. value of exports is allowed to be used for importing raw materials and components required in the production of the export products or a group of allied products. The import entitlement is generally determined on the basis of twice the import content subject to a maximum of 75 per cent of the f.o.b. value of exports.

Two central principles seemed to emerge from these and other declarations: (1) the import entitlement would not exceed 75 percent of f.o.b. export

value; and (2) the import entitlement would, subject to the preceding constraint, equal only twice the value of import content.

As it turned out, however, neither of these principles appears to have been taken seriously since the intensification of the export drive began during 1963. Why were they so clearly flouted? It appears as though the authorities initially thought that some uniform incentive should be provided and this uniformity was thought to be present in the rule of twice-the-import-content on the ground that each exporter could thus earn one extra import-content to produce one more unit for domestic sale. Of course, this does not at all mean a uniform *ad valorem* incentive to export for all commodities covered by such a scheme; but that does not appear to have been appreciated. At the same time, the ceiling of 75 percent of f.o.b. value appears to have been imposed for any or all of the following reasons: (1) the schemes were supposed to yield net foreign exchange for non-exporting industries and hence entitlements in excess of 100 percent seemed ruled out; (2) an excessive entitlement might encourage over-invoicing of exports; and perhaps (3) larger entitlements would result in "throw-away" exports.

The general flouting of the 75 percent ceiling and the twice-the-import-content rule appears to have been a reflection of the shift in practice to the notion that the value of exports must generally be maximized and that uniformity of the kind implicit in the twice-the-import-content rule, as well as any ceiling on the entitlements, must not be taken so seriously as to impede the export drive. These attitudes were evident also in the growing number of concessions granted for rail transport and the accelerating clamor even for (economically) perverse rules under which the concessional rates would be linked directly with the distance over which the goods must be carried. We shall revert to this point later, when we evaluate the economic effects of the entitlement schemes.

Permissible imports. Unlike some exchange retention schemes, the import entitlement schemes did not permit free use of the entitlements. Invariably, a list of authorized imports was issued. An analysis of these lists and accompanying official declarations shows several features.

1. The imports allowed were claimed to be direct inputs into the industries covered by the exports promotion scheme in question. This was generally correct; but there were important qualifications:

(a) Since different industries were frequently grouped together into a single scheme, the directness of the importable inputs, as far as any *one* industry was concerned, could not be considered to be really maintained by the scheme.

(b) Similarly, from the viewpoint of the exporting manufacturer, if he was a multi-product manufacturer and the different products had interchangeable materials, the directness of the imported inputs into the exported product

surely did not rule out in practice their use for manufacture of the other unexported products within the same firm.

(c) Moreover, as many materials (especially chemicals) go into a large range of industries, thus straddling different export promotion schemes, and as the legal transferability of entitlements frequently occurred via traders, it is only natural that *illegal,* inter-scheme transfers also occurred from time to time.

(d) Finally, the "directness" principle was openly flouted eventually by the introduction of the special dryfruits scheme under which *ad hoc* licenses were given to exporters of diverse items (including chemicals and engineering products) to import high-premium-yielding dryfruit. This scheme amounted of course to nothing but an indirect method of cash subsidization and no pretense could be made of dryfruit being a direct input into the exported items.

2. There were, further, occasional changes of items in permissible imports of materials and components. There appears to have been a conflict between the interests of the exporters and those of the domestic producers of materials competing with imports. Exporters sought to include high-premia materials, whereas domestic producers of these materials opposed this because inclusion in the permissible imports list would reduce their profits. In a sheltered market these conflicts assumed economic significance, and the occasional shifts in items on the import list seemed often to reflect the relative bargaining positions of the pressure groups involved rather than significant changes in objective economic conditions.

3. In the beginning, the use of entitlements was further restricted to the import of materials, spares and components, while the import of capital goods for replacing or extending capacity was excluded. This restriction was probably prompted by a desire not to disrupt Capital Goods (Import) Control (CGC), although of course there was no reason why permission to import equipment could not be allowed, subject to prior approval by CGC. Yet another reason may have been that the influential policy-makers really regarded the entitlement schemes as more or less breaking the bottlenecks to exports arising from inability to use *current* capacity because of scarcity of imported materials and did not fully appreciate the subsidy aspect of the schemes or the possibility that expansion of capacity in the export industries itself might be desirable from the viewpoint of export promotion. These restrictions, however, were gradually reduced and, in some cases, altogether eliminated, so that it became customary eventually to have large proportions of the entitlement specified as expendable on imports of equipment.

Transferability of import entitlements. While import entitlements had earlier been subjected to extremely stringent restrictions concerning transferability and sale, they eventually became more readily saleable although several restrictions continued. Several variants of transferability were employed in the different schemes.

A typical formula, widely used, permitted the entitlement to be transferred by the exporter, who might be a trader or a manufacturer-exporter, to other manufacturers covered by the *same entitlement scheme*. Among other variants the transferability of the engineering scheme, for example, was restricted within each of *three* groups: (1) general engineering and electrical manufactures; (2) machinery and transport equipment; and (3) non-ferrous semis, alloys and fully processed manufactures. In fish products, handicrafts, processed goods, leather and leather manufactures, silk fabrics and ready-made silk garments, again the transferability of imports was confined to other exporters within the scheme and does not appear to have been extended to all manufacturers. For dyes and chemicals entitlements in art silk exports, on the other hand, transferability extended even to units in cotton and woolen textiles.

Premium on entitlements. Thus import entitlements were generally transferable within a scheme and could earn whatever premium cleared the market at any point of time. Occasionally, indeed not infrequently, ceilings were imposed on the chargeable premium.

In the bulk of the entitlements issued, the effective subsidization to any exporter depended on the premium on the entitlements (in addition, of course, to the entitlement rate itself).[9] In practice, the segmentation of the different entitlement markets meant that the level of the premium varied from commodity to commodity. Besides, the premium varied over time, within each market. The factors which must have determined the premium included the restrictiveness of the permissible imports list, the entitlement rate, the leakage into prohibited sales and expectations about the current and future inflow of entitlements into the market.[10]

Changes and variability in the export incentive offered by the entitlements schemes. So far we have considered the questions of the fixation of entitlement rates, the transferability of the entitlements and the premium on entitlements. From this, it is easy to infer the effective subsidy which was available, at a single point of time, on export sales to an atomistic exporter. But the question remains whether this export incentive tended to be variable, with the effective subsidy on exports changing from time to time.

There is little doubt that the export incentives were variable under the entitlement schemes, although it is difficult to quantify this variability accurately in view of the paucity of reliable information for many schemes. There were three major reasons why such variability arose:

1. changes in the *coverage* of the schemes
   (a) products were included and/or excluded from period to period; and
   (b) exports to certain areas were excluded and/or their entitlements were changed from time to time;

2. changes in entitlement for *given* products, arising from changes in formula used or revised notions about the incentives, from time to time; and
3. changes in the premium on the entitlements, arising from:
   (a) revisions in rules governing the transferability of entitlements; or
   (b) changes in the coverage of the items for whose import the entitlements could be used; or
   (c) inevitable, periodic shifts in the premium which entitlement licenses (with given coverage and transferability) enjoyed in the market; or any combination of all of these factors.

In conclusion, the Indian export promotion policies were based essentially on the entitlement schemes which applied by 1965–66, in significant degree, to nearly 60 percent of Indian export earnings, although the magnitude of export subsidization they involved was unforeseeably discriminatory in incidence among the different items.[11]

Economic Effects of Import Entitlement Schemes.

We now turn to an analysis of the main economic features and consequences of these import entitlement schemes, which (as noted) constituted the bulk of India's export subsidization effort until the June 1966 devaluation. To begin with, in contrast to the simple exchange retention schemes of countries such as Pakistan, the Indian schemes had the following, almost unique features:

1. the number of entitlement rates was very large and subject to occasional change;
2. by and large, the entitlement rates were below 100 percent of export value;
3. the market for the (transferable) entitlements was segmented by export promotion schemes;
4. the premium on entitlements showed fluctuations in the different, segmented markets;
5. the list of permissible imports excluded consumer goods;
6. the value of exports covered by the scheme, on the most liberal interpretation which would include tea and coffee exports, amounted to around 80 percent of the total Indian exports and to around 60 percent on more restricted assumptions; and
7. the value of imports coming under entitlements was throughout less than 5 percent of the *total* value of imports (including aid-financed imports).

The import entitlement schemes, set in the framework of an overvalued exchange rate, were undoubtedly a useful improvement on a situation where otherwise exports were being seriously discriminated against. But the essential

question is whether these were an *efficient* way of countering the effect of the overvaluation of the exchange rate on exports. The analysis that follows in this chapter is addressed to this question and seeks to establish the inefficiency of such schemes.

As the Indian import entitlement schemes were characterized by considerable segmentation, differential rates and non-transferability resulting in differential premia, we shall analyze the efficiency of these schemes (1) on the hypothetical assumption that these markets and rates were unified and (2) on the more realistic assumption that the markets and rates were differentiated. We will, in fact, be arguing that these schemes were basically an inefficient way of simulating the working of a flexible exchange rate system; and that these inefficiencies were compounded by the differential nature of the effective subsidization granted under the Indian regime.

Subsidy Aspects per se

Among the several, significant effects of the Indian import entitlement schemes, omitting (as we have noted) the aspect of differential rates and selectivity in general, we shall note the following main features: over-invoicing of exports; revenue effect; self-limiting export promotion; instability of the incentive offered; utilization of foreign exchange allocations explicitly for creating incentives; and welfare effects.

Over-invoicing of exports. Insofar as the import entitlement schemes constituted subsidy measures, they gave rise to an incentive, *ceteris paribus,* to over-invoice exports: an incentive that would be eliminated under a straightforward, direct adjustment of the exchange rate (which would obviate the need to subsidize exports to counter the disincentive offered to exports by the overvaluation of the exchange rate).[12]

We must note here that the incentive to over-invoice led some exporters, especially (though not exclusively) in sectors such as plastics and art silks, to send out shoddy goods with faked, higher-price declarations, which were cleared in foreign markets at "what they could fetch." At a time when India's immediate and long-term export drive had to rest increasingly on the export of manufactures (and, for that matter, quality and complex manufactures by and large), the building up of goodwill was quite important. This was precisely what was jeopardized by the practitioners of over-invoicing. We shall soon see that the instability of the incentive offered by the entitlement schemes, combined with the differential incidence of the benefits on the numerous, different items, accentuated this phenomenon by encouraging the entry into the export trade of roving traders, in search of quick profits, whose primary objective was short-run, immediate profit maximization.

Revenue effects. An argument frequently advanced in India in favor of the import entitlement schemes, as a method of export subsidization, as against direct subsidization, is that these schemes finance themselves: the subsidy is

paid by the users of the import licenses. However, insofar as this is the case, it would be equally open for the authorities to levy such a tax directly on imports and to finance therewith a direct subsidy on exports. Hence, the argument in favor of the entitlement schemes must rest on the illusion that taxation of imports may be feasible if disguised but not otherwise. Such an illusion may well exist, but we doubt its plausibility and have seen no evidence in support thereof.

Besides, we may note that if we were to compare a regime with an overvalued exchange rate combined with entitlement schemes for export, with an adjusted exchange rate, the revenue effect would have been against the former regime for the simple reason that imports exceeded exports approximately by the amount of the net aid inflow which was quite considerable.

Self-limiting nature of the subsidy. Further, the entitlement schemes contrasted unfavorably with direct, *ad valorem,* subsidies in another respect. Whereas *ad valorem* subsidies apply the incentive equally at all levels of export (and concomitant prices), the entitlement schemes build into their structure an important feature which reduces the incentive with the value of exports achieved.

This self-limiting aspect, implying that the more successful the scheme is in increasing exports, the less the incentive to export *at the margin,* arises from the fact that the incentive rests crucially on the entitlement premium (once the entitlement rate is fixed). If export value increases, thanks to the entitlement schemes, import entitlements entering the market will proportionately increase, thus tending to push the premium down. But the lower the premium the lower also the incentive, at the margin, on exports.

An *ad valorem* subsidy instead would maintain the full incentive. A flexible exchange rate or suitable devaluation, on the other hand, would have effects similar to an *ad valorem* subsidy, except for the incremental cost of imported and import-competing inputs which would operate with respect to the import side.

Instability of the incentive. A related feature of such export subsidization schemes is the additional source of instability that they constitute, in view of the fact that the premium on entitlements would vary, in contrast to an *ad valorem* export subsidy. Moreover, as we have already noted, the frequent changes in the premia brought about by changing rules concerning permissible imports and transferability, for example, as also frequent changes in the entitlement rates themselves, constituted further elements of instability in the operation of the entitlement schemes in India.

Utilization of foreign exchange allocations for creating export incentives. The economic consequences and inefficiencies that we have just discussed arose primarily from the fact that the entitlement schemes operated by diverting the allocations of premium-fetching imports, by way of economic reward

and incentive, to exporters. Among the other effects of such a policy, we may now note two in particular.

(1) The system may have resulted in foreign exchange being allocated to industries (which albeit were induced thereby to export) for non-priority use. For example, if imports of luxury goods were permitted under the entitlements schemes, and this was merely to provide a high-premium incentive for export, and the import of luxury goods was otherwise intended to be prohibited, this could well be regarded as a *minus* factor in the evaluation of the entitlement schemes (from the point of view of this policy). On the other hand, if the government did not seek to prohibit imports of these luxury goods or if they were merely diverted from established importers to import entitlements, the foreign exchange used (*via* the entitlements) on importing these luxury goods could not be properly regarded as "misallocation" from the viewpoint of socially declared objectives. Thus, for example, the Pakistan bonus scheme has permitted imports of consumer goods (including luxury goods), but so has their general, import licensing policy.

On the other hand, the Indian entitlement schemes, as we have noted, followed exclusively the principle of exclusion of consumer goods. Where, however, the leakage into non-priority allocations may be alleged to have occurred is in industries such as art silk where the *total* foreign exchange allocations (AU plus import entitlement licenses), as a result of the export incentive taking the form of import entitlements rather than *ad valorem* subsidies, may have been greater than otherwise. In the absence of any statistical evidence on AU licenses by sector-of-use (for any length of time, for this industry), it is impossible to arrive at any reasonably firm conclusion on this question.

(2) Another effect of the use of foreign exchange allocations for promoting exports, in the Indian context, was quite favorable (although it would have ceased to be so under an adjusted exchange rate which could obviate the reliance on strict import controls and the resulting inflexibility). Until these entitlement schemes were operating, there was practically no legal way of getting hold of foreign exchange in order to break expensive bottlenecks and unforeseen demands. The entitlement markets thus served to introduce a much needed flexibility in an otherwise excessively inflexible system.

While this basic advantage to the economy, arising from the introduction of legal accessibility to scarce imports (albeit with restrictions, but still significant), was considerable, many exporters who were interviewed argued that the entitlement schemes, in view of their granting such access to imports, were also a superior, more effective way of sustaining an export drive than *ad valorem* financial subsidies. (1) It was argued that *flexibility* of access to foreign exchange was a considerable advantage, which would not be available if the subsidy was a financial one; and that their export performance

would have been affected adversely by the replacement of these schemes by financial subsidies.[13] (2) It was further argued that the vast majority of exporting producers exported just enough to get the amount of foreign exchange for maintaining full capacity utilization in their plants and that their motivation in exporting was *not* to increase overall profits but to expand capacity utilization; and hence the export drive would suffer by the replacement of entitlement schemes by purely financial incentives. (3) Finally, it was also claimed that, with foreign exchange not otherwise available in a free market, it was possible that firms which might find it attractive to export on being given a financial incentive to do so, might not be in a position to produce at all for export (the assumption, of course, being that their AU allocations were meager).

While these beliefs were strongly held, only the last argument has some element of logic in it. The first argument is fallacious because any advantage following from flexibility can generally be quantified and the corresponding incentive provided through fiscal subsidies.[14] As for the second argument, there is little evidence of Indian firms following a policy of output, rather than profit, expansion. The very fact that many firms were known to sell their entitlement licenses, at least at the margin, indicates that the force of this argument is not considerable. The last argument, based on the fact that firms restricting themselves to legal purchases would not be able to produce for export, but would have to confine themselves to diverting existing production to exports, has some plausibility. Even in this case, however, we have to allow for the fact that incremental export earnings would be released into the economy and hence could be used eventually for augmenting production for exports. We are thus left essentially with the argument that the entitlement schemes introduced flexibility into the import regime, undoubtedly resulting in sizable gains via the breaking of costly bottlenecks.

Other welfare effects. We may now consider other more direct welfare effects associated with the fact that the entitlement schemes involved a departure from unified exchange rates. As already noted, an *ad valorem* subsidy on exports would help, in an overvalued exchange rate situation, to reduce the discrimination against exports. On the other hand, a system under which export subsidization is combined with an overvalued exchange rate involving import controls differs significantly from a system where the exchange rate is altered to equilibrium levels and thus implies a unified exchange rate policy.

Thus, in the Indian-type import regime, we have already observed that imports were partly allocated on an AU basis and hence the effective rate on these imports was the parity plus the relevant tariff. On the other hand, insofar as other inputs were purchased from the market, the effective import rate on these included the import premium as well. Thus, as we shall argue

at length in Chapter 13, there followed non-unified exchange rates and unpredictably different and bizarre incentives for resource allocation.

In this situation, the introduction of even a unified export subsidy would have perpetuated the continuation of non-unified exchange rates, while helping to reduce the overall disincentive to exports. But, in fact, such a subsidy would give rise to the possibility of losses arising from the effective export rate for a commodity *exceeding* the effective average import rate on its inputs. Such a situation could lead to the possibility mentioned earlier that the process would yield "value subtracted" at international prices.

Selectivity of the Subsidization

In point of fact, many of the inefficiencies resulting from the entitlement schemes were compounded by the selectivity with which they were administered and from which we have so far been abstracting.

Undoubtedly, in an ideal world, one should want to make rational departures from unified exchange rates. There are, in fact, a vast number of grounds on which we can argue for optimal intervention in the shape of trade tariffs and subsidies and tax-cum-subsidies on production, consumption, and factor-use.

However, the Indian export subsidization schemes involved policy intervention in a selective manner, with little economic rationale. As argued earlier, the principle apparently aimed at in the beginning was the supply of one more unit of "import-content," in addition to "replacement," as the economic incentive for export promotion. The equivalent *ad valorem* subsidy, therefore, would have varied among different export commodities and, converted into different *ad valorem* rates of import entitlements for different commodities, it did. The effective export subsidy further varied among commodities because, for administrative reasons and as a result of notions about priorities in some undefined sense, the entitlement licenses could be marketed, as we have already seen, only within segmented markets and hence carried differential premia.

In point of fact, toward 1965–66, the principle of export subsidization had clearly begun to veer around to the proposition that exports should be maximized—although, we should not forget that, on many *traditional* exports which were outside the range of such export subsidization, domestic absorption continued to create difficulties in the way of more successful export promotion.

The principle of maximizing exports, which became fairly widespread among the newer manufactures, was practiced by a continuous tendency toward raising the effective subsidization. Also, for example, it became generally possible to ask the Ministry of International Trade for *ad hoc* entitlements, for chemical and engineering exports, to make up for any ostensible

difference between the domestic sale price of a product and its supposed f.o.b. export price plus the subsidy normally available through drawbacks, fiscal tax concessions, and entitlements. In addition, we have also noted how transport freight concessions were sought, and sometimes granted, to compensate for "transport cost disadvantage" to products manufactured in the hinterland. The fact that transport involves a real cost to the economy and hence must be accounted for, instead of being compensated for, was apparently forgotten in the general strategy of pushing out any and all of the new exports in particular.

Thus, the policy of export promotion generally adopted during the Third Plan period, ending in the devaluation of June 1966, can best be described as having ultimately become one of indiscriminate export promotion, with even a perverse bias toward fixing the subsidy inversely to the competitive strength of the exportable commodity. This system had its counterpart in the indiscriminate protection that import policy furnished to domestic industries.

It is thus difficult to escape the conclusion that, while the Third Plan witnessed a major shift toward export subsidization, export promotion policies were inefficiently designed and implemented. These policies were to be subjected to change in the direction of greater efficiency with devaluation in June 1966. We discuss these changes in Part III. But first we proceed, in the next chapter, to discuss the other measures, such as use of import duties to mop up premia, which were also undertaken during the latter part of Phase II, prior to the June 1966 devaluation and associated policy changes.

NOTES

1. The discussion in this chapter is an abridged version of Bhagwati and Desai, *India,* pp. 371–467.

2. Manmohan Singh, *India's Export Trends* (Oxford: Clarendon Press, 1964).

3. The regression equation $x = a + bt$, fitted to the price and volume indices for the periods 1948–61, 1951–61 and 1953–61 confirms the statistical significance of this stagnation. The estimated equations are reproduced in Table 3–3.

4. Singh, *Export Trends.*

5. Bhagwati and Desai, *India,* p. 394.

6. On the other hand, the "negative" entries in Table 3–4 show that the 1948–50 average was by no means the highest feasible share, even in the ensuing decade, for cotton textiles, tobacco, groundnut, and linseed oilseed and oils.

7. Bhagwati and Desai, *India,* pp. 394–395.

8. *Annual Report, 1963–64,* Government of India, Ministry of International Trade, New Delhi, p. 14.

9. Here, as elsewhere, we are referring only to the incentive provided an individual, atomistic exporter under the entitlement schemes. It would be incorrect to generalize the argument to the point of saying that therefore the replacement of such a scheme by an identical *ad valorem* export subsidy would produce equivalent real effects.

10. For example, the premia rose severely for these licenses during May–June 1965, when the import policy announcement was delayed and the removal of the entitlement schemes was widely expected. This happened again in the months prior to devaluation in June 1966.

11. For further evidence in support of this conclusion, see Bhagwati and Desai, *India*, pp. 428–430. The figure of 80 percent there exceeds the figure of 60 percent here because it includes nearly negligible entitlements given to items such as tea and jute.

12. Whether over-invoicing would be worthwhile would depend, of course, on the relative values of the black market foreign exchange rate and the degree of export subsidization. In India, the incentive to over-invoice was clearly present in many cases.

13. This assertion, of course, is an important indictment of the import control regime and the inflexibility it entailed.

14. We presume that necessary production would be feasible under the export subsidy solution.