

# RISING PRICES, BLACK MONEY AND DEMONETISATION

BY

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**FORUM OF FREE ENTERPRISE**

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# RISING PRICES, BLACK MONEY AND DEMONETISATION\*

PROF. B. P. ADARKAR

This is a complicated and at the same time an intriguing subject. Various aspects of it affect almost everyone—the man in the street as well as the well-to-do, the haves as well as the havenots. Most people, however, have vague notions, and the more enterprising ones have also ready-made solutions for it. On the whole, I would say that this is not a field in which laymen can easily pass muster as wise men, because the theoretical and practical issues involved are beyond their ken. Before I proceed, I shall sum up my conclusion as follows: Rising Prices have **not** caused Black Money; nor has Black Money caused Rising Prices; and Deimonetisation is no remedy for either Rising Prices or Black Money!

In their search for the scapegoats, the Government blames black marketeers, hoarders, smugglers, tax evaders, and then of course, attributes its troubles to a series of droughts, wars etc. Critics of the Government, on the other hand, blame the Government for its policies including deficit financing, high and punitive rates of taxation, all sorts of

\* Based on a speech delivered by Prof. B. P. Adarkar, formerly Economic Adviser in the Ministries of Labour, Finance and External Affairs, and later Minister, Indian Embassy, Bonn, West Germany, at a meeting arranged by the Forum of Free Enterprise, in Bombay, on the 3rd September 1973.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

—Eugene Black

controls and restrictions, apart from mismanagement of the Public Sector industries, official corruption, etc. However, in fact, in Roger de Coverley's words, much can be said on both sides. Still, I was somewhat amused to read in the papers that one of the Government's spokesmen, Mr. D. P. Dhar, Minister for Planning, holds deficit financing to be responsible for the situation, although he does not seem to admit that bad planning and extravagance have been at the root of the whole business, as well as of deficit financing itself!

According to the Hindus all knowledge begins with the Vedas. Now, the Veda in this case is the report of the Wanchoo Committee on Direct Taxes and Black Money, which mainly deals with tax matters. but has, on the whole, made a very good analysis of the causes of black money. However, although the Committee's diagnoses were more or less correct, their prescriptions have been somewhat out of focus. The Committee's Report consists mainly of four parts : First, tax evasion and black money; second, tax recovery; third, tax assessment; and fourth, tax administration. We are here concerned with the first part dealing with tax evasion and black money. The Committee correctly held that high rates of taxation, a rigorous system of controls, licences and permits, the ban on company donations to political parties, a general decay of public morality, and official corruption, were some of the principal factors responsible for black money and the prevalence of a parallel economy. The Committee observed : "When the marginal rate of taxation is as high as 97.75 per cent, the net profit on concealment can be as much as 4,300 per cent of the after-tax income. The implication of 97.75 per cent income-tax is that it is more profitable at a certain level of income to evade tax on Rs. 30 than to earn honestly Rs. 1,000. We will not be surprised that placed in such a situation, it would be difficult for a person to resist the temptation to evade taxes." Commenting on the official contention that high rates of taxation were necessary to reduce the inequalities of income and

wealth, the Committee further observed : "In theory this might be a valid proposition, but in practice, high rates of taxation are apt to make the rich richer and the poor poorer, thereby widening the gap between the two classes (because of tax evasion) . . . . In such a situation, honesty becomes the first casualty and not many would find it easy to resist the temptation." The official view has been extremely naive and doctrinaire : why should anyone earn, say, Rupees ten lakhs to make a present of 9 $\frac{3}{4}$  lakhs out of it to Government? He would rather share it with the tax official, if necessary! If governments function like highway robbers, it is the surest way to turn honest persons into dishonest ones.

Turning to the various recommendations of the Committee, the more significant of them from our point of view are those relating to revision of tax rates, measures to deal with tax evasion and tax procedures. Apart from this, their confidential recommendation regarding Demonetisation, which they reportedly made in their Interim Report but did not pursue in the Final Report, needs to be considered. The other recommendations about tax arrears, exemptions and deductions and tax administration are not of direct relevance to our subject.

As regards the rates of income tax, after strongly criticising the extortionately high rates ranging up to 97.75% at the highest level, the Committee proposed a maximum rate of 75% only with minor adjustment at lower and intermediate levels of income. To make a real dent on tax evasion and black money, this recommendation must be regarded as both ineffective and pointless. I wish the Committee had suggested even more drastic reductions. They could have drawn a moral from the French experience, for instance. In France, tax evading and black money practices had become rampant after the War, and the Government decided to reduce the income tax rates to well below 33 $\frac{1}{2}$  per cent. This had such an impact on the situation that evasion and black money both almost disappeared. And, moreover, the tax collections showed no diminution ! Tax evasion and black

honey management are a difficult and dangerous art and the incentive to resort to them disappears at lower tax levels. However, even the modest proposals of the Committee were rejected by the Government of India, while they have avidly pounced upon those recommendations which were convenient and pleasant to them! The other recommendations of the Committee regarding tax evasion and procedures, which are being introduced in forthcoming legislation, are so drastic that I fear there will be more corruption than ever before, so that black money is likely to be transferred from the pockets of the business community to those of the officialdom!

### I. RISING PRICES AND SCARCITIES

Since 1947, when prices had been already inflated, to this date, the value of the Rupee has fallen to about  $\frac{1}{3}$ rd, i.e., prices have risen by nearly 300 per cent. As compared to the pre-war levels, they have risen even more. But it has been contended by Government spokesmen that inflation and high prices are a world-wide phenomenon and that India had only imported some of it in the last few years. Now, although it is true that prices have risen in many parts of the world, it would be a false alibi for the Government of India, because, firstly, the rise in prices here is much steeper and much more continuous than in other countries; and, secondly, higher prices elsewhere have been accompanied by rising profits, higher wages, greater employment, a bigger GNP etc., while in India the reverse is mainly the case!

The most potent cause of the inflation in India is **deficit financing**, which has been going on at a reckless pace all these years. In a single year, 1972-73, alone, it amounted to Rs. 1,278 crores. This expansion of paper money is taking place mainly because of over-ambitious and wasteful Planning and the spendthrift ways of the Central and State Governments. Caught in their own self-made vicious circles and spirals of wages and prices, these Governments are unable to disentangle themselves from the consequences of their reckless policies. It is indeed a rake's progress, and like

an inexorable destiny, inflation seem; to be taking its own course and one cannot see where it is all going to end, except perhaps in a hyper-inflation like the one in Germany after World War I. It might be said that deficit financing is Justified in the case of a planned economy so as to provide an ampler monetary base for a developing economy. This is indeed a valid theory. However, deficit financing is justified **only** if (a) it is in moderate doses: (b) productivity and production are also going up at a more than commensurate pace; and (c) it is subject to checks and balances, particularly ensuring that the price-level is either steady or falling slowly. Deficit financing is not at all justified if the prices are rising steeply. Unfortunately, the Government has ignored this elementary prudence and availed itself of this milchcow of "easy money".

Amongst the other causes of rising prices, real scarcity of food and food products caused by repeated failures of the monsoons in the last three years is undoubtedly a principal one. However, I am not sure that the virulence of this factor could not have been reduced, if the Government had paid more attention to the development of agriculture and irrigation in the country, instead of getting involved in long-term heavy projects of slow gestation and wasting huge fortunes on them. Five costly and destructive wars with Pakistan and China during the last 25 years and the huge military budgets caused by them was another important factor in the equation of high prices. The next important cause of scarcity and inflation has been the failure of production in both the Public and Private Sectors in recent years due to inefficiency, corruption and extravagance on the one hand, and restrictive, lop-sided economic policies on the other. The result has been the emergence of surplus capacities which have remained unutilised.

The enormous growth of population in India (and also in the rest of the world) has upset the balance between the world's food resources and the demand for consumption, especially in the Communist countries and in Afro-Asia, and

brought about a rise in the international prices of food-stuffs. Food being a commodity of a high marginal utility, even a moderate fall in supply must lead to an excessive rise in its prices. This is what has happened particularly in India. The disparity has, moreover, led to hoarding (including domestic hoarding) and black-marketing, thus aggravating the rise in food prices.

**Wheat and Rice Takeovers.** The wheat takeover, undertaken in haste and without proper administrative preparation, has been a gross failure. It was a case of good intentions, paving the way to the Nirvana of hunger for all. Collection of wheat in the surplus states and its distribution in the famine-stricken areas were both completely mismanaged. Moreover, movement of grain was hindered by rail strikes and floods. Meanwhile, like the Demon **Bhasmasura** who turned to ashes whatever he touched, the Government has succeeded in destroying the entire system of trade in the wheat **mandis**, causing widespread unemployment in them at every level. The price offered for wheat purchase was too low, both in terms of international prices and in view of internal scarcity. The Government soon realised that it could not dictate terms to the market, regardless of the laws of economics and normal human behaviour. What was surprising, however, was that the same gentlemen, who insisted on a price of Rs. 76 per quintal in the country, have been prepared to pay nearly twice that price for wheat imported from America and to waste precious foreign exchange on it too. What kind of financial policy is this and whose interest? can it be said to serve? The replies of the Union Minister concerned, Mr. A. P. Shinde, to criticism on this point, have been to say the least most unsatisfactory and arbitrary from the economists' and commonsense viewpoint. There is a public feeling that our buying agents in Delhi and Washington, who were the same as those who bought the infamous corn mixed with **dhatara** poison seeds, have been deeply committed to some questionable deals. Otherwise, Mr. Shinde's lame excuser fail to convince any-

body. Out of the planned procurement of 8.5 million tonnes, only 4.3 million tonnes could be collected by the Government's agencies in the country. It is doubtful if even the whole of this has reached the public, without rotting in official godowns and docks and being held up in the railway bottlenecks. Altogether, the wheat takeover has been a first-class bungle. Let us pray that the Government does not rush into another bungle over the Rice trade now.

**Price Controls.** In Bombay, prices of foodstuffs have been fixed, but supplies have gone underground. So you have beautiful, cheap prices, but no foodstuffs available anywhere; and more rigorous the controls, the less is the availability of things. The Chief Minister has been so proud of his performance that he even recommended his system to the Prime Minister and to other State Governments! Militant methods have given somewhat better results, but for how long? Also, they can lead to the growth of lawlessness and anarchy in the country.

Now to prevent a runaway Inflation. So far as the food problem is concerned, there seems to be no other way than to call off the takeover of wheat and leave the distribution to the producers and dealers. At the same time, the Government should deal firmly with black marketeers and hoarders wherever they are found and control speculative activities. Also, for the buffer stock, the Government must keep on buying in the open market as well as straight from the producers and co-operative societies. The international grain market is very tight and even at exorbitant prices, stocks are not available, while there are too many hungry nations competing for them. Moreover, active help must be given to agriculture by way of subsidisation with a view to modernisation and increased production. It is necessary to take modern science to the very door of the farmer, instead of merely discussing and advertising it in laboratories and conferences.

But the surest method of drawing the reins here is to

**stop further deficit financing** at all costs. Things have reached a stage where any expansion of currency or credit can only aggravate the inflation. To put the monetary situation into the reverse gear, therefore, complete stoppage of deficit financing is an absolute necessity.

The proposed retrenchment of Rs. 400 crores in the Central and State budgets can only be a drop in a bucket: it can have no impact on the price level by itself, and is no substitute for discontinuing deficit financing.

Similarly, raising the bank rate and imposing higher reserve requirements on the credit banks, though recommended by orthodox theory, can be of peripheral use only, in the present situation.

Apart from a spurt in agricultural production, which can come about either with good seasons or because of modernisation, a general increase in industrial production (including particularly consumer goods production) can also help to bring down the prices. However, this implies a complete re-organisation of the Public Sector and measures to galvanise the Private Sector. The Public Sector is suffering from bureaucratic lethargy and other serious evils, such as corruption, inefficiency and irresponsibility, in many of its establishments. Most of them are being run at a loss and the Central exchequer, which means the taxpayer and the common man, is being saddled with debts, arising from mismanagement. It is strange that even when, in the Soviet Union and other communist countries, the profit incentive is being regarded by their economic thinkers as essential in the operations of public establishments, here in India, the Planning hierarchy brush it aside as an irrelevant detail! As regards the Private Sector, the only essential reform is the removal of irksome and destructive restrictions and controls, which have been sapping the energy of struggling industrialists.

As regards other measures to deal with inflation, a Prices or Wages Freeze is utterly impracticable in India. On

the other hand, there is a strong case for a **strike holiday**, particularly in the Public Sector, for a certain period, say, five years. The Public Sector, which is a nationalised sector and which is modelled on industry in communist countries, has really no right to enjoy this luxury, as in communist countries strikes are banned and wage claims are settled by the governments themselves. On the other hand, both for the Public and the Private Sector, it is necessary to evolve a rational system of settlement of disputes and to insist upon both employers and employees observing the procedures of law.

## II. BLACK MONEY

I need not go into the question, how black money arises, in great detail, as by now the sources of black money are fairly well known. Also the Wanchu Committee has done full justice to that question. Tax evasion arising from high taxation rates and from double, if not, multiple taxation on the same tax objects, is, of course, the primary source. Smuggling of gold, fountain pens, watches, and various other luxury goods in collusion or without collusion with Customs officials, through various channels, is another source. Moreover, wherever anybody has any authority under the law to punish or enforce restrictions and regulations, it is black money which is used to grease the palms. Black market dealings in foreign exchange in contravention of exchange control regulations, to take advantage of the difference between the official and open-market rates, are another important source. The next one is the growth of Party funds. In the last general elections, there were nearly 4,000 candidates contesting parliamentary seats and each one of them reportedly spent between Rs. 2,00,000 and Rs. 5,00,000, the final total figure amounting to between Rs. 800 million and Rs. 2,000 million. Of course, the money was spent not just on travel and propaganda but on the votes of illiterate voters. Apart from party funds, large chunks of black money change hands in property deals, in which promoters of housing societies, estate agents and

owners of Rats get neat packets of black money. And, doctors, lawyers, architects, hotel owners and many others accept, payment in cash without receipts to evade income tax and other taxes.

**Estimates of Black Money.** Before we consider the question of the total quantity of black money in circulation, we must remember certain important points. First of all, a distinction must be drawn between **Black Money** and **Black Wealth**. What we loosely call "money" consists of not only currency notes and bank deposits, but also various items of wealth, such as gold, jewellery, land, houses, and other possessions, which are purchased with money. But the correct definition of money is that which restricts its meaning to notes and coins in circulation plus bank deposits, which circulate and pay for goods and services. The second point is that the black money which we have in view when we talk of demonetisation, consists only of notes and **not** bank deposits. You can demonetise the notes, but you cannot conceivably demonetise the bank deposits or the Black Wealth which people have purchased with black money! Of course, you can **confiscate** various items of black wealth, but that is not the same as demonetisation.

The other aspect of this question to be noted is that a small part of the black money occasionally is converted into white money in various ways, in small bank accounts, in cash payments of official and private dues, doctors' and lawyers' fees etc. Likewise, white money also in smaller quantities becomes black, when its holders have no black money and payment in black money is insisted upon. Thus, the total quantity of black money in the country is a somewhat volatile concept.

Estimates of black money have varied from Rs. 100 crores to Rs. 10,000 crores. A brave attempt was made by the Wanchoo Committee to calculate the extent of tax evasion and they came to the conclusion that "The money value of deals involving black money may have been not

less than Rs. 7,000 crores for 1968-69", but they were modest enough to admit that "the amount of tax-evaded income for the year 1968-69 is only a estimate, based on certain assumptions about which substantial opinion exists for want of adequate data." It must, however, be pointed out that the Committee's estimate was not one for black money but for "tax-evaded income" or rather for the value of deals based upon "tax-evaded income" which is not the same thing as black money. The economist Member of the Committee, Dr. D. R. Rangnekar, defined black money not as "stock in existence at a particular point of time." but referring essentially to "the process of generating and absorbing 'black income'". On the basis of this definition, he concluded that it was of the order of Rs. 2,350 crores in 1965-66, Rs. 2,833 crores in 1968-69, and Rs. 3,080 crores in 1969-70. Obviously, these estimates refer to "black income" arising in the "parallel economy" during the particular years. "Black income", like the GNP, must also be regarded as growing from year to year. However, it is clear that black incomes accumulated from year to year amount, to the **black wealth** in the country—which then becomes the base of the parallel economy. It is also clear that from the viewpoint of demonetisation, the black money that matters is black **currency** partly hoarded and partly financing the deals, involving black money. Moreover, this black currency, multiplied by its (lower) velocity of circulation: constitutes the finance of black transactions of all kinds. It may seem from the foregoing that the definition of black money depends upon what is one's **quaesitum**. If the purpose is demonetisation, black money is only black currency. If the purpose is prevention of tax evasion, then it is "tax-evaded income." If the purpose is to find out what are the annual earnings of the parallel economy, then it is "black income." If, on the other hand, the idea is to hound out illegal hoards of ill-gotten wealth, including gold, jewellery, property etc., and to confiscate them, then, of course black money is "black wealth."

Therefore, as the total note circulation in the country

is about Rs. 5,500 crores, black money, as distinct from black income and black wealth, cannot exceed that figure. My estimate is that the total quantum of black money (which consists mainly of Rs. 100 and 10 notes) is probably in the neighbourhood of Rs. 1,500 crores. In a recent statement, Mr. Shashi Bhushan, a socialist leader, said that it was Rs. 10,000 crores. Probably he had black wealth in mind; if so, I must say that for black wealth as a whole, it may be even higher. I agree with a friend who said: "Black money is like an ice-berg. Only a part of it is visible above the surface." To carry this metaphor a little further, let us hope that the ship of India's economy will not founder on this particular iceberg!

### III. DEMONETISATION

How to deal with black money? In the hot pursuit of black-money holders, some people seem to have lost their sense of direction and have advocated the demonetisation of 100-rupee notes. However, this remedy will be worse than the disease itself. First of all the real culprits have got away: they have converted their 100-rupee notes into notes of smaller denomination, viz., Rs. 20, Rs. 10, Rs. 5. Also, as stated earlier, they have bought land and housing property, gold and jewellery, art treasures etc., and also dispersed their holdings in small bank accounts in the names of members of their families, apart from paying for various goods, services, rents etc., in cash. By all means, track down black money, if you can, to its source, although it does become a wild-goose chase. But, demonetisation of 100-rupee notes is a wild hit at the bull's eye: it will not hurt the guilty ones but a lot of innocent people. Not all 100-rupee notes are black money. Many are held in small numbers by middle-class people. In fact, statistically speaking, although the people of these classes have only a few 100-rupee notes each, the number of the people multiplied by the average holding of each will probably add up to a figure far bigger than the holdings of the richer holders, who are comparatively fewer and many of whom have

already got rid of them. Actually, demonetisation is no terror to those politicians, officials and big business men, who have had enough notice to take the necessary precautions. It is the dumb goats which will be caught: the black sheep have jumped the fence long ago! Moreover, the other side of the medal of black money is corruption, which seems to prevail at all levels, from top to bottom. In the event of demonetisation, the Devil will take care of his own, and many may escape the rigours of demonetisation. Administratively, it will involve enormous and fruitless work for the Reserve Bank of India of investigating claims of hundreds of thousands of people all over the country, for which it may have to open thousands of temporary offices in many cities, towns and even villages. Also, inevitably, there can be much corruption in the process.

Apart from this, the effects of demonetisation on the economic system as a whole may prove quite disastrous. Black money accumulation is unethical and needs to be strongly condemned. However, currently whether we like it or not, black money is used for financing many (even normal) business transactions partly or wholly. If it is suddenly withdrawn, much of the business—even regular business—will come to a grinding halt. Also, demonetisation could shake the public confidence in the nation's currency, with serious repercussions on its international value as well. This confidence factor becomes particularly important in view of the fact that nearly half of the rupee currency is in terms of 100-rupee notes.

Does black money cause inflation? This is a major misconception which seems to have coloured the thinking of those who have been advocating demonetisation. Far from causing inflation, **black money is actually an anti-inflationary factor**, as its velocity of circulation is much lower than that of white money. Where it is locked up in safes or in safe deposit lockers, its velocity of circulation is actually **zero**; where it is used for illicit transactions, it



ian be somewhat higher. In a sense, it has been a blessing, so far as **inflation** is concerned, in that a large part of the currency expansion brought about by deficit financing, has not circulated freely but gone underground! If all black money became white overnight, prices would indeed rocket sky-high, and indeed that would be some Inflation!

### The Real Solution for Black Money

The real solution for the evil of black money lies not in lopping off its branches (by demonetisation etc.) but in attacking it at its roots. In other words, we must identify the causes and then try to remove them or at least to mitigate them. First of all, the Government should **reduce the level of taxation** all round. In spite of the fact that the Wanchoo Committee made this as a major recommendation, the Government has set it aside in the mistaken belief that by reducing the tax rates, less revenue would be collected. This, however, is a fallacy and an optical illusion. The experience of France, which I quoted earlier, gives the lie direct to it. Not only the income tax rates should be reduced, but the lower limit of Rs. 5,000 for exemption should be raised to Rs. 7,500 or even Rs. 10,000, in view of the fall in the value of the rupee and the fact that at this level the poor taxpayer has less incentive to avoid taxation,

As regards the **Wealth Tax**, it should be abolished altogether, as it involves double taxation and is a potent cause of black money and corruption.

The third suggestion I would like to make is that the entire system of **licensing and controls**, which has resulted in the creation of the "Permit Raj", should be drastically overhauled and gradually done away with. The more the controls, the greater is the black money and corruption potential. Even the foreign exchange control should be abolished. In the first place, this control was never very essential, as India had been receiving large chunks of foreign exchange under the various Aid programmes and Loans, which were quite adequate for the five-year plans. Secondly,

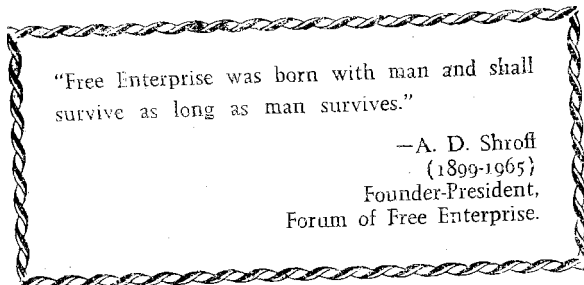
because of the exchange control, large quantities of foreign exchange have been held abroad by Indians in number accounts etc., which would have normally been repatriated to India, if the owners of the funds had a reasonable guarantee that they would get their exchange requirements from the Government whenever necessary. This would have provided for a great relief in our foreign exchange market and could have even strengthened our currency in the international market. Not only this, but the Government would have had at its disposal larger amounts of foreign exchange also. Whether the Rupee should be a free currency and be based upon floating rates is a separate question which cannot be considered here. It was unfortunate that the Government in its hurry to grab every possible pound and dollar in its anxiety and obsession for Planning did not consider the possible effects of exchange control on the Rupee and indirectly on the functioning of the planned economy itself. Similarly, instead of import and export controls, which were no doubt partially responsible for the exchange control, the Government could have (a) raised the import duties on various items to a sufficiently high level, and (b) in suitable cases, put an embargo on imports of certain types. As it is, the system of controls has encouraged smuggling on a vast scale, and in the process, the Government has lost much of its foreign exchange as well!

The fourth measure I would suggest is that the Government should issue a notification asking holders of black money to hand it over and accept 90% of its value in white money from Government, up to a fixed date, say 1st April 1974: after that, any further surrender of black money should be allowed against 75% of its value, up to say, 1st July 1974. And, after that date, the Government should confiscate any undeclared black money, wherever it is found, as also property etc., purchased with black money. Such rigorous measures alone will be necessary to eradicate the evil of black money, but they will be of no use, unless the Government's administrative machinery is

Strict and incorruptible, which means a reform of the corrupt, which must start at the top everywhere and end up at lower levels. In this connection, I may refer to the successful measures recently adopted along these lines by President Morcos in the Philippines.

The fifth group of measures in this connection will be those relating to the Government's plan and non-plan expenditures. There is no doubt that a large part of the money spent by the Government both at the Centre and in the States through the Five-Year Plans and through the normal non-plan budgets, has not only inflated the money supply beyond the limits of necessity and thus caused a steep rise in prices, but also enabled unscrupulous politicians, officials and even ministers to feather their own nests in the process. On the whole, the Government should now go slow on the Five-Year Plans. For one thing, the Plans have not been at all successful in achieving their target rates of economic growth. Many developing countries which had no five-year plans of any kind have been able to achieve much higher growth rates than India with her plans. For another thing, the system of planning adopted by the Government has tied up into knots all industrial and commercial activity throughout the country. Therefore, I am inclined to the view that there will be no great calamity if we now gradually wind up the entire system of Planning and replace it with a system in which the Government concentrates on its main nation-building functions, viz., the provision of an infra-structure for a free national development, consisting of increased transport facilities, technical education, population control, aerial navigation, tele-communications, various public utilities etc. I feel that the country has by now after 20 years of planning somehow reached the "take-off stage" of industrial development, and if private enterprise, as well as the public sector industries, are given complete freedom to grow and function, economic development will not only take care of itself but achieve a rate of growth far better than the Government planners have been able to achieve.

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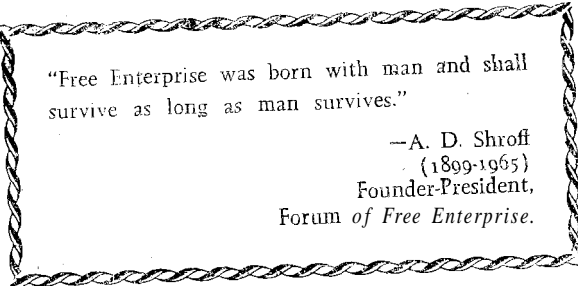
"Free Enterprise was born with man and shall survive as long as man survives."

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Published by M. R. PAI for the Forum of Free Enterprise, 3rd Floor, 235, Dr D N. Road, Bombay-400 001, and printed by H. NARAYAN RAO at H. R. MOHAN & CO., (Press), 9-B, Cowasji Patel Street. Bombay-400 001.